CHALLENGES FACING THE U.S. CAPITAL MARKETS TO EFFECTIVELY IMPLEMENT TITLE VII OF THE DODD-FRANK ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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CHALLENGES FACING THE U.S. CAPITAL MARKETS TO EFFECTIVELY IMPLEMENT TITLE VII OF THE DODD-FRANK ACT

Wednesday, December 12, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Biggert, Hensarling, Neugebauer, Campbell, Pearce, Posey, Fitzpatrick, Hayworth, Grimm, Stivers, Dold, Canseco; Waters, Sherman, Lynch, Miller of North Carolina, Maloney, Moore, Carson, Himes, Peters, and Green.

Ex officio present: Representative Bachus.

Chairman GARRETT. Good morning. The Capital Markets and Government Sponsored Enterprises Subcommittee is called to order. I thank everyone for being with us. Today's hearing is entitled, "Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act." I welcome the panel, and I welcome my colleagues on both sides of the aisle.

Before I begin, I will start with this, a little more than a housekeeping matter—I made a similar statement previously to a private sector panel who appeared before us, and it is apparently apropos that I make this statement here, and that is is that it was agreed in a bipartisan manner with the rules of the committee with regard to testimony and its preparation for the committee and for both sides of the aisle's members of the committee—Mr. Gensler and Mr. Cook, as you are aware, the committee rules require that the committee receive written statements 48 hours, that is 2 days, in advance of the hearing. In this case, this committee invited you all to testify before Thanksgiving. The SEC's written submission arrived at approximately 1:25 yesterday afternoon. The CFTC's submission did not arrive until around 4 p.m. yesterday.

And the reason I bring it up is the same reason I brought it up when the private sector was here; the reason we agreed that we should have these things in all of our hands 48 hours in advance is for ourselves and our staffs, for all of us to be able to read it, understand it, and digest it in a timely manner. In this case, as

I say, it goes back almost several weeks that this meeting was noticed, and also, as you know, this was actually postponed one time.

So I hesitate to put a rationale as to why the Commissions are unable to provide the statements in a timely manner. I hesitate to wonder why they are not able to comply with the House rules when I am sure that you would require various businesses and what-have-you to comply with your rules. Some would suggest that it appears to reflect a lack of respect for the committee and its members, and I will—just before we begin, I will just ask both of you, is that the reason or is there—

Ms. WATERS. Would the gentleman yield?

Chairman GARRETT. Yes.

Ms. WATERS. With all due respect for your concern about whether or not our witnesses are in compliance with the rules, I would respectfully ask the Chair to have a private conversation with them about their workloads and what they are attempting to do. And I am not attempting to make any excuses, but I think we would be better served if we could move forward. For today, I think you have indicated your concern. Let us do a private meeting or a private response to that and move on, because the issue before us today is of such great importance that I would like us to not utilize all of our time with them having to make an excuse for it. As the ranking member, I am concerned about these issues. I take it seriously, and I would respectfully ask that we move forward and have Mr. Gensler and Mr. Cook both talk with you a little bit later about this.

Chairman GARRETT. That is fine, and I will defer then to the ranking member's wishes on this, because I am sure she shares the same concern that I do that her staff has the opportunity to review this, as our staff and our Members do as well.

And so with that, we will move into the hearing, begin with opening statements, and I will recognize myself for 5 minutes.

As everyone is well aware, the main reason Congress is still in session after the recent election is because negotiations are ongoing to try to reach an agreement on the so-called fiscal cliff. However, there is another cliff that is receiving a lot less attention, but has the potential to be as problematic and costly to Main Street businesses, retirees, farmers, municipalities, and many others, and that, of course, is the Dodd-Frank regulatory cliff. And while the President campaigned for reelection, his financial regulators kept a number of these potentially economically damaging rules, you might say, bottled up to get through the November 7th election.

Now that the election has passed, the regulators have been free to unleash their regulation tsunami, you might say, on the U.S. economy. Whether it is the Qualified Mortgage (QM) definition; the Volcker Rule; the risk retention issue; or the Collins Amendment, the economic impact of each one of these individually and collectively will be severe.

Today's hearing will focus on just one specific area of this regulatory cliff, the new regulations of the U.S. swap markets under Title VII.

So let me begin by correcting a common mischaracterization from friends across the aisle sometimes: Republican do not oppose all regulations. In fact, in the aftermath of the financial crisis, Republicans proposed additional regulations for the swap markets in a regulatory reform alternative, and, believe it or not, we do support regulation of the market. Unfortunately, some of our colleagues always present a false choice on this issue. They say, either you support what is exactly proposed by the regulators, the CFTC, or you support deregulating the swaps market altogether.

This cannot be further from the truth. My colleagues and I support commonsense, thoughtful regulations in the markets that promote transparency and allow for Main Street end users to be able to effectively hedge their day-to-day operations in a prudential manner. Unfortunately, in terms of the proposals that have been issued so far, this has not been the case.

Recently, the CFTC had a Global Markets Advisory Committee meeting with foreign regulator counterparts, and during that meeting the head of the European Commission's Financial Markets Infrastructure, Patrick Pearson, described in detail many potential negative consequences of some of the proposed rules in Title VII, and he stated at the time, "Washington, we have a problem." And I believe if he was sitting up here, he might say, "Chairman Gensler, we have a problem."

The criticism the CFTC has received from foreign countries has been overwhelming. Europe, Asia, and Australia have formally weighed in as well. If this keeps up, some suggest that our President may have to go around the world at the beginning of the year and do one of his famous apology tours for what is going on here in this country.

The criticism of this as received is by no means limited to foreign regulators. There has also been a lot of criticism levied by many domestic entities, including some of your counterparts at the SEC and even some of your own Commissioners. Even former Clinton Administration Chairman of the Council of Economic Advisers Martin Baily, a senior fellow now in the Economic Studies Program at the somewhat liberal-leaning Brookings Institute, has suggested that a swing of the pendulum has gone back and is overly harsh.

I also constantly hear about the CFTC being a world-class regulator, and that is what we all want. Now, I am told it is the best entity to determine the rules of the road for the swaps market, but some might have some doubts. For example, does a world-class regulator rush forward on some rules and then, after that, issue dozens of so-called short-term no-action letters to exempt market participants? And would a world-class regulator circumvent the lawful, good-government rulemaking process of Congress by issuing regulations through guidance or staff emails? Does a world-class regulator ignore specific letters from congressional oversight panels, or does a world-class regulator front-run its foreign and domestic counterparts in order to try to have some sort of legacy here for this institution in this country? Does a world-class regulator not properly prepare its rulemakings, only to find them struck down repeatedly in the courts? And would a world-class regulator throw an entire consumer funding market into disarray, doing so by encroaching on another regulator's discretion? And does a world-class regulator repeatedly defy congressional intent by not following congressional statute? Does a world-class regulator create arbitrage opportunities and reduce competition for market participants by overreaching on its proposed rulemaking?

So from the refusal to work collaboratively with foreign and also domestic counterparts, to the attempts to bypass the appropriate cost-benefit analysis that we require, to laws to rush unorganized exemptive actions creating more market stability, to refusal to follow explicit congressional intent to allow voice brokerage, to finally forcing market participants to leave the swap markets to go over now to the future markets because, well, it is a chaotic and overreaching nature of the rulemaking, I can say that the entire implementation, then, of Title VII has been somewhat, you might say, of a train wreck. And now, because of a train wreck, we have as a class its migrating away from the swaps into the futures markets, and I am not sure why then the ranking member went through all the hard work on the law that—well, he is not here with us today—bears his name if the regulation is being finalized—not this ranking member, the ranking member of the full committee—if the laws that are being finalized by the CFTC simply make swaps now economically unfeasible.

So what do we need? We need an appropriate and workable regulatory regime over our swaps market if there is to be one. A regulatory framework should promote transparency, increase efficiency, and allow end users to effectively hedge the risk. And this committee and others will have to hold many other oversight hearings going forward to ensure that this is the eventual outcome, and the implementation, therefore, is too important and affects too many people to let us to continue to deteriorate. We must get things back on the right track, and that means involving some commonsense approach.

With that, I yield back, and I recognize the gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman, for holding this important hearing today. And I would like to welcome Mr. Gensler and Mr. Cook here today.

Mr. Cook, I understand that this perhaps will be your last hearing, that you will not be the Director of the Division of Trading and Markets following this session, so we would like to thank you for your service.

Mr. Gensler, thank you for appearing here once again, and I would like you to not feel constrained to defend yourself against the accusations that were just made about you and your work.

Under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Congress responded to one key cause of the 2008 financial crisis: the unregulated over-the-counter derivatives market. Through the Act, the Congress tasked the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) with bringing much needed transparency to this market, which amplified the collapse of the housing bubble and cascaded losses across the global financial system.

The CFTC and the SEC are now in the process of implementing what the Congress has tasked them with both through regulation of firms at the entity level and with regulation at the transaction level, including clearing, data reporting, margin, trade execution, and business conduct standards. Once in place, these rules will bring much needed stability to the financial system, while also lowering costs to the end users who rely on these products to run their businesses.

With that said, our hearing today will begin to get into the details with regard to some of the rulemakings the CFTC and the SEC are now conducting, particularly with regard to how swaps regulations will extend across U.S. borders. On this point, I think it is important that we be sure not to import unregulated risk back to the United States, while also recognizing some of the legitimate concerns raised by market participants, including a lack of harmonization between the SEC and the CFTC, challenges raised by the faster implementation timeline in the United States relative to the European Union and Asia, as well as lack of global harmonization and a lack of clarity regarding implementation dates.

In addition to exploring these concerns, I look forward to hearing comments from stakeholders related to a number of other issues related to Title VII and its implementation. I hope we can all agree on the broad goals and structure of Title VII, which will strengthen our financial system even as we continue to debate the implementation details of some of these reforms.

With that, Mr. Chairman, I thank you very much, and I yield back.

Chairman GARRETT. Thank you.

The gentlelady yields back. The chairman of the full Financial Services Committee, Chairman Bachus, is now recognized for 5 minutes.

Chairman BACHUS. Thank you.

We all know the Dodd-Frank Act is 2,300 pages long, and Title VII, which is the subject of this hearing, is 444 pages long. Reforms are absolutely necessary. We all know what happened, we witnessed what happened in 2008, and there should be no question that we need reforms.

Actions of companies like AIG and others—there were a lot of innocent parties in the economy—jobs that were lost as a result of those actions. And I think we know and I think the dealers should report their trades to a data repository or an appropriate regulator. Dealers should submit eligible trades for clearing to a central counterparty or registered clearinghouse and electronic platforms. And exchange trading and voice brokerage should be available to market participants.

Having said all that, the rules must have some flexibility. They must be flexible enough to have alternative forms of execution to flourish. If all derivatives were supposed to be traded on an exchange, then they would all be futures. Derivatives are different from exchange-listed products, and imposing the listed futures or equities market model on the derivatives is not the mandate of Title VII. And I know there are some different interpretations.

I want to say that the very complexity of this, we were all there, a lot of this was done in the last 2 or 3 days, the last night things were thrown together, and that is a problem for the regulators. This was not something you went out and wrote; it was handed to you. I don't underestimate your challenges, and I want to compliment the SEC and the CFTC and your staffs, because actually we have had seven hearings before this subcommittee. That has required a lot of preparation on your part. You are dealing with challenges. You are continuing to deal with misbehavior in many cases in the market. This is the greatest rewrite of our financial laws since the 1930s, I suppose.

And I want to say, Mr. Cook, this may be your last appearance before the committee. I appreciate your service. I appreciate, Chairman Gensler, that you served here under a difficult time. I don't think the committee members ought to underestimate the challenges and sacrifices that you have made, and the SEC and the CFTC.

My concern, and I think a concern of a lot of us—and this is not blaming you—is just that law is ambiguous in parts, it is subject to different interpretation. If we have a conflicting definition of what is capital, for instance, which appears to be the case with the regulators, and even the global regulatory bodies, people can't seem to agree on some of the definitions, then our financial institutions are having to deal with various interpretations, various different approaches by the regulators. And I would just urge you to try to sync those, because there is a real concern, I think, on the Hill, and part of this is the law itself and the complexities of the law, so it is not something that you created; but it is absolutely essential that when it becomes operational, it syncs together and it is functional. And I would just urge you to consider as this is implemented its effect on the economy, the markets, the institutions, and even your abilities to regulate. It is going to be absolutely essential that you cooperate in this effort.

I want to say this: The Financial Services Committee has been successful in a bipartisan way, many times working with the SEC and the CFTC, in fixing some of the big problems with Title VII, including striking the provisions that would impede American businesses use of derivatives to ensure stable pricing and to reduce volatility, and fixing the indemnification provisions in the swap push-out program. That has all been done by this Congress, with the help of the regulators, and moderating the extraterritorial reach of Title VII.

So I would hope that in this next Congress we can continue to work together, not pointing fingers or publicly castigating each other, but it is going to require a lot of behind-the-scenes work and a lot of work together, because we are all patriotic Americans, we all want what is best for the economy, and for the sake of the financial industry and the consumers and the American public, we need to try to get together and cross those bridges and try to what I would say is make these regulations functional and the implementation as smooth as possible.

I appreciate your attendance, and I would like to say that Mr. Schweikert, who is vice chairman of this subcommittee, and one of the most capable members of this committee, will not be serving on it over the next 2 years, and neither will Mr. Dold, Ms. Hayworth, and Mrs. Biggert. I think we all agree they are some of our most thoughtful Members who won't be with us, and that is a tremendous loss our committee, I think, in its ability to perform its service.

But I thank the gentlemen for being here. Many times, there is a lot of criticism, and a lot of frustration on your part, but no one ought to think that this is a problem that you created, because it is not. Thank you.

Chairman GARRETT. The gentleman yields back, and I, too—

Chairman BACHUS. And also Mr. Canseco, who is one of my best buddies; I have been to San Antonio with him on two occasions. I want to thank you for your service.

Chairman GARRETT. I thank the gentleman from Alabama, and I also echo the words dealing with Director Cook for your service, and we do appreciate that, and also for the members of the committee. It is indeed a true brain trust that we are losing here on the committee. These members brought a significant amount of ability to the committee. I think that was one of the things we all said with this class coming in and these members of the committee, that they got right to it, they understood the issues, and they did delve into it in a big way. And, of course, that goes in strong measure to my vice chairman, whom I will certainly miss in that capacity, and the many services that he performed for me as well. So I thank you all for your service to the committee, and I will allow you a moment at the end, 10 seconds, if we get permission from the ranking member.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. Sort of a point of personal privilege. For all of us, we love being on this committee, but do you notice a pattern here of how many of us are going to be gone? Could it be you? No, it has truly been one of my great joys being on this subcommittee.

Chairman GARRETT. I said I liked you in the past being vice chairman of the subcommittee. But thank you. And with that—and we will be mindful of the time—

Ms. WATERS. Mr. Chairman, what I am going to do is I am going to build in a little bit of extra time to make up for the difference. So with our next speaker Mr. Lynch, there will be 2 minutes.

Chairman GARRETT. The gentleman from Massachusetts is recognized for 2 minutes.

Mr. LYNCH. I thank the ranking member and I thank the chairman for your courtesy. I would also like to thank the witnesses here for your good work, for your service, and for helping the committee with its work.

As we know, Title VII of the Dodd-Frank Act brought historic and much needed reform to the over-the-counter derivatives market by bringing these financial products out of the shadows and onto transparent exchanges and requiring companies to actually show that they have the cash to back up their commitments.

As the full committee chairman, the gentleman from Alabama, mentioned earlier, in the AIG example we had a small London affiliate of the insurance parent manage to quietly make enough of these risky bets to put the fate of the company at risk and also the fate of the entire financial system in jeopardy. Congress has now enacted Title VII to address this kind of rampant speculation and turn the over-the-counter derivatives market from that opaque backroom market operation to a more transparent public market, something more akin to the stock exchanges.

And I have to say that the regulators have done much to put these reforms into effect, and I want to thank you for your continued work, but more must be done before we can deem the derivatives market safe and sound. We also want to make sure that the rules apply to the entire derivatives industry, whether the swaps market, the futures market, or any other market if it has the capability to bring down the economy, as happened in the AIG example.

So I hope that the regulators will move forward with necessary reform measures, and that this committee will again provide you with the resources necessary to get that work done, because it is very important to the entire financial system. I thank the chairman for the additional time, and I yield back.

Chairman GARRETT. The gentlelady from California?

Ms. WATERS. Next, we will have Mrs. Maloney for 2 minutes.

Mrs. MALONEY. Thank you, and welcome to the witnesses.

Title VII of Dodd-Frank is in many ways the heart of our financial reform. Derivatives trades are unregulated, and transacted completely in the dark between two counterparties with little oversight. The financial crisis proved that if one financial institution became overly leveraged and invested in overvalued instruments, that one institution could bring down the whole system.

With AIG, confidence fell like that, and they came before this committee and told us they didn't know where their swaps were, they didn't know their exposure, they only needed $50 billion. They kept coming back; next time $85 billion, and we still don't know what is going on. It ended up being $185 billion in taxpayer money.

Dodd-Frank tried to change that. It put rules in place, capital and margin requirements, recording and clearing components and other checks on an institution's ability to add risk to the system, to put sunlight so that people could understand what was going on.

Now, the CFTC, to its credit, has released roughly 60 draft rules and proposals, yet in the days leading up to the October 12 effective date, a number of the rules—they were forced to issue these no-action letters and guidance because they needed more time to act and to get it right. And we do need to give the regulators enough time to get it right, and to really get it right, because it is so critically important, and in a way that we do not implement rules that drive business away from America, and that we do not implement rules that make it difficult for us to interact with the global markets, and with other countries, and certainly with the SEC.

But I feel that markets run much more on trust than on capital. And I would like to see America remain the financial capital of the world, and I would like to see rules that help us remain in that position.

I would like to also understand why all the financial crises seem to happen in London. AIG exploded in London in their Financial Special Markets Office, not in their well-regulated New York office. The London Whale, the LIBOR crisis. Why do all of the crises happen in London?

Thanks. My time is up.

Chairman GARRETT. I thank the gentlelady from New York.

Ms. Moore is recognized for 2 minutes.

Ms. MOORE. Thank you so much, Chairman Garrett and Ranking Member Waters.

I just want to laud the SEC and the CFTC for the extraordinary work that both agencies have done to this point. It is a Herculean task when you consider a point that Ranking Member Waters has driven into the ground, and that is you are not adequately funded to do the work that we have asked you to do in such a short timeframe.

I am concerned about a couple of things today that have already been mentioned, and I look forward to hearing from the regulators on the rulemaking process, particularly on H.R. 4235, which Mr. Dold and I authored, which removes the requirement that SDRs as primary regulators be indemnified prior to sharing the data with other regulators, including foreign regulators. The SEC has testified to this committee that it favors removal of this indemnification requirement, two CFTC Commissioners have opined on this, and yet the CFTC interim guidance on indemnification is something that is not being—it raises grave concerns among our foreign regulators as to its efficacy.

Finally, I am troubled, as we have heard earlier, by reports detailing the parties are encouraging the use of product swap futures over swaps to avoid margin, and that they are being marketed as economic equivalents. Although I think that they carry unique market risk, this is a regulatory arbitrage, I believe, and I would argue that promotion of these products may provide another damaging example of market participants putting their interests ahead of their end-user customers.

I do thank you for your testimony, and I look forward to hearing from our witnesses. I yield back, sir.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Connecticut is recognized for 2 minutes.

Mr. HIMES. Thank you, Mr. Chairman. I would like to just take a few seconds—thank you, Chairman Gensler and Director Cook, for being with us. I would like to just take a few seconds to try to offset some of the criticism of you in which the hearing opened.

Of all the vast causes in the web of the difficulties that brought down the economy in 2008, no area, I think, is more complex than the areas that you have been charged to oversee, derivatives; not Fannie Mae, not Freddie Mac, not pick-a-pay mortgages, not the activities of Countrywide. This is one of the more catastrophic areas as we look back on where we were and also probably the most complex area, and I salute you and compliment you for really working hard around something that is enormously challenging in the face of criticism. And I exempt the chairman of the committee when I say this. It is often churlish of your efforts, and it is a criticism that also forgets the devastation that was visited on this country, the trillions of dollars of lost value as a result of the downturn, the devastation that was visited. The criticism forgets when words like "tsunami" are bantered about, what kind of tsunami hit America households in 2008 and 2009. So thank you for your efforts in that regard.

You also are struggling uniquely, I think with cross-border issues. And we have had lots of conversations on this issue, and I think that regardless of party, we agree that final regulations from a public policy standpoint should avoid international arbitrage. We don't want these instruments, which are so useful to so many commercial end users, and that, by the way, in many instances are also very dangerous, to move to less regulated environments and therefore decrease our transparency of these instruments. We also, of course, want to make these regulations with a nod towards our industry competitiveness.

So I close with just a request, which is that in particular as we look back on the events of October 12th and some of the concern about offshore entities not perhaps registering, I would make a request of both of you that you give us a perspective and an update perhaps on how you believe those events inform final rules and how you feel about them. But again, I close as I began, by saying thank you for your efforts and your constructive work in this terribly important area.

I yield back.

Chairman GARRETT. The gentlelady from California?

Ms. WATERS. Mr. Green for 2 minutes.

Mr. GREEN. Thank you, Madam Ranking Member, and I thank the Chair as well, and I thank the witnesses for appearing.

It is my belief that the general public probably does not put a lot of emphasis on words like "arbitrage" and "cross-border swaps," but I do think the general public understands that a major institution such as AIG ought to be properly funded. And I think the general public understands that this country by and through its representatives did the right thing when we did not allow AIG to bring down the economic system not just in this country, but probably and possibly worldwide.

So I am here today to thank you for what you are doing to help us perfect Dodd-Frank. There is still great work to be done, but any time we pass legislation of this magnitude, there is work to be done in the years to come. I plan to work with you and I plan to work with my friends across the aisle to make sure we do this great work. And I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back. And that concludes all time for Members on both sides of the aisle.

We will now turn to our first panel, which is comprised of the Chairman of the CFTC, Gary Gensler, and Mr. Robert Cook, Director of the Division of Trading and Markets at the SEC.

Chairman Gensler?

STATEMENT OF THE HONORABLE GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION (CFTC)

Mr. GENSLER. Thank you, Chairman Garrett, Ranking Member Waters, Chairman Bachus, incoming Chairman Hensarling, and members of the subcommittee for your time. I, too, want to thank all the Members I may be testifying before for the last time, unless you come back to this body, which often happens; and to Robert Cook, because I think we have all worked so well together on an enormous challenge that was created out of the 2008 crisis: How do we best bring commonsense rules of the road to help best protect the public.

Two-and-a-half years after Congress and the President came together to ensure that swaps markets reform works for the American public, we are here before you. And I just want to address the chairman to say that we have deep respect for this committee and for Congress. We will work to get testimony in earlier where we can. We just always are trying to make it complete and to address all the questions that we think might come up from the committee. So it may be balancing that a little bit to that issue.

A crisis, as we all know, put 8 million people out of work, partly due to the unregulated swaps market and, yes, as Congressman Himes said, a very complex market. Congress directed the CFTC and the SEC to bring reforms to this market, and given the magnitude of the crisis, Congress actually asked us to do it in 1 year, and they gave us a lot to do, as was mentioned, maybe up to 60 rules that were mandated for the CFTC and others for the SEC.

Where are we today, 2½ years in? We haven't been doing this against a clock; we have been trying to do it thoughtfully, taking into consideration all the costs and benefits and the nearly 40,000 public comments that we received in nearly 2,000 meetings that we have had.

We have completed about 80 percent of the rules. The marketplace is increasingly moving to implementation, and the results of completed reform, central clearing, which this committee, I think, on a bipartisan basis endorsed, will start to be a reality throughout 2013 and phases through 2013. And this fulfills the President's commitment at the G-20 meeting in Pittsburgh in 2009 to have that in place be the end of 2012. This committee, this Congress made that happen.

Transparency has begun with reporting to regulators, but beginning on the first of the year, it will be to the public as well. We price in volume for certain interest rate and credit default swap indices like the indices that were in the midst of the London Whale. And, yes, swap dealers will begin to register at the end of this month.

Now, the CFTC has been working to complete these reforms in a deliberative way, taking into consideration and seeking broad public input, and working with our friends at the SEC and international regulators.

We have also looked at phased compliance. We have been a significant supporter of phasing compliance. We want to smooth the transition from an opaque, unregulated market to a transparent, regulated marketplace. As Chairman Bachus said, if I may quote you, you want to make it operational, sync together and function.

So in the midst of that implementation, and it is upon us now, it is the natural order of things that many market participants have sought further guidance. Sometimes the questions come early, but as all of us know, because we were all in school at one point, sometimes we do our papers late into the night the day before it is due, and that is just human nature. We will address questions that come up early, and we will do our best to address them even if they come up late.

Prior to a milestone on October 12th—and this milestone was just because the SEC and the CFTC had finished the foundational definitional rules, and so the definition of "swap" and "swap dealer" and so forth went into effect on October 12th—we got a lot of those questions, some early, some late. Along with my fellow Commissioners and staff, we sorted through about 20 issues, and I think that we sorted through them for the benefit of the public to make it operational, sync together and function; but we also said, if you have further questions, come in. And we have gotten further questions. We are committed to working through those questions to smooth this transition, because it is very significant and important.

Four years after the crisis, though, it is time for the public to benefit from this transition to transparency and lower risk. Reforms that hold the similar promise of the 1930s reforms in the securities and futures markets I think can contribute to decades of economic growth and innovation. That is what transparency is about. It helps growth and innovation in our economy.

So though we are nearly complete, we have two important areas I just want to address, we still have to finish rule writing, and they have come up already in this hearing. First, final rules to promote pre-trade transparency. This is through the trading platforms, the swap execution facilities. And I know you will hear from Mr. Giancarlo later today, with whom we have spent a lot of time.

These execution facilities will benefit the public by bringing greater liquidity and competition in the markets. Buyers and sellers will meet in the marketplace on the most standardized swaps; not the customized, but the most standardized swaps.

The Commissioners are reviewing the draft final rules now, and though we had hoped to maybe get them out in December, yesterday, or 2 days ago, we provided some additional relief that we will try to get these out in January or February and phase them in throughout 2013 to give the market time to phase this in.

Second is guidance in phased compliance regarding cross-border application of the swaps market reform. Congress recognized the basic lessons of modern finance in the 2008 crisis in adopting Dodd-Frank. Swaps executed offshore by U.S. financial institutions can send risk straight back to our shores. It was true with the affiliates of AIG, of Lehman Brothers, Citigroup, and Bear Stearns. And yes, risk here can send things crashing to Europe, and we certainly did that with our housing crisis, hurting people in Europe as well.

Under the guidance and completed rules, swap dealing of more than $8 billion in notional value with U.S. persons would require somebody to register, and we anticipate many will do so at the end of this month.

The best way to protect taxpayers and promote transparent markets swaps, markets reform should cover transactions of overseas branches and overseas affiliates guaranteed by U.S. entities. I think failing to do so, if we don't cover somehow the overseas affiliates that are guaranteed back here, not only will we expose the public to risk like AIG, but we actually will probably send jobs from the United States to overseas because our U.S. firms would just send the jobs overseas, but the risk would still back here. I think that is a competitive issue.

Furthermore, for foreign firms that register, we are committed to substituted compliance. What does this mean? That means if there is comparable and comprehensive foreign regulatory requirements that we can look to, let us look to them. For a lot of reasons, it is the right thing to do. But we are also a small agency, and a bit underfunded, so it is good to look to other regulators.

But where the overseas swap dealer transacts with a U.S. person, let us say back here in the United States, maybe it is in New Jersey or in California, but they are transacting back here in the

United States, we think that on a transaction level, those foreign swap dealers should come under Dodd-Frank just like a U.S.-affiliated swap dealer. Again, this is consistent with the law, but it also enables U.S. and overseas firms to compete on a level playing field, rather than U.S. firms coming under Dodd-Frank, and overseas firms not. That does not seem to be the right competitive place to be.

I thank you for this opportunity to testify today. I know I ran a little over. I just want to say one last thing. I am so damn proud of the people at the CFTC, sir. I know that there are going to be many criticisms raised about this agency. That is because this agency is doing something for the American public. The crisis was partly about the swaps, and 8 million people lost their jobs. And you all, I think, coming together gave us a heck of a task, but it is an important task. The dedicated folks of the CFTC are not trying to be, as you say, a "world-class regulator." They are just trying to comply with the law, put it in place, ensure for transparent markets, and ensure, yes, for a smooth transition so it is operational, syncs together and functions. Thank you.

[The prepared statement of Chairman Gensler can be found on page 120 of the appendix.]

Chairman GARRETT. Thank you.

Director Cook?

STATEMENT OF ROBERT COOK, DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Mr. COOK. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, good morning. My name is Robert Cook. I am the Director of the Securities and Exchange Commission's Division of Trading and Markets. Thank you for the opportunity to testify today on behalf of the Commission regarding Title VII of the Dodd-Frank Act.

Let me begin by acknowledging the chairman's concerns about the timing of the testimony, to apologize for that, and to assure you that it was by no means any indication of disrespect, and we would be happy to address any further concerns in that regard at your convenience.

As you know, Title VII creates an entirely new regulatory framework for over-the-counter derivatives and directs the SEC and the CFTC to write a number of rules to implement this regime. The SEC has authority over security-based swaps, and the CFTC has authority over swaps. The vast majority of products subject to Title VII are within the CFTC's jurisdiction.

My testimony today will provide an overview of the SEC's efforts to implement Title VII since Chairman Schapiro's testimony before the subcommittee in April. In addition, I will discuss the Commission's efforts to address the implementation of Title VII in the cross-border context.

Since enactment of Dodd-Frank, the SEC has proposed substantially all the rules required by Title VII and in some cases has adopted final rules, and we continue to work hard to implement the title's provisions. Our adoption efforts to date have focused on the key definitional terms under Title VII and the rules relating to clearing infrastructure.

In July, the SEC, acting jointly with the CFTC, adopted final rules and interpretations related to product definitions. This effort followed a joint adoption in April of final rules and interpretations relating to Title VII entity definitions.

Although the completion of these two joint rulemakings is a significant milestone in the journey toward full implementation of Title VII, the adoption of these two definitional rules did not trigger a requirement to comply with other rules the Commission is adopting under Title VII. Instead, the compliance stage applicable to each final rule will be set forth in the adopting release for each such rule, taking into account the scope and complexity of that rule's requirements and any other relevant factors known at the time of the adoption. In this way, the Commission will be better able to provide for the orderly implementation of the various Title VII requirements.

To that end, the SEC issued in June a policy statement describing the order in which it expects to require compliance with the Commission's final rules and requesting public comment on that proposed order. The SEC's approach aims to avoid the disruption and cost that could result if compliance with all the rules were required simultaneously or haphazardly. The policy statement also emphasizes that those subject to the new regulatory requirements should be given adequate but not excessive time to come into compliance with them. Market participants have generally had a positive response to the policy statement, and we are taking their comments into account as we work toward completing the Title VII adoption process.

In addition to the key definitional rules, the Commission has also adopted rules relating to clearing infrastructure. In June, the Commission adopted rules that established procedures for its review of certain actions undertaken by clearing agencies. These detail how clearing agencies will provide information to the Commission about the security-based swaps the clearing agencies plan to accept for clearing, which the Commission will then use to aid in determining whether those swaps are required to be cleared.

The rules also require clearing agencies designated as systemically important under Title VIII of the Dodd-Frank Act to submit advance notices of changes to the rules, procedures and operations that could materially affect the nature or level of risk at those clearing agencies.

In October, the Commission adopted a rule that established standards for how clearing agencies should manage their risks and run their operations. This is designed to help ensure that clearing agencies will be able to fulfill their responsibilities in the multi-trillion-dollar derivatives market as well in the more traditional securities market.

Finally, also in October, the Commission proposed capital margin and segregation requirements for security-based swap dealers and major security-based swap participants.

The next major step in our efforts to implement Title VII will be the Commission's efforts to address the international implications of Title VII in a single holistic proposal. Our cross-border approach is being informed by discussions with fellow regulators in other jurisdictions, and we are also paying close attention to the comments on the CFTC's proposed guidance.

In part, the purpose of the publication of a single proposal addressing the international implications of Title VII across the full range of regulatory categories and transaction requirements is to give investors, market participants, foreign regulators, and other interested parties an opportunity to consider our proposed approach as an integrated whole. The cross-border release will involve notice-and-comment rulemaking, not only interpretive guidance. As a rulemaking proposal, the release will incorporate an economic analysis as required by the Exchange Act that considers the effects of the proposal on efficiency, competition, and capital formation.

Although a rulemaking approach takes more time, we believe there are a number of benefits that will make this approach worth the effort, including a full articulation of the rationales for and economic consequences of particular approaches and a consideration of usable alternative.

In conclusion, as we continue to implement Title VII, we look forward to continuing to work closely with Congress, our fellow regulators both at home and abroad, and members of the public.

Thank you for the opportunity to share our progress and current thinking on the implementation of Title VII. I will be happy to answer your questions.

[The prepared statement of Director Cook can be found on page 99 of the appendix.]

Chairman GARRETT. And I thank you, Director Cook.

At this time, we will begin the questioning, and I will recognize myself for 5 minutes.

So, Christmas is coming, and I am in the process of trying to buy some gifts for the family, and I won't say what I bought, but I will just lay out what I have done to try to achieve that, to do that.

One is I went online, and I bought some stuff from Texas. So I ask Chairman Gensler, would you say that when I bought those packages for my kids from Texas online, would that be interstate commerce that I was engaged in?

Mr. GENSLER. I am not sure where the question is going, but I think it is good for your children for sure, and it is probably interstate commerce.

Chairman GARRETT. Okay. And then I bought some other things from Michigan through one of the catalogues, mail catalogues. And would you say when I did that, it was also through means of interstate commerce?

Mr. GENSLER. Again, I hope your children are happy with the gifts.

Chairman GARRETT. They don't ask for much. They are good kids.

And lastly, one of them I had to go and call up a company out in California and buy their gifts. Would you say that was a means of interstate commerce that I did with them?

Mr. GENSLER. If I understand the question, whether using a telephone, online, and there may have been a third means in there—

Chairman GARRETT. Yes, mail.

Mr. GENSLER. These are all means of interstate commerce, I think I understand that they are. Even carrier pigeons might be a means of interstate commerce.

Chairman GARRETT. If they had not become extinct.

So that seemed pretty clear to us, and it was pretty clear to Congress when we put in the language any means of interstate commerce would be appropriate and allowable under SEFs. But it seems as though the Commission, a hard-working staff, I agree with you all, are having difficulty in defining that. And that now I understand that the Commission is considering revising the rules that will reference the latter one, the last one, which was the voice over the telephone, is that correct? You are revising it to include voice, but you are using language not in the actual rule to do so; you are doing so in the preamble.

So the question is if it is so clear to both of us right here that these are any means of interstate commerce, why isn't it clear to the Commission, and why is this one little area something that is already resolved and done with?

Mr. GENSLER. Just to bring it back to basics, what Congress asked us to do, both agencies, is to ensure greater competition where buyers and sellers meet in a transparent marketplace through swap execution facilities. "By any means of interstate commerce" is in the statute. We got a lot of comments, and they were good comments, on our proposal that we have to ensure that we are technology neutral, whether it is telephone, Internet and these three means, and that is what is being considered by the Commission right now—

Chairman GARRETT. Okay.

Mr. GENSLER. —revising it to be technology neutral.

Chairman GARRETT. Okay. I will close on this, that it seems that all three of your "any means of interstate commerce," this should be able to be resolved quickly.

Moving on through the process here, I see a different process between your agency and the SEC as far as handling some of these things. For example, with cross-border applications, one agency is doing a formal rulemaking process, and the other agency is doing more through—and therefore with cost-benefit analysis, the other agency here is doing it not so much with rulemaking, a formal process, instead is doing it through guidance and missing what Congress intended, which is cost-benefit analysis.

So in one specific area, you are in the process of creating a new definition of U.S. and non-U.S. persons, correct; the agency, CFTC, in the process of defining a new definition of what a U.S. person is as opposed to a non-U.S. person?

Mr. GENSLER. It is included in an exemptive order that actually also has cost-benefit.

Chairman GARRETT. So when the SEC did this, they went through the regulation, as I understand it, to do so, but the CFTC misses that and does it through guidance. As a matter of fact, this was a letter that I think our office sent to yours asking why are you going through guidance on some of these things as opposed to what the SEC is doing here, I will say more thoughtful and more compliant with Congress' intent in going through a formal rulemaking process? So, first, why are you doing it; and second, should we anticipate an answer to our letter back from this summer?

Mr. GENSLER. Congress included in Title VII something for the CFTC that was not included for the SEC. There is a specific provision for cross-border application in swaps, not securities-based swaps. It is actually Section 722(d). We got a lot of questions in our rulemaking. We put out the 55 proposals, all with cost-benefit. As we finalized rules, we are doing—and benefiting from cost-benefit on all of those. But people ask, can you interpret these words, make a legal interpretation of these words, in Section 722(d)? And we put that out to public comment and notice, and we are benefiting from public comment as well on that.

Chairman GARRETT. So you can't do that through a rulemaking process as opposed to a guidance and seeking advice?

Mr. GENSLER. There are a number of places; this is probably the fourth or fifth place that we have addressed through interpretation. It was referred to earlier. The indemnification area is another area for swap data repositories we used and interpret it. People have asked us, can you interpret words, and we are trying to do that in this circumstance.

Chairman GARRETT. I am mindful of my time and other Members'. These things can all be done, and it may be asking the agencies for that. I am sure the SEC was being asked for some of these clarifications as well. But I applaud what the SEC did. It complied with congressional intent here through a formal process.

With that, I yield now to the gentlelady from California for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman.

I want to get back to some more discussion on extraterritoriality. Under Section 722(d) of the Wall Street Reform Act, the CFTC was given latitude and flexibility in terms of how you would regulate swaps that crossed national borders. You actually would.

In June, the CFTC released its interpretive guidance on the cross-border application of Title VII of the Wall Street Reform Act. That guidance defined foreign branches or guaranteed subsidiaries of U.S. persons to be U.S. persons and therefore subject to the entity and transaction-level requirements of Dodd-Frank.

Many in the industry, again, have expressed concern that non-U.S. entities have been stopping business with the branches or guaranteed subsidiaries of U.S. firms overseas. Others have even suggested that the guidance encourages U.S. firms to incorporate subsidiaries overseas simply to avoid our U.S. derivatives reforms. At the same time, we certainly don't want unregulated risk occurring in the offshore branches or subsidiaries of U.S. firms to be imported back here to the United States.

So, Chairman Gensler, how are you reconciling these competing concerns given that other parts of the globe are still behind us in terms of derivatives reform?

Mr. GENSLER. An excellent question, and it is a matter of balance. The overseas affiliates guaranteed back here can send risk back here, and so I think Congress included 722(d) to ensure that risk didn't flow back here as it did in AIG, in Lehman, in Bear Stearns, and in others. But what we have said is for those offshore guaranteed affiliates, substituted compliance can be the way to move forward. Foreign regulators that are comparable and consistent, that is okay with us. And we are also saying we are not going to have any of those rules come in for some time.

The only rules that come in on January 1st is if a dealer is dealing with U.S. persons, which is more of a territorial U.S. person, not the guaranteed affiliates. And we are saying until next summer, let us continue to work with the other overseas regulators to sort through it. So narrow U.S. person will come into place early, say January 1st. The guaranteed affiliates we are delaying that, phased compliance as well as substituted compliance.

Ms. WATERS. Thank you.

Mr. Cook, can you weigh in on the question also?

Mr. COOK. Sure. Thank you. The Commission has not yet issued its cross-border guidance. It is the front of the agenda for us in terms of implementation of Title VII. I do believe that the task at hand is to try to strike the right balance between, on the one hand, achieving our domestic regulatory priorities, and on the other hand, recognizing that this is a global marketplace and that we need to understand that what we do here will impact what the other regulators and other jurisdictions do.

I would point to a statement that recently was issued by a number of the leaders of different regulatory agencies around the world, as a result of a meeting earlier at the end of November, where there was a discussion about how to best achieve international coordination consensus. And that is part of an ongoing dialogue that I think we will incorporate into our cross-border release and try to take that into account at that point.

Ms. WATERS. Finally, let me just remind everybody that the President's request for the CFTC and the SEC is $308 million and $1.566 billion, respectively. However, the House Appropriations Committee has passed a bill appropriating only $180 million and $1.371 billion for your agencies. Give me a moment and tell me how this funding level will affect ongoing operations, especially as it impacts on implementation and enforcement of Title VII authorities. Do your counterparts overseas face similar funding shortfalls? How are they funded?

Mr. GENSLER. Simply put, the CFTC is an underfunded agency. We are about 10 percent larger than we were 20 years ago and the futures market we oversee has grown fivefold. And Congress has asked us, of course, to take on this important task in the swaps market. We won't be able to address everybody's questions. There will be gaps in our oversight.

Ms. WATERS. Mr. Cook, we are very concerned about the SEC. It looks as if you are losing people over there. What is going on? How do you deal with the question of a lack of adequate funding?

Mr. COOK. Thank you. I think that does present challenges, particularly in the implementation phase. I think writing the rules is less people-resource intensive, however, than ultimately overseeing, examining, and bringing enforcement actions to enforce the new regime. So I think as the progress moves forward, the challenges will become greater, because there is a wide range of new types of market participants and new types of transactions that are coming within this regulatory framework, and there needs to be strong and effective enforcement around it to make it meaningful.

Ms. WATERS. Thank you very much, and I yield back.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Arizona is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. There are just so many different questions here to run through. Just because you touched on it, and it wasn't going to be one of my original questions, indemnification of depository, why not do a full rule set?

Mr. GENSLER. Indemnification of data repositories?

Mr. SCHWEIKERT. Correct.

Mr. GENSLER. We did an interpretation to try to interpret it so that foreign regulators could have access, and if it was regulated by them or it is under their laws, that they have access without that indemnification. And though that addressed probably the bulk of their concerns, as the Congresswoman had raised earlier, the question still remains whether this Congress or the next Congress addresses that.

Mr. SCHWEIKERT. Chairman Gensler, my understanding is the way you did that then, you did not do a cost-benefit, go through those mechanics?

Mr. GENSLER. That is correct. It was a legal interpretation of when does an indemnification have to be used. There is probably, I think it is four or five different places that we have done this where people have come to us and said, what does a word mean? It is not a full rulemaking, but when does that indemnification under the words in the statute?

Mr. SCHWEIKERT. All right. Thank you, Mr. Gensler.

Mr. Cook, my understanding, when it comes to cross-border, the SEC is doing a formal rulemaking, you are doing a full cost-benefit analysis, correct?

Mr. COOK. Yes, sir.

Mr. SCHWEIKERT. Mr. Gensler, wasn't that actually in the—and help me, I have only had little bits of information on this—the court case that recently went against the CFTC, that was because you had not done that?

Mr. GENSLER. For different reasons, actually, sir. We do—

Mr. SCHWEIKERT. Let me just, because I want to help define this. My understanding is the court ruled that you had not done enough cost-benefit analysis. Do you disagree with that?

Mr. GENSLER. I do, respectfully. Though the litigants raised that issue, the court spoke to a different topic. It was whether there had been a specific mandate from Congress that we put in place position limits. We believe that Congress really did mandate it, and the judge sent it back and said he saw it differently. But we did do full cost-benefit in the position limit rule, as we have in all of the 40 or 50 or so rules that we do. We benefit from them. And we do them with the chief economist has to sign off on each one personally before we consider them.

Mr. SCHWEIKERT. So in this particular case, because I know in a lot of what we read there is the constant discussion of harmonization between U.S. regulators, foreign regulators, and often we are concerned is there harmonization between the two of you in both the approach, the methodology, use of language in the regs. Because many of us are starting to see a more complex world coming in swaps where there is multiple products wrapped in there.

And if there is a currency in there, okay, that might be exempt. There might be a package swap that actually has, from both of you, that sort of harmonization really does become really important. Is there a difference between the way your two regulatory bodies are approaching these?

Mr. GENSLER. We have jointly worked together and harmonized, we have had joint rules on the definitions you just mentioned about swaps and mixed swaps and securities-based swaps. So I think the public has a great deal of guidance and rules on that. But to the extent they need to come back, as you say, on these package swaps we would address it together, and I would look forward to that.

Mr. SCHWEIKERT. Okay. In my last 60 seconds, Mr. Cook, do you have any comment? Am I seeing different approaches? Is that just cultural between your two regulatory bodies?

Mr. COOK. I can't speak to the CFTC's statute per se. But one of the reasons it drove us towards doing a rulemaking in the cross-border context is that we looked at the data. And in our market, the security-based swap market, most transactions involve a party that is not in the United States. So this is really a cross-border market. And how you do the cross-border rules is really how you do Title VII. And so we felt under those circumstances that when you were looking at the whole it was important to take a holistic approach to the cross-border rules and that, because it had such a significant impact on how those rules were going to work, that we needed to do a formal rulemaking.

Mr. SCHWEIKERT. Okay. Mr. Cook, thank you.

Mr. Chairman, I know I am literally out of time. I am comfortable with what Mr. Cook is doing because of the amount of data you are going to collect.

Mr. Gensler, it makes me a little nervous, particularly because of the different approaches there.

And there are so many other questions I wanted to get to, but, Mr. Chairman, I know I am out of time. Thank you.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from California has joined us.

Mr. SHERMAN. Thank you.

Mr. Gensler, I am a little concerned about whether your budget is adequate. You have expressed those concerns. I wonder if you could provide for the record a couple of things. First, if we really wanted effective regulation, what should be the budget of your agency? And second, will it be a fee structure so that we could collect that amount from those who rely on derivatives? I am not really asking for an oral answer now, but I wonder if you could provide that for the record?

Mr. GENSLER. We could.

We are about a $205 million agency. The President put a budget of $308 million forward. It is for about 1,040 people, up from our 700 people now. But what we really need is also an enhanced technology. We need to probably close to double our technology because it is so data-intensive.

Mr. SHERMAN. But although you are dealing with a market that is 5 times as large as it was a couple of decades ago, the 308 would be sufficient to properly regulate the market?

Mr. GENSLER. I think that it is appropriate also to phase in wherever we are. I don't know where we might need to be 5 or 10 years from now. But I think this is—to be a 1,000-person agency—our friends at the SEC are 4,000, just to put it in context. We are really like the smallest regulator around.

Mr. SHERMAN. Okay. And hopefully you can provide us with a fee structure so that the average person working in my district isn't paying these costs; they are being paid by those who deal with derivatives.

Next, I would like unanimous consent to submit for the record a letter from Senator Blanche Lincoln, dated December 16, 2010, and addressed to the CFTC. She was the primary author of the title we are dealing with.

Chairman GARRETT. Right. Without objection, it is so ordered.

Mr. SHERMAN. Deepened liquid commodity markets will provide benefits to our economy. Pension plans and institutional investors, even ordinary people saving for their retirement now depend upon mutual funds that invest not only in stocks and bonds, but also commodities. Will the new position limits arbitrarily limit mutual fund trading in these markets and take this kind of investment away from those who are saving, whether they be pension plans or individuals? And particularly, how would that relate to index commodity funds?

Mr. GENSLER. I think not. Congress has debated position limits since the 1930s when they were put in our statute. And they are really to promote the integrity of markets to ensure that no one actor, no one speculative actor, has too big a footprint in the marketplace. But the nature of the ratios that were in position limits, the mutual funds or pension plans could invest, it is just that they couldn't have, no one could have an—

Mr. SHERMAN. Is there much difference, though, with an index fund? Five small index funds do exactly what one big index fund does. Would you classify the index funds as speculative investors?

Mr. GENSLER. Again, Congress has given us guidance on that, that it is the producers and merchants and people who actually use a physical commodity or intend to use it or receive it who are not under position limits, and then everyone else colloquially are called "speculators," but they are the non-producer merchants and hedgers.

Mr. SHERMAN. I don't know if I would use the word "speculator" for an index fund, but I will move on.

My next concern is just the whole process of these no-action letters. And you have market participants who are trying to complete the work needed ahead of a compliance date, and then at the 11th hour, the date is extended. Certainly, it would be better if the date were extended prior to the 11th hour. I understand that the CFTC has been issuing numerous no-action letters and temporary relief exemptive orders and that they tend to come in at the 11th hour. It can be frustrating for those who don't know until that 11th hour whether that document will be issued.

Do you think that full implementation schedule with adequate time for compliance would be more appropriate, or in the alternative, post a full no-action letter until all the Dodd-Frank rules are finalized? And just in general, what can be done so that companies don't have to wait until the 11th hour.

Mr. GENSLER. With all due respect, it is a bit of both. The data reporting rules were completed in 2011, one year ago, and when they were completed we said the compliance would be July 15th or 17th of this year. We extended the general compliance of that until about this time. So now they have had 1 year, the big dealers, to get ready, or 2½ years since the law. There are further questions. We really want to smooth this transition, and so we give further phased compliance when it is targeted. We could stick with the January 1st deadline, but we think it is appropriate to give that additional relief.

Chairman GARRETT. Thank you. And the gentleman's time has expired.

Mr. SHERMAN. I yield back.

Chairman GARRETT. Thank you.

The chairman of the full Financial Services Committee is recognized for 5 minutes.

Chairman BACHUS. Thank you. Chairman Gensler, on page 7 of your written statement, about halfway down, you say, "we are very committed to allowing for substituted compliance, or permitting market participants to comply with Dodd-Frank through complying with comparable and comprehensive foreign regulatory requirements." You go on to say, "The guidance—you are talking about cross-border guidance, which is what a majority of these questions have been about—includes a tiered approach for foreign swap dealer requirements, which was developed in consultation with foreign regulators and market participants."

When you say consultation, after that meeting a lot of the participants at least expressed that they have grave concerns, that they didn't appear to agree that was the approach you were taking. Have any of the foreign regulators endorsed the CFTC's approach? I know in conversation with Brazilians that substituted compliance has come up, and I know they are hoping for that.

Mr. GENSLER. The consultation started in early 2011, so nearly 2 years ago. The approach that entity-level requirements would come under substituted compliance and transaction level would be done separately actually came from the international bankers, the IIB, that you will hear from later. I saw Sally here, who represents them. It came from their letters initially, this concept.

So we largely embraced, we could be criticized from the other side, we largely embraced what market participants and the large international banks said, entity level, substituted compliance, and they then said transactions with U.S. persons in Alabama, New Jersey, California, Arizona—it would be Dodd-Frank. We put that out to public consultation with a lot of consultation with international regulators, Canada, Australia, Japan, Europe, et cetera, and we continue to work the issues. I would say that with banks registering, the largest banks registering near term, we are going to have many issues to sort through, and we are committed to sorting through those issues.

Chairman BACHUS. Yes, and you are talking about those firms which register, when you are making that statement?

Mr. GENSLER. Right. Yes, just the firms that register.

Chairman BACHUS. But I have seen expressions from some of the foreign regulators that they feel like some of the guidance may be in conflict with their own regulations, and I guess that is what I am saying. They said you know they are in conflict. So how are you dealing with those conflicts?

Mr. GENSLER. One example is in Japan. They have a clearing requirement they actually put in place November 1st, and we now have a clearing requirement we finished in November. There is a conflict because we both say they have to be cleared and registered clearinghouses. They have yet to register the London clearinghouse and we have yet to register the Japanese clearinghouse, and so we are working on relief so that our U.S. firms can use that Japanese clearinghouse even though it is not registered here and give that clearinghouse, they have asked for a year in that case. And so we are going to do that in the next few days. Where there is a direct conflict, we are completely committed to sorting that out and sorting it out in a practical way.

Chairman BACHUS. And with the no-action letters, some of them were sort of last minute. If we see that we are trying to work out these conflicts and more time is needed, I suppose you will announce that ahead of time?

Mr. GENSLER. Yes.

Chairman BACHUS. Okay. Mr. Cook, has the SEC endorsed the CFTC's approach to cross-border guidance?

Mr. COOK. The Commission hasn't formally made its proposal. We have been very much engaged with both the CFTC and foreign regulators on how to approach this issue. There are concerns, frankly, between—there are a lot of jurisdictions that are at the cusp of implementing their G-20 commitments. And I think there is a real opportunity at this moment in time to find a way to strike the right balance and to bring the whole system to the right place, because I think any one piece of it that doesn't come along or that goes along too far can disrupt the dynamic.

Different jurisdictions have different ways of thinking about this. The Europeans, for example, talk in terms of mutual recognition instead of substituted compliance. What all that means is something that I think is part of an ongoing dialogue, the devil is in the details. What does substituted compliance really mean, where will you recognize, where won't you, how broadly will you look. I think that is part of the work that we all have in the next few months, frankly.

But there has been part of this international dialogue an effort to catalogue conflicts, overlaps, inconsistencies, so at least we know what we are talking about. Where is there a conflict. As Chairman Gensler says, that is a real problem. We need to figure out a way. Where are there inconsistencies?

Chairman GARRETT. Thank you. We got the point. Thank you.

Chairman BACHUS. All right. Because you have had a Singapore bank, a Swedish bank said we are not going to register. But I appreciate it. That is the answer I wanted, is that you are identifying those conflicts and the dialogue is proceeding.

Chairman GARRETT. Thank you.

The gentleman from Massachusetts is recognized.

Mr. LYNCH. Thank you, Mr. Chairman. I appreciate it.

Mr. Gensler, I want to thank you again for your service. You have done some great work on this. I did hear your opening remarks, especially with respect to the extraterritorial application of Dodd-Frank's derivatives reforms. I remain concerned that financial firms will still try to avoid those reforms in Title VII by using the foreign subsidiary structure. I read part of your proposed guidance, and I think you are right on the mark when you, I am quoting you here, you said that in your view the concerns regarding risks associated with the affiliated group structure are heightened where a U.S. person guarantees a foreign affiliate or subsidiary. You go on to say, you ask whether the term U.S. person should be interpreted to include a foreign affiliate or a subsidiary guaranteed by a U.S. person.

And I think you are right at the heart of the issue there. When the American taxpayer bailed out AIG, for example, we didn't just bail out AIG's AIG–FP, their London affiliate. The conduct of AIG–FP had already infected the entire company so that when we came in, we had to bail out the entire company. The kind of risks that are posed by the derivatives market that we tried to address in Dodd-Frank don't stop at our borders. These are international risks. When a company has agreed to backstop a foreign affiliate, that affiliate is for all intents and purposes a U.S. company. And I know in your remarks as well you address the job issue where the jobs could also follow that foreign affiliate.

I would just like to get your thoughts on how we might tighten up the language in your proposed guidance to try to get at that problem in a more effective way.

Mr. GENSLER. You are very kind. I am just trying to maintain it, not lose it. I think if we do not cover the guaranteed affiliates offshore, that you can basically blow a hole out from the bottom of Title VII. And all of what Congress intended on transparency and risk—I served on Wall Street for 18 years, we often structured around legal entities, and that is the nature of modern finance. Many of these large financial institutions have 2,000, 3,000, 4,000 legal entities. It is a matter of structuring. And if you can put a legal entity somewhere and guarantee it, the risk still comes back here.

And in the middle of a crisis, you pull one thread of a financial institution and the whole sweater comes undone. If there is a run on one subsidiary in Japan or Australia or Canada, the United States, Europe, it runs elsewhere. So our risks run to Europe, but also those risks run back here. But we are comfortable with substituted compliance if there are real rules over there to cover our guaranteed affiliates.

I think if we don't cover them, also it is not good for the jobs. I see the Congresswoman from New York. I think the large financial institutions in New York would then just move the jobs to some jurisdiction, put a legal box on the structure in that jurisdiction, be done with it, be happy that the CFTC gave the relief that they requested. But I don't think it is good for New York jobs, I don't think it is good for the economy because the risk would just flow right back here in a crisis. And we are somewhat like the fire department. We have to look at our rules in the context of crisis, what are the rules in crisis so that the risk doesn't hit our taxpayers.

Mr. LYNCH. What kind of cooperation are we getting right now in terms of substituted compliance? I know Congressman Frank earlier was working on that with our colleagues in the EU, but how is that going?

Mr. GENSLER. Excellent. I can't say enough good things about our friends and colleagues in the European Union and London and France, Brussels, Germany, throughout, and other countries as well. They are anxious as to how this will work. We have said, let's give it more time, let's work through the substituted compliance issues. But they have been excellent.

Mr. LYNCH. Okay. Thank you.

My time has expired. I yield back. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

The gentlelady from Illinois is recognized for 5 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

And thank you, Chairman Gensler and Director Cook, for being here. Am I right that there is a different timetable that has been adopted by the SEC and the CFTC on comparable requirements?

Mr. GENSLER. You are right that we were given maybe an easier task than the SEC because we are just a futures and swaps regulator, a derivatives regulator, so that is what we have been focused on, and they have a much broader portfolio. So we have completed about 80 percent of the rules. We actually got the same time scale, 1 year. Congress gave us 1 year to complete the task. But here we are, 2½ years later.

Mrs. BIGGERT. Right. Is that going to be confusing for firms and costly for U.S. firms?

Mr. GENSLER. Though there may be challenges, the swaps that we oversee, interest rate swaps and the physical commodity swaps and credit indices represent about 95 percent of the marketplace. They are also used by corporations and municipals across this country. The securities-based swaps are not only a smaller part of the market but they are generally not used by your small and medium-sized companies across this country.

Mr. COOK. I agree that most of the market is under the CFTC's jurisdiction, 95 percent versus 5 percent. I think as a practical matter, as the SEC begins to move towards finalization of rules that have already been adopted by the CFTC, we will need to take into account that framework, and to the extent that there is any perceived need to be different need to explain it and justify the potential cost to market participants. There are different products, and so sometimes it makes sense to have differences. The types of information you report for an oil-based swap might be different than what you would report for an equity-based swap. And there may be other examples. But I think that ultimately, if we are different, we are going to need to be able to justify those differences.

Mrs. BIGGERT. So you are talking about December 31st or January 1st?

Mr. GENSLER. It actually would have been finished in July of 2011, we were supposed to be complete.

Mrs. BIGGERT. But it has been extended?

Mr. GENSLER. We extended it through three 6-month extensions called exemptive orders. But now that we have completed so many of the rules, we have moved to these more targeted phase compliance, either no-action letters and the like.

Mrs. BIGGERT. But you talk about January 1st or December 31st?

Mr. GENSLER. That is correct.

Mrs. BIGGERT. The reason I ask is it just seems like kind of an odd time to launch such a big project. Aren't most companies really focused on closing the books for the year, and really are they having to do a lot in this last couple of months that is going to cut into that time?

Mr. GENSLER. For many of them we delayed and deferred the compliance and gave additional times throughout, as they requested. There are some that we are delaying from December 31st. For instance, the trade association, International Swap Dealers Association, has come in and said many of their sales practice regime, they want it delayed from October to the end of the year. We did that. They have now come in and said they are only about 20-plus percent done, could we give them 4 more months. And we have something in front of the Commission to give them 4 more months. So we are working through to phase each of these where issues come up.

Mrs. BIGGERT. So you don't think that this really has any—it won't cause—if there are operational problems, they can be solved easily?

Mr. GENSLER. This is a very significant change, an important change for the public. But as firms register come January 1st and start sending information to data repositories, that is a positive for the American public. As long as people are operating in good faith, we are going to continue to work with each of these market participants to get this in place in the smoothest way possible.

Mrs. BIGGERT. So there is some flexibility?

Mr. GENSLER. Yes, absolutely, absolutely.

Mrs. BIGGERT. Thank you. I yield back.

Chairman GARRETT. If the gentlelady will yield to me, I just have one follow-up question. So with regard to this issue of swaps and guarantee of swaps, the Commission has said that guaranteed swaps aren't actually swaps, whereas the SEC has held a contrary view on that. My question to the Commissioner is, can you point me to the page of Title VII where the word guarantee is explicitly set out anywhere that gave you the idea that a guarantee of a swap is a swap?

Mr. GENSLER. I am sorry, because I will probably get a little geeky here. In the securities law, a guarantee of a security is a security, and that is in statute, predates Dodd-Frank. So a guarantee of a securities-based swap is a security. That happened on their side, as I understand it anyway. What we look to is Section 722(d), does it have a direct and significant effect on the commerce or activities in the United States, and so that is where we—

Chairman GARRETT. You use that as an expansive, and it could bring in anything then as long as it is—

Mr. GENSLER. No, it is related to the guaranteed affiliates. So if a large financial institution here guarantees that offshore affiliate, as sure as we are sitting in this room, if that offshore affiliate fails, the risk is going to come cascading back here of that legal entity.

Chairman GARRETT. Let me just say that the SEC, as I said, at the outset, takes a contrary view on—

Mr. GENSLER. Actually, theirs is more direct. It is right in statute. But Robert might want to address it.

Chairman GARRETT. My time has—

Mrs. BIGGERT. I yield back.

Chairman GARRETT. The gentlelady yields back.

I will go to the gentlelady from New York. Mrs. Maloney is recognized for 5 minutes.

Mrs. MALONEY. Thank you.

In Dodd-Frank, it was made clear that clearinghouses must provide open access, be transparent, and that data repositories cannot bundle or require that additional services be bought from them. I am hearing there are some difficulties in this area, and I would like to submit some questions in writing on some technical items there.

And I would like to go back to the opening question of the chairman, the statute that we adopted defined swap execution facilities as being able to use any means of interstate commerce. Your proposed rule in January 2011 restricted the permitted modes of execution. But I understand that your draft final rule allows for voice, but it is only made clear in the preamble and is silent in the regulation. Why is it not clear in the regulation or the rule itself?

Mr. GENSLER. As it is a draft and it is internal documents, can I just speak more broadly just to the—Congress said by any means of interstate commerce. We got a lot of comments. And I can only speak for this Commissioner. I believe that the final rule should be as Congress directed, technology neutral. By any means of interstate commerce covers phones, Internet, carrier pigeons. However there is still a requirement, and it is a very real requirement, that it is multiple parties having the ability to transact, buy or sell with multiple parties. That is how markets work best. It was true in days of old when you had a central market for fruit and vegetables, and it is true in this electronic era that multiple people meet multiple people, but they can meet them in a number of different technology ways.

Mrs. MALONEY. I would like to ask about, in your judgment, why so many of the crises seemed to happen in London. And as you said, in many of the cases it comes back and hits the American taxpayer. So is their regulation the same as ours, is it stricter, looser? But it is unusual that many of the major financial crises that have rocked the confidence of the markets have started in London. Why do you think that is?

Mr. GENSLER. I think more generally, risk knows no geographic border or boundary. It can go around the globe. So risk here in the United States of our housing crisis also splashed over to Europe. It is true in both directions.

But the nature of modern finance is that these large financial institutions will have several thousand legal entities sometimes, or just hundreds, and often will put a legal entity somewhere that satisfies their capital needs. And sometimes, they want lower regulation in an island nation. It could be the Cayman Islands. Long-

Term Capital Management had their entity set up in the Cayman Islands. Bear Stearns had a number of their legal entities in the Cayman Islands. They found that was appropriate for them for tax planning and other reasons, but the risks still came back here.

Mrs. MALONEY. If the risk comes back to us, is the substituted compliance as strict in London as it is in America? It is unusual that the crisis happens in London. Mr. Cook, would you like to comment on that?

And I will say that in Basel III, we are hearing from some of our financial institutions that the capital requirements are more onerous on American banks because American regulators are going to enforce them and their competitors may feel they will not enforce it. So this is a problem if someone can go to another, have a different standard in what is a competitive global market in the case of capital requirements, have a situation which is a disadvantage to American firms. And certainly, I am concerned about the threat to American taxpayers. You can say you have substituted compliance, but how are you enforcing the substituted compliance? You hear from some financial institutions, I won't say it publicly, but they don't feel that it is regulated in certain cases in certain places, and I am wondering, is London one of them? Why are so many financial crises in London? I would like to hear from Mr. Cook.

Mr. COOK. Thank you. I think that is going to be a very important consideration if substituted compliance is granted, is how do you evaluate the foreign regime and whether it is deemed sufficient and along what metrics. Saying you are going to give substituted compliance is just the beginning. You then have to figure out, you have to understand the other regime, how it works, and then you need to think about as well how is that regime being enforced.

I think one of the advantages of substituted compliance is that you basically retain jurisdiction, so in the future, if you determine that the regime is inadequate or is not being adequately enforced, then you can determine that the substituted compliance is no longer available. I think the question you are raising about the different capital and other requirements, while we are not, I think, the banking regulators who are behind the Basel regime, I think it does raise the broader question of how do we make sure that there is full implementation of these G-20 commitments in the derivatives space, not just in the United States but in other countries as well. And I think that is part of the advancing international dialogue, and I think there is a lot of progress being made, but that is something that would need to be taken into account before recognizing any other regime for substituted compliance purposes.

Mrs. MALONEY. Thank you. Thank you for your service. My time has expired.

Chairman GARRETT. Thank you.

I recognize the gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I appreciate you both being here today. Chairman Gensler, in the last couple of years, I think this committee has expressed a lot of concerns about the rulemaking process as you begin to implement this title, and some people have felt that some of these rules were inconsistent, confusing, and others felt that the CFTC was dodging some issues by just issuing guidance rather than being very prescriptive, and then others have said that you are overreaching the original intent of Dodd-Frank.

I think the question and what the concern was is that was going to cause uncertainty in the market participants. And I think what we are beginning to do now is see that playing out. For example, as you are aware, recently ICE decided to move trillions of dollars worth of swap, energy swap contracts over to the futures side. And so the question is, is when you look at a lot of regulations and the policy that you are making, it almost appears that you believe that the intent of Congress was to somehow drive people out of the swap market. Do you believe that was the intent of Congress?

Mr. GENSLER. Not at all, and I don't think that is what our rules are about either. I think swaps are critical to our well-functioning economy so that end users, whether farmers or ranchers or large financial institutions, can lock in a price and hedge a risk and then focus on what they do well, and create jobs and innovate. And it is to promote transparency in that market and lower the risk of that market, but it is just like the reforms of the 1930s, transparency in the securities and futures markets, I think, helped promote economic growth these last 7 or 8 decades.

Mr. NEUGEBAUER. As we are beginning to see how some of the market participants are reacting to this, has the agency said internally, hey, we didn't anticipate, for example, that ICE would move trillions of dollars worth of transactions out of one space to another space? Are you beginning to wonder whether the road you are going down is actually accomplishing the intent of Congress and is it beneficial to the marketplace?

Mr. GENSLER. Every day when I walk in, I wonder about that very question, because markets adjust, evolve; this is a very complex market. And so that is why we have changed. Nearly every one of the final rules have been changed from the proposals. We have reproposed some of them. We are not shy of doing that. If we don't think we got the first one right, like we did on block rules, we do not shy away from phasing compliance and where we think we can under the law to giving the appropriate relief to smooth this into place.

In terms of futures and swaps I think you had a regulated futures market that has worked well through the crisis and for many decades and an unregulated swaps market that, frankly, did not work well in 2008. So when Congress said regulate this and bring it up somewhere here, it is sort of inevitable that some of these swaps might now be called futures. But if I might say, futures is transparent, it has a low risk profile because it is centrally cleared, and the dealers or the equivalent of dealers tend to be regulated. So I think whether it is futures or swaps, Congress has said it should be transparent and have some oversight.

Mr. NEUGEBAUER. I think there is no question that there is a place for both of those products in our financial markets. What I am concerned about is that we seem to be by some of the policies and the rules that you are initiating, trying to move the marketplace more to the futures space, whereas this is a valuable part of risk management that many of the market participants that I talk to are very concerned about—one is that in the form that it has been in the past, certainly everybody is for the transparency and making sure that we address some of the risk factors of that, but I don't think there is support that we move all of the market to the futures.

Mr. GENSLER. You and I completely agree on that.

Mr. NEUGEBAUER. We would like to see some things that would indicate that is the Commission's position. And I think one of the things that we keep talking to you about, Chairman Gensler, is the cost-benefit analysis before we implement a lot of this and anticipating some of the consequences, unintended consequences of some of this rulemaking process rather than being in a hurry to just put out a lot of different rules. And so obviously the market is telling you something here, and hopefully we will look for your response as to rethinking whether you have done some things here that are pushing—we don't need the government telling people what markets they can participate in. What we need the government to be doing is making markets transparent and fair. But we don't need the government trying to tell people that these are the products we think you should be using.

Chairman GARRETT. Thank you. Thank you very much.

Ms. Moore is recognized for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

I just sort of want to pursue the line of questioning that Mr. Neugebauer ventured into, because it seems to me that you are suggesting that futures are transparent, they are well-regulated, and we all know that swaps were not. And now that this new swaps future market is developing, I am wondering if you are concerned about the regulatory arbitrage of only about 50 percent of margin being required and if they are being treated as equivalents don't you think that—margin may just be one of the regulatory gaps that exist. Wondering what your thoughts are on that.

Mr. GENSLER. One of the innovations in the market in the last few months has been this product of future on a swap, so it is a future, it trades or on a futures exchange, and it is clear, and it is transparent. But yes, we are taking a look at it to better understand it. It is a new product. If I can call you chairman as well, the chairman said the market should innovate, that we are not deciding whether it is futures swaps or futures on swaps, but we are certainly taking a look at the development.

We have historically had reason to have higher margin requirements on swaps because they were not as liquid as futures. Margin is meant to be there just if one party defaults to unwind the position after somebody goes bankrupt. If liquidity comes to the swaps market, an active liquidity like the futures market, then you would want to ensure that the margins were more aligned.

Ms. MOORE. Mr. Gensler, much of your testimony was devoted to how you thought that your regulatory work has been focused on making sure these swap execution facilities get up and running and they are well-regulated. You say that you don't want to pick what kind of products people ought to use in the marketplace. Are you concerned that these SEFs may just become irrelevant as you see the exit from swaps into the new product? Is that any concern about market stability?

Mr. GENSLER. I think it is critical that we finish these rules on swap execution facilities. This has been a long journey together, 2½ years when Congress only gave us 1 year. I think the swap execution facility rules need to be finalized. We have something in front of the Commissioners. We will find a consensus amongst the five of us and try to finish this up in January or February so that these commercial enterprises—

Ms. MOORE. It won't be a dinosaur by the time you are done, will it? It won't be irrelevant?

Mr. GENSLER. Knowing some of the men and women who work at these institutions, no, I don't think so. I think they are very clever and innovative institutions. But I think we need to finalize these, complete the task that Congress gave us, and then let these swap execution facilities and designated contract markets provide a service to the public and compete.

Ms. MOORE. Let me ask you a question about some of the extraterritorial stuff that we have been talking about today. Mr. Dold and I, and I am sure he is going to pursue this, we passed H.R. 4235. And a couple of the Commissioners—Commissioner Sommers and Commissioner Scott D. O'Malia—have said that they really do think that there should be a legislative fix to this. And I would submit that H.R. 4235 was that fix. And so if you were to join with these Commissioners, we could repeal the indemnification provisions that were passed by this committee, I believe unanimously. And I am wondering if you would endorse that kind of legislative fix to this?

Mr. GENSLER. We have been working with the international regulators, and we did within the law the best we could to address this issue through the interpretive approach. It was interpreting this indemnification. Foreign regulators, who have required data to be in a data repository, can access that data without the indemnity.

Ms. MOORE. I guess my understanding is that they have grave concerns about the guidance versus this legislative fix. Why don't we just do H.R. 4235?

Mr. GENSLER. That, of course, is not the Commission. We have done what we can.

Ms. MOORE. I know, but if—

Mr. GENSLER. I imagine in 2013 Congress will take this issue up as they take up, whether it is our reauthorization of the Commodity Exchange Act or other things that Congress takes up.

Chairman GARRETT. Thank you. I thank the gentlelady.

Mr. Pearce is recognized for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Gensler, I am fascinated with your discussion. On page 14, it paints a vivid picture: Picture the NFL expanding eightfold to play more than 100 games in a weekend without increasing the number of referees. This would leave just one referee per game, and in some cases, no referee. Imagine the mayhem on the field, the resulting injuries to players, the loss of confidence fans would have in the integrity of the game. So I think I would like to begin my discussion about this idea of how many referees it would take. And so I go, to judge the future, I take a look at the past, and so I am looking. The CFTC was pretty involved in MF Global, right? You were there.

Mr. GENSLER. The CFTC—

Mr. PEARCE. You were the referee, yes?

Mr. GENSLER. The CFTC oversees the futures market—

Mr. PEARCE. Yes, so the CFTC was deeply engaged in MF Global, is that correct?

Mr. GENSLER. It is one of the many Futures Commission merchants, yes. MF Global is one that we oversee.

Mr. PEARCE. And MF Global had about 30,000 futures accounts and 318 SEC-regulated accounts, so one of the many. It is almost 100 percent under CFTC regulations. And yet the referees in the room made a decision, according to Chairman Schapiro, when I questioned her, that they were going to allow it to be described as a security trading firm, not the 30,000 accounts, but the 318 are going to dominate the process. And you see that is a little, just for those people who might be watching out there in America, that was a little sleight of hand. You talked about the clever, innovative companies that you try to regulate. But there was a clever sleight of hand because when declared it a securities firm, then it was allowed to process bankruptcy in a way that favored investors.

Mr. Cook, would you have any idea who made the recommendation that this would be a securities firm and not a futures trading firm?

Mr. COOK. Sir, the MF Global unit that had customers—

Mr. PEARCE. I am asking, do you know who made that suggestion? Because Chairman Schapiro said that someone from SEC made the suggestion. Were you in the room that day?

Mr. COOK. I was on the phone at the time.

Mr. PEARCE. Were you in the room?

Mr. COOK. No, I was not.

Mr. PEARCE. You were not a participant, but you were one of the referees on the field, I think is what we are talking about. Mr. Gensler drew us a very good word picture there. You were one of the referees.

Mr. COOK. Yes, there was an ongoing call among the regulators that included the CFTC and the SEC to determine what to do in light of the shortfall in accounts and the obvious inability of this firm to open up the next morning.

Mr. PEARCE. Yes, but who made the decision that it was going to be a securities firm and not a futures firm?

Mr. COOK. The decision was made to refer this to SIPC because—

Mr. PEARCE. And that allowed then the investors to be protected at the loss, at the loss to the consumers.

Mr. COOK. Well, no.

Mr. PEARCE. And I am reading, if you will allow me, I am reading your testimony, sir. And you say that in the discussions before us on derivatives trading, we are here to avoid systemic risk, we are here to enhance investor protection, we are here for transparency, we are here for consistent and comparable requirements, we are here to protect the consumers. And yet, you were on the phone and Mr. Gensler was in the room; you were the referees. We were the referees, but we need hundreds more of us. You two guys were sitting there when 30,000 accounts were turned over and you protected the investor and you did not protect the consumer, and you want us to sit up here and give you more money, you want us to sit up here and believe the fairy tales that you are giving us that somehow you are going to act differently under derivatives trading.

And I say, if I am going to look at your future, I am going to look at your past. You two guys, not the ones sitting across the hall from you. And I just wonder about this Administration, which constantly talks about the 99 percent. When it comes down to the rub, it protected the 2 percent. It didn't protect the small guys, it didn't protect the hog farmers—30,000 accounts versus 318 accounts. Mr. Gensler, you worked at Goldman Sachs. You knew those guys. They started picking up assets that day.

Mr. Chairman, I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Carson is recognized for 5 minutes.

Mr. CARSON. Thank you, Chairman Garrett, Ranking Member Waters, Mr. Gensler, Mr. Cook, and all of the witnesses.

I want to remind my colleagues of the importance of cooperation and collaboration with our international partners. I believe the United States should demonstrate our global leadership by raising our financial standards and not entering into a race to the bottom of sorts of banking standards. I also believe that if the provisions of Dodd-Frank were in place 5 years ago, we would not have faced the economic crises we are just beginning to crawl out of. So I am very reluctant to carve out more exceptions or exemptions to Dodd-Frank before the rules have actually been put in place to fully implement the law or without more speculation that could go wrong.

My colleague, Peter King, would have us suspend enforcement of Dodd-Frank's Volcker Rule until our international partners have instituted their own regulations addressing proprietary trading. As I mentioned in my opening statement, I strongly believe that the United States should lead by example and not wait for others to take the lead. What do you guys see being the pros and cons of Mr. King's proposal?

Mr. COOK. Both the CFTC and the SEC have a role in implementing the Volcker Rule. I think the Commission hasn't taken any position on this proposal. We are actively engaged at a staff level with the other agencies to move forward with the Volcker Rulemaking, taking into account the enormous number of comment letters we got, over 18,000, a very complex set of issues, but I think we have been making a lot of progress. And I think as a staff person, our goal is to continue moving forward with the implementation process as expeditiously as we can.

Mr. GENSLER. And though I am not familiar with the proposed legislation, the Volcker Rule is one of the more challenging, maybe the most challenging of rules I think the regulators were given, to prohibit one activity, proprietary trading, to help the taxpayers not bear some risk, and yet permit things that are important to markets, market making, hedging, underwriting and the like. So prohibit one thing, permit another, and then where is the border or boundary between the two? So it is one of the most challenging I think, and there are five regulatory agencies working on that. Internationally, they don't have the similar rule, and so we are dealing with Congress' will and trying to get that in place when they don't have that overseas.

Mr. CARSON. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Dold is recognized for 5 minutes.

Mr. DOLD. Thank you, Mr. Chairman.

I certainly want to thank Mr. Gensler and Mr. Cook. Thank you for taking your time to be here.

Mr. Gensler, back in March the committee held a hearing about the potential danger of our regulatory framework if foreign regulators are required to comply with the indemnification and confidentiality provisions in Dodd-Frank. The European Securities and Markets Authority expressed concern that the CFTC cannot overrule the Dodd-Frank Act itself and concluded that the confidentiality and indemnification issue could only be fully addressed with a legislative amendment by repealing the original provision in Dodd-Frank.

As you know, this committee passed, as my colleague Ms. Moore noted, H.R. 4235, which would provide this legislative fix, a solution that I believe is supported by the SEC and certainly supported by our foreign authorities as well. The CFTC's interpretive guidance says that the CFTC will not require foreign regulators to indemnify a registered SDR or its primary regulator. This regulatory workaround is essentially to ignore the law, to ignore a provision of Dodd-Frank. On what basis of authority do you propose that the CFTC can ignore the law and how can foreign regulators rely upon this interpretation?

Mr. GENSLER. With all due respect, I think we actually took this law into consideration. Also, as I understand it—I am not a lawyer, but rules of international comity—in essence, when there is a conflict between laws how do we address that? We are doing that in the cross-border rules as well. So we have interpreted the indemnification provision that Congress put in place, but said if a European regulator or Asian regulator, or Canadian regulator actually requires that information to be in that data repository, that Dodd-Frank doesn't trump their law, that they can have access to that information without an indemnity. So it was actually taking into consideration what I have come to understand as the international regimes on comity and recognition that has gone all the way to our Supreme Court.

Mr. DOLD. On H.R. 4235, Mr. Gensler, Ms. Moore asked, do you support that legislative fix. Obviously you said, well, perhaps they are going to do that in 2013. Unfortunately or fortunately, however you want to look at it, we are going to be in session here for a little while and we have an opportunity to fix it right now. Would you support an H.R. 4235 fix which has passed the committee here unanimously? So again, why put off until tomorrow what we can try to deal with today? Would you support something along those lines?

Mr. GENSLER. I will just leave it that I support the interpretive guidance that we completed. I think that we addressed the issues that ESMA raised with regard to that. ESMA doesn't have to indemnify if there is information in that data repository that they have asked to be there.

Mr. DOLD. Two dissenting Commissioners, Mr. Gensler, stated that the Commission has purposely chosen to interpret the statute in a manner that constrains other domestic regulators' ability to examine the swap market data. If the DOJ needed to access data from an SDR for an investigation, would it need to enter into an indemnification agreement? Can the DOJ do that? And if not, why would the CFTC limit access to relevant data?

Mr. GENSLER. I might have to have our General Counsel get back to you on the specifics of that question, but I know that other U.S. regulators have two paths: they can get it directly from the data repository; or they can come to the CFTC, and we would forward it to the Department of Justice in your scenario.

Mr. DOLD. I have nothing further. Thank you again for being here.

I yield back, Mr. Chairman.

Mr. GARRETT. Thank you. The gentleman yields back.

The gentleman from Texas is now recognized.

Mr. CANSECO. Thank you, Mr. Chairman.

The derivatives portion of Dodd-Frank, which is Title VII, has spawned some of the most baffling and complicated regulations that the financial markets have ever seen. In part, this is due to the vagueness of Dodd-Frank and more so, and largely due to the manner in which some regulators, particularly the CFTC, have gone about implementing Title VII.

Now, in recent months, and leading up to October 12th, there has been a decrease in trades with U.S. firms. International regulators have condemned the overreach of the CFTC, all which shows that Title VII is doing plenty to increase confusion, and is taking business away from the United States, yet it remains an open question whether any of these rules are making our financial system safer or sounder.

Mr. Gensler, in past appearances before this committee, you have touted the CFTC's work and cooperation with international regulators. For example, when you testified before our committee in early 2011, you stated that the CFTC is "actively consulting and coordinating with international regulators to harmonize our approach to swaps regulations," and that you had worked closely with regulators in Europe, the U.K., and Japan. And just recently, in October, you stated in a speech that the CFTC has "consistently engaged with our international counterparts through bilateral and multilateral discussions to promote robust and consistent swap market reform."

Recently, the regulators of the U.K., France, and Japan sent the CFTC a letter and urged your agency to better coordinate regulation with them, and it has been widely reported that regulators of other countries are concerned about your agency's approach. So my question to you is, what happened?

Mr. GENSLER. What happened is what happens in human nature is that not—we don't always agree, partly because we have different underlying statutes, we have different cultures, we have different political systems. We have been sharing our drafts rules, our term sheets. We get feedback. I don't know of any other U.S. regulator who does this, by the way, with all due respect. We really do get a lot of excellent feedback, but ultimately there will be some differences. We can narrow those differences, but we will have some differences.

Mr. CANSECO. So what you are saying is that it is going to take some time to get these regulations in sync with the EU and Japan and other traders?

Mr. GENSLER. We have made tremendous process. There are laws in place in Europe, Canada, the United States, and Japan to have central clearing, data reporting, and, at least here in the United States and Japan, for some of this public transparency. Europe is still focused on that.

Wherever there is a direct conflict, we are going to sort that through and be very practical, as we have been in Japan, as we have on this indemnification issue, within the law and recognizing international regimes, called this international comity. But where there are some differences where they haven't adopted a law, whether it be in the Cayman Islands or other places, we have to make sure that our taxpayers are protected and our markets are transparent.

Mr. CANSECO. I understand that, but in the meantime we are losing a lot of that market share and all of that opportunity.

What assurances do you have that we are going to get these regulations in sync with the Europeans and the Japanese and others?

Mr. GENSLER. I think that as we have moved forward, we have done that where we can. Another example is—and I know it was raised earlier by other Members—margin, the amount of money that is put up on transactions. We proposed something along with the bank regulators in the spring of 2011. We have not finalized that because we went out internationally with the Europeans and Asians and put out a concept on how to do this earlier this year. And we are committed to try to do this in sync, with them, which may take until late in the first half of this coming year.

Mr. CANSECO. Now, let me ask you this: Do you believe that the international regulators are wrong in their statements that they made at the GMAC conference earlier this autumn? Fabrizio Planta of the European Securities and Markets Authority stated that this is not workable with regards to the rules that are being implemented by the CFTC. And he says, they are not workable, and we, as international regulators, have the responsibility to find mutually acceptable workable solutions to solve these issues. And Patrick Pearson from the European Commission stated that the message is, Washington, we have a problem. That is an objective fact, not a subjective one.

Mr. GENSLER. I believe this is workable. We have something that is in our law, which is registration. Congress debated that firms will register, and they will register starting in a few weeks. That is not in European or Asian law. So that is just a difference in approach.

They will register, but then we will look to substitute a compliance, we will look to phased compliance. We have an exemptive order that we are finalizing pieces of to give more time for that. But when they are dealing with enough U.S. persons, they will register so that the public here is protected as well and that we level the competitive playing field. We don't want our firms from New York or elsewhere in this country to have to register, but just if you are in Frankfort, or Paris, or London, or Tokyo, that you don't register when you deal with U.S. persons in this country. That would seem not only to be a conflict with the law, but it wouldn't be appropriate competitively.

Mr. CANSECO. Thank you. I see my time has expired.

Chairman GARRETT. The gentlelady from New York is recognized for 5 minutes.

Dr. HAYWORTH. Thank you, Mr. Chairman. And I want to express my appreciation for the privilege of having worked under your guidance on this subcommittee for the past 2 years.

And Mr. Cook and Mr. Gensler, thanks for your service, Mr. Cook particularly, upon this particular occasion.

Recognizing that Dodd-Frank is a massive law that was passed with the best of intentions, but, of course, it was not composed in its entirety by people who are so deeply immersed in the world of financial services and its products and processes as you are and as those we are seeking to serve are, do—I realize you have been given a set of tasks that can be, as we have heard, amply documented not only in this hearing, but throughout the past couple of years; that we are working to try to provide a certain element of—obviously a tremendous element of control, of assurance, of security, of minimization of risk to the vulnerable, but in so doing it is clear that trying to map that law onto a regulatory structure and onto our financial services industry has created tremendous problems in terms of process and timing, and they have real cost in a highly competitive world. So these issues that we are talking about, as you know, as we all know, have real consequences, as Mr. Canseco was just saying. We lose market share when products and offerings and services move elsewhere in the world where it is perceived that they are more welcome or there is more opportunity.

I want to ask you more specifically in that regard about cross-border guidance, and I know you had a—Mr. Gensler, you had a little conversation with Chairman Bachus about it, and you say there has been a cost-benefit analysis done. Earlier this year, in February at a CFTC open meeting, your counsel said that indeed there had been a cost-benefit analysis on a particular rule, but when Commissioner O'Malia asked it about subsequently, in fact it turned out that there actually hadn't been a numerical sort of analysis that they could actually look at and say, yes, this is what it is going to cost, this is what we reliably project.

Clearly we need that kind of quantitative analysis, because obviously we have to assess the costs and benefits of what we are doing. There is a happy point in there somewhere statistically, there has to be realistically.

So do you have a real quantitative analysis that you can provide of the cross-border rules? And if so, could you provide that to the committee in the next few days?

Mr. GENSLER. We consider cost-benefits on each of our rulemakings. Sometimes they measure 100 pages long in some of these and throughout these 40 or so rules. Thus, it measures into the thousands of pages and always signed off by our chief economist.

It benefits from market input, but it is both qualitative and quantitative. And often we ask market participants for numbers, and they are not able to give us numbers, partly because it is a competitive issue, they may not want to send it, and partly because this is a new regime—

Dr. HAYWORTH. Right.

Mr. GENSLER. —as well. So we consider that throughout the various rules.

It also has to be measured against the cost to the American public, and I think Congress was well aware of that, of the job losses, the businesses that shuttered, the people who lost their homes as a result of a crisis that in part was due to this opaque marketplace.

Dr. HAYWORTH. Sir, without—and I don't mean to interrupt you abruptly, but do you—all taken, yes, although the root cause remains Federal action that facilitated the kind of unwise investment in the housing markets, the high-risk investments that resulted in this. The derivatives were a symptom, if you will, or an end result, but the root cause was actually Federal action, I would submit.

But, sir, do you have a quantitative analysis of any of these cross-border rules that you can share with us, understanding limitations that you have described?

Mr. GENSLER. In each of our rules, whether it is about data reporting, clearing, business conduct, there is cross-border—cost-benefit considerations written up.

Dr. HAYWORTH. Understood. Can you provide them to us, sir; can you give us some sort of documentation of them?

Mr. GENSLER. We could probably pull together those 40 or so cost-benefit sections and send them in and so forth.

Dr. HAYWORTH. Yes, sir.

Mr. GENSLER. But they are rule by rule.

Dr. HAYWORTH. Understood. But whatever you could provide us, I think that would be useful.

I know my time has expired, and I thank you.

Chairman GARRETT. Anything we can get from the Commission with regard to cost-benefit analysis would be beneficial, and a first, so that would be great.

Mr. Stivers is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

And I appreciate both witnesses being here today. Big picture, we all want to promote market integrity, lower risk, and have harmonized regulation both here in the United States and internationally.

I would like to start with harmonization because I think it is really important. Since the two of you are at the table, how would you, in very brief terms, characterize the coordination between the SEC and the CFTC on swaps rules as they stand today? Are you in unanimity, are you close, are you—do you have distance between you?

Mr. GENSLER. I would say the coordination has been exceptional. And I want to take this moment to thank Chairman Schapiro, because I know her term is almost up, as well as Mr. Cook, because they have been incredible partners to this agency. We jointly put in place definitional rules, as Congress asked us to do. We jointly address public reporting of hedge funds. Many of the other rules we were not asked by Congress nor required to be "joint," but we had to consult and coordinate and harmonize where we can, and we have done that.

But where we are different is in timing. The CFTC has completed about 80 percent, and Robert could tell you—Mr. Cook could tell you their percent. But that is partly because that is all we really do. We oversee futures and swaps, and they have a lot more to oversee.

Mr. STIVERS. If we could allow him to quickly characterize where you are, and then I have a bunch more questions.

Mr. COOK. Sure. I would agree that there has been good coordination in terms of sharing documents back and forth.

Mr. STIVERS. Would you agree you are in the same place?

Mr. COOK. As far as timing, we are in a very different place, but again, we are 5 percent of the market, and they are 95 percent of the market.

I think the other thing is that at the proposal stage, there has been a lot of similarity, and there have been some differences. Sometimes those differences reflect difference in products; sometimes they reflect a difference in approach. I think that it is appropriate at the proposal stage to put out different ideas for people to think about. As we move into our final rulemaking stage, we will need to really focus hard on where we are different, and is there a justification for being different from the CFTC?

Mr. STIVERS. And I would argue very strongly that differences in timing create a lot of uncertainty in the marketplace. And also the fact that the CFTC didn't go through the administrative rulemaking process without formal comments, they are doing many things through guidance and non-action letters, I think that is a real problem. And I would urge you to try to come together more on timing because I think it will help keep the market from becoming fragmented.

I would like to ask Mr. Gensler, approximately how many no-action letter requests do you have before you now on these swaps rules?

Mr. GENSLER. We have worked through many of them, but I think that we have between 10 and 15 right now that we are still working through. But if I am off, there could be a handful more.

Mr. STIVERS. So when you add those up with the ones you have already approved, how many would be in effect at the beginning of—well, in short order? How many—add the 10 to 15 you have now with—how many no-action letters have you already approved?

Mr. GENSLER. I don't have an exact number. It is on our Web site, and we can get back to you, sir, with a specific number.

Mr. STIVERS. That would be great.

The whole point of that is if you had gone through the administrative rulemaking process, you could have gotten comments, you could have changed rules, and you could have gotten the benefit of cost-benefit analysis that we talked about.

I do want to ask Chairman Gensler the status of H.R. 2779, which is the inter-affiliate swap bill that Congresswoman Fudge and I sponsored. It passed the House with 357 votes, and I know you proposed the rule to allow inter-affiliate exemption from clearing requirements. How is that going?

Mr. GENSLER. We proposed something probably around when your bill was, but maybe it was after that, recognizing that we might not have the time to complete that, and we had this cross-border and other issues in front of us. We did use a no-action letter to give us time until I think it is April 1st to complete that. We got very good comments from the public, and we look to complete that in the first quarter.

Mr. STIVERS. Thank you.

I am running out of time. I would like to insert a letter for the record on harmonization from our international partners that Mr. Canseco referenced. In the letter, they state that they have really deep concerns about the differences between their positions and ours right now.

I yield back the balance of my time to the chairman for a question that he would like to ask.

Chairman GARRETT. I appreciate that.

Just very quickly, with regard to position limits in the court case right now, first, I have heard media reports that the Commission might be thinking of appealing that decision?

Mr. GENSLER. We actually did file papers to appeal it.

Chairman GARRETT. Okay. And second, I have heard rumors actually from fellow Commissioners stating that you plan to draft another positions limits rule to try to fix that problem.

Mr. GENSLER. We are looking at that as the district court suggested that—they remanded it, so recognizing that Congress really said, get this in place. And if I might say, position limits work. They work in the markets to promote integrity in the markets.

Chairman GARRETT. Has your solicitor or your counsel notified the court at the same time that you are filing an appeal that you are also going down another track of potentially proposing another rule?

Mr. GENSLER. I will raise that with our counsel, but it is really—

Chairman GARRETT. Because that would—

Mr. GENSLER. We appealed it because we think that Congress directed us to put position limits in place. They said, in fact, not even do it in the year, do it in 6 and 9 months, and then report back to Congress once we have done it.

Chairman GARRETT. I am just—

Mr. GENSLER. But in the meantime, we are also looking at—

Chairman GARRETT. Having been in court and seeing other cases by this Administration where the Administration filed in court, and the court says no, and at the same time at the last minute they come back into court and say, never mind to the appeal that has been filed, we have seen already courts from the bench saying, why didn't you let us know that you were doing this? You are basically running down two expensive tracks at the same time, one an appellate process trying to appeal your original position, and the other at that time creating another rule. We have heard so much that the Commission is short on assets and resources to get the job done. This just seems to be one case of an evidence of that, why that may be the case.

With that said, and coming to the close of this first panel, I appreciate both the Chairman and the Director being with us today. There will be opportunity for Members to submit other questions in writing. Now, I would normally end it right there, and say to the next panel to come on up, but that does remind me of my opening comment that we have already done that in the past, sent letters to the Commission asking for answers on some things, and several months later, we are still awaiting answers from the Commission.

So on one hand, I am extending that offer to all the Members, all my colleagues on both sides of the aisle, to once again within the next 30 days submit questions to both members of the panel. I would ask the panel before they leave, is it their intention to answer these questions and any previous questions from any Members that they may have in a timely manner, timely being within the next week or so?

Mr. GENSLER. In a timely manner, yes. In a week is very often a challenge. I am just being very realistic. A week sometimes—

Chairman GARRETT. How about any outstanding correspondence from myself and anyone else who may have—

Mr. GENSLER. I am not aware of any outstanding ones, but I would like to work with your staff to ensure that—if there are any outstanding ones.

Chairman GARRETT. Okay. Sure. I appreciate that. I am sure the Commission will—

Mr. COOK. We will work very hard to get to your answers as quickly as we can.

Chairman GARRETT. Great. Thanks.

With that, I thank both members of the panel. This first panel is dismissed. Thanks a lot.

Mr. GENSLER. Thank you very much.

Mr. COOK. Thank you.

Chairman GARRETT. And to the second panel, greetings. While you are getting your papers, et cetera, organized in front of you, I welcome the second panel.

First, a couple of housekeeping items. I know some members of the panel have testified here before, and others have not. So for those who have not been here before, and as a reminder to those who have, your complete written statements will be made a part of the record. You will be recognized for 5 minutes for a summary of your statement right now. Sometimes, we say to capsulize your statement. And, of course, right in front of you, in front of Eric there, is the little clock with red, green, and yellow lights. It goes down to 5 minutes and final time.

Also, I will just say that I saw all of you sitting here for the first panel. And so we understood from the first panel everything is going well. We will move quickly through the process and have harmonization not only around the world, but back here at home as well. And I assume the second panel is going to tell us the exact same thing, that everything is moving smoothly, and we have no real need for concern, in which case we can leave here happily. If not, then I get the old adage of the former radio host Paul Harvey: And now, we hear the rest of the story.

So with that, we have seven members to the panel. We will start right off as we normally do from the left. Mr. Bailey from Barclays, we recognize you and welcome you to the panel, and you are recognized for 5 minutes.

STATEMENT OF KEITH BAILEY, MANAGING DIRECTOR, MARKETS DIVISION, BARCLAYS, ON BEHALF OF THE INSTITUTE OF INTERNATIONAL BANKERS (IIB)

Mr. BAILEY. Good afternoon, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Keith Bailey. I am from Barclays, where I am a managing director in the markets division. I appreciate the opportunity to testify today on behalf of the Institute of International Bankers (IIB) on the implementation of Title VII of the Dodd-Frank Act and its impact on the market.

The IIB greatly appreciates the hard work that has been done by the regulators and the congressional committees to promote efficient transition of markets to meet the goals of Title VII. The challenges facing the CFTC and the SEC in getting this right are considerable, given the OTC markets operate on such a global basis.

My testimony will focus on the continuing uncertainty surrounding the cross-border application of the Title VII regulations, the effect this is having on the market today, and the risks to the market if the implementation process is not placed on a more stable footing.

Congress in the Dodd-Frank Act recognized the need for international consistency and coordination in the implementation of Title VII's derivative reforms. As the committee is aware, in support of this goal, the Act limits the overseas application of U.S. rules to activities where there is either a direct and significant effect on U.S. commerce or the potential for evasion.

We support the goals of Title VII, which will provide greater market transparency and increased oversight of the global swaps market; however, there is growing concern surrounding the sequencing of rules by the CFTC and the divergence between the CFTC and the SEC regarding the process and timing for the consideration and adoption of rules governing how swaps and security-based swaps are offered to clients. As the committee is aware, the industry is facing quickly approaching compliance deadlines with respect to swaps without the benefit of final guidance as to the international scope of these rules.

The lack of clarity related to the rules' cross-border application manifests itself in particular with respect to three aspects which apply equally to registration with the CFTC and the SEC, albeit the more immediately pressing concerns over the CFTC's requirements. The first is, who has to register as a swap dealer? Given the need to register by December 31st, firms had to make decisions a while ago as to which entities to register with the CFTC. Making these decisions without being fully informed as to the rules that will apply and what it will take to comply imposes an untenable level of unpredictability on firms. The inability to properly plan affects the ability of firms to serve their clients.

The second major challenge is the creation of a new definition of "U.S. person." The CFTC has proposed a definition that is expansive and without precedent, posing difficulties for market participants to know which entities around the world will be in scope. This is important because if a registered dealer trades with a U.S. person anywhere in the world, that transaction will be subject to U.S. requirements to clear and to execute that trade on a U.S.-registered clearinghouse and swap-execution facility, potentially in conflict with local regulations.

Conflicts introduce compliance risks for both the dealers and clients, resulting in trades simply not occurring. A narrower definition of “U.S. person” will reduce the instances of this conflict.

Regulators must also mutually recognize each other’s clearinghouses and exchanges. The expansive U.S. person definition further contributes to the uncertainty over who has to register under the so-called aggregation rule. As it stands now, this rule requires affiliates of non-U.S. dealers that register with the CFTC to themselves register as swap dealers if they transact even a single transaction with a U.S. person. This would significantly increase both the number of registered swap dealers and the resources the CFTC will require to regulate them. It is hard to see how the liabilities of non-U.S. entities with only a very limited U.S.-facing activities could pose a risk to U.S. commerce.

Substituted compliance is the third issue. It applies more broadly than just to the execution of transactions. For example, to what extent is a foreign-headquartered bank accountable to the CFTC for risk management of its global swap activities if the CFTC’s rules are different than those of its home country prudential regulator?

The CFTC is proposing to apply the offshore prudential regulators rules, but only if their rules pass a narrow substitute compliance test that will require a high degree of comparability. The IIB agrees with the numerous global regulators who have suggested that such an approach won’t work. As demonstrated this past October, such uncertainties create paralysis in the market. Clients, regulators, and Title VII’s objective for transparence and efficient markets are the losers.

The resolution of these issues cannot wait until the last minute. As discussed at greater length in our written statement, there are near-term steps the CFTC can take to alleviate these uncertainties. Such actions not only would provide the breathing space needed for global regulators to resolve their differences in striving for convergence in achieving the G-20 objectives for OTC derivatives reform, but also would provide the time for the CFTC and the SEC to establish a consistent approach to the cross-border application of Title VII’s requirements.

Thank for inviting us here today to contribute to the dialogue, and I look forward to any questions you may have.

[The prepared statement of Mr. Bailey can be found on page 68 of the appendix.]

Chairman GARRETT. And I thank you.

I now recognize Mr. Bopp from the Coalition for Derivatives End-Users. I hope to hear so much about what would be impacted by this. Thank you for being on the panel.

Mr. BOPP. Thank you.

Chairman GARRETT. You are recognized for 5 minutes. Make sure you do pull your microphone close to your face.

STATEMENT OF MICHAEL D. BOPP, GIBSON, DUNN & CRUTCHER, LLP, ON BEHALF OF THE COALITION FOR DERIVATIVES END-USERS

Mr. BOPP. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, I want to thank you for inviting the Coalition for Derivatives End-Users to be represented at this important hearing. The Coalition includes more than 300 end-user companies and trade associations, and collectively we represent thousands of end users from across the country. Our members are united in one respect: They use derivatives to manage risk, not to create it.

Many U.S. companies are able to maintain more stable and successful operations through the use of a variety of risk-management tools including derivatives, yet derivatives used by end users must be put in perspective. End-user trades account for less than 10 percent of the notional value of the overall derivatives market.

The Coalition has been very engaged throughout the regulatory process, meeting with regulators dozens of times, submitting nearly 20 comment letters. We very much appreciate the receptivity of regulators to hearing our concerns and for taking the time to meet and speak with us on numerous occasions.

We also work with Congress, and in particular with your committee, on legislative means to prevent unnecessary regulatory burdens from being imposed on Main Street businesses.

On behalf of the Coalition, I would like to take a moment to thank the Financial Services Committee for its hard work in helping to move legislation through the House to address some of the unintended consequences of the Dodd-Frank Act. In particular, I want to thank Congressmen Grimm and Peters for the end-user margin bill; Congressman Stivers, Congresswoman Fudge, and Congresswoman Moore for the inter-affiliate swaps bill. The overwhelmingly bipartisan and collegial process that led to passage of both bills in the House demonstrates that there are changes to the Dodd-Frank Act that make sense and can achieve a consensus.

With regulatory compliance deadlines looming in the next few months, however, the Coalition is concerned with the direction in which certain rules appear to be heading. We are primarily concerned about regulations relating to margin and capital requirements, inter-affiliate trades, Treasury hedging centers, and the application of rules across borders. I will touch upon these points briefly.

The proposed margin requirements, particularly those proposed by the prudential banking regulators, are especially troubling and would harm Main Street businesses. Congress was clear both throughout the legislative process and in the text of the Dodd-Frank Act that end users should not be subject to margin requirements because they do not meaningfully contribute to systemic risk. Congress also made it clear that imposing margin requirements would unnecessarily impede end users' ability to efficiently and effectively manage risks.

As proposed, however, the rules contradict congressional intent and would impose unnecessary margin requirements on end users, diverting working capital away from productive business use. A survey conducted by our Coalition found that a 3 percent initial margin requirement could reduce capital spending by as much as $5 billion to $6.7 billion among S&P 500 companies alone, costing 100,000 to 120,000 jobs.

We are also concerned that inter-affiliate derivatives trades, which take place between affiliated entities within a corporate group, may face the same regulatory burdens as market-facing swaps. There are two serious problems that need addressing. First, under the CFTC's proposed rule, financial end users would have to clear purely internal trades between affiliates unless end users posted variation margin between the affiliates or met specific requirements for an exception. If end users have to post variation margin, there is little point to exempting inter-affiliate trades from clearing requirements as the costs could be similar.

Second, many end users, approximately one-quarter of those we surveyed, execute swaps through an affiliate. This, of course, makes sense as many companies find it more efficient to manage their risk centrally and to have one affiliate trading in the open market instead of dozens or even hundreds of affiliates making trades in uncoordinated fashion. But it appears from the regulators' interpretation of the Dodd-Frank Act that purely non-financial end users will face a choice: Either dismantle their central hedging centers and find a new way to manage risk, or clear all of their trades. Stated another way, this problem threatens to deny the end-user clearing exception to end users because they have chosen to hedge their risk in an efficient, highly effective way. It is difficult to believe that this is the result Congress hoped to achieve.

Finally, the proposed cross-border guidance is also a cause for concern for the Coalition. The guidance would impose additional costs on end users and would diminish their available choices of counterparties. We are also concerned by the CFTC's creation of a new regulated entity found nowhere in the four corners of the Dodd-Frank Act. The term "conduit" as used in the proposed guidance could be applied to central hedging centers and, again, could force end users to abandon these efficient structures for executing trades.

Throughout the congressional development of the Dodd-Frank Act and the regulatory process that has followed its passage, the Coalition has advocated for a more transparent derivatives market through the imposition of thoughtful, new regulatory standards that enhance financial stability while avoiding the imposition of needless costs on end users. We believe that imposing unnecessary regulation on derivative end users, which did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy.

Thank you.

[The prepared statement of Mr. Bopp can be found on page 85 of the appendix.]

Chairman GARRETT. I appreciate that. Thank you, Mr. Bopp.

Ms. Cohen, welcome to the panel. You are recognized for 5 minutes.

STATEMENT OF SAMARA COHEN, MANAGING DIRECTOR, GOLDMAN, SACHS & CO.

Ms. COHEN. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, my name is Samara Cohen, and I am a managing director in the securities division of Goldman Sachs. My responsibilities include developing and delivering trading, hedging, and risk-management solutions to the firm's OTC derivatives clients, with specific focus on the market structure changes resulting from global regulatory reform. In my current role, I interact regularly with market participants that transact in swaps to manage risk, access liquidity, and improve returns. Thank you for inviting me to testify at today's hearing to share a perspective with you and answer any questions you may have.

Goldman Sachs supports the overarching goals of Dodd-Frank's derivatives provisions, including decreasing systemic risk and increasing transparency, and has devoted substantial resources to build necessary compliance systems.

Commissioners and staff at the regulatory agencies, including the CFTC and the SEC, were given a very difficult task, and we commend their efforts to fulfill the goals of the legislation. Along with our customers, we have been carefully monitoring the way that regulators view the cross-border reach of Dodd-Frank's derivatives provisions, including how the U.S. regime will interact with the regulatory reform efforts under way in other G-20 jurisdictions.

Today, I will raise four challenges we and our clients see with the CFTC's approach to Title VII implementation and the consequences that might result from their proposed cross-border guidance.

First, the CFTC has taken a sweeping approach to its jurisdiction beyond U.S. shores that is without precedent. Recent public meetings held by the CFTC and others have made it clear that swap market participants and non-U.S. regulators have substantial concerns about this expansive approach. These concerns will inform the ways in which swap market participants operate, with some local banks in Asia, Europe, and South America signaling to U.S. financial institutions that they will have to stop trading with U.S. dealers to avoid CFTC swap dealer registrations. The approach also may encourage foreign regulators to be similarly expansive as they craft their own regulatory regimes.

Second, the CFTC's definition of "U.S. person" that dictates registration and application of Title VII requirements is overly broad and at times vague. As a result, market participants do not know whether they or their counterparties are or are not U.S. persons and cannot make informed business plans. In addition, the breadth of the definition makes it nearly certain that some market participants will be both a U.S. person for the purpose of U.S. regulation and an EU person or its equivalent for the purpose of EU regulation, causing unnecessary overlap and potential conflicts in regulation.

Third, regarding sequencing, the CFTC has chosen to finalize substantive Title VII rules and require compliance with them before specifying to which entities they will apply. As a result, market participants face significant uncertainty as to what rules may apply. In contrast, the SEC recognizes the need to finalize the cross-border application of its rules well before requiring compliance.

Our fourth and final concern relates to the fact that the CFTC's cross-border approach has not been developed in coordination with non-U.S. regulatory regimes as is necessary in a global derivatives market. In the short term the timing mismatch between the CFTC's rulemaking and that of other G-20 jurisdictions could cause swap customers to move their business so that U.S. regulations do not govern their swap transactions.

While a permanent solution to these issues is being developed, it is critical that the CFTC address the industry's immediate concerns to avoid harmful and potentially permanent disruptions to the swap markets on and around December 31st. Specifically, the CFTC should temporarily permit the simplified form of the "U.S. person" definition in the CFTC's October 12th registration no-action letter for compliance with all Title VII obligations. This definition is simple and clear, but still captures the vast majority of entities that market participants generally consider U.S. persons. While a final U.S. person definition is developed, in consultation with other regulators, the CFTC should apply Dodd-Frank requirements to transactions between registered swap dealers and U.S. person customers only.

We appreciate the opportunity to offer our views to this committee, Congress, and the regulators as we work together to fully implement these important new rules.

Thank you, and I look forward to your questions.

[The prepared statement of Ms. Cohen can be found on page 88 of the appendix.]

Chairman GARRETT. Thank you, Ms. Cohen.

Mr. DeGesero, of the Fuel Merchants Association, welcome to the panel.

STATEMENT OF ERIC DEGESERO, EXECUTIVE VICE PRESIDENT, FUEL MERCHANTS ASSOCIATION OF NEW JERSEY, ON BEHALF OF THE PETROLEUM MARKETERS ASSOCIATION OF AMERICA (PMAA), THE NEW ENGLAND FUEL INSTITUTE (NEFI), AND THE FUEL MERCHANTS ASSOCIATION OF NEW JERSEY (FMA)

Mr. DEGESERO. Thank you, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Eric DeGesero, and I am representing the Fuel Merchants Association of New Jersey, the Petroleum Marketers Association of America, and the New England Fuel Institute. Our members collectively distribute 60 percent of the gasoline and 90 percent of the heating oil consumed by the American public.

First, we want to commend the CFTC for its dedication to moving forward with prudent futures and swaps market regulations which will bring greater transparency, certainty, and fairness to all commodity market participants. Bona fide end users of commodities, many of which are our members, feel that the futures and swaps markets are not serving the best interests for what they were created: managing risk and discovering price.

So why Title VII? For the first time, Dodd-Frank requires all swaps, whether cleared or not, to be reported to swap data repositories. This is an important step to help the CFTC capture the trillions of dollars traded in the opaque swaps market.

Additionally, Title VII is important because it limits excessive speculation on energy trades, enhances prohibition and prosecution of fraud and manipulation, and promotes greater consumer protections. While the rules might not be perfect, they are a welcome start in overturning the Commodity Futures Modernization Act (CFMA), which watered down oversight, exempted Wall Street from position limits and requirements that ensured transparency and competition and prevent fraud, and manipulation, and excessive speculation.

Before passage of the CFMA, commercial hedgers comprised 60 to 90 percent of the market for commodities. Today, 60 to 90 percent is purely speculative, and that is only the markets that we know about. This level of speculation is excessive and undermines risk mitigation and price discovery mechanisms, exacerbates market volatility, and unhinges the markets from supply and demand fundamentals.

Commodity futures markets were established as a tool for true physical hedgers to manage risk. They weren't set up strictly for investment banks to dominate the marketplace.

The very definition of "cash-settled swaps" as look-alikes means that what occurs in the financially settled swaps market directly impacts what occurs in the physical market.

In recent years, excessive speculation on oil futures exchanges has driven prices at the pump. In April 2011, Goldman Sachs warned clients to lock in trading profits before oil and other markets reversed, suggesting speculators were boosting crude prices as much as $27 a barrel, which translates to upwards of 40 to 60 cents per gallon at the pump. Goldman noted that every 1 million barrels of oil held by speculators adds an 8 to 10 cent rise in oil prices.

So not to say that we are opposed to speculation. Quite the contrary. We need speculation in the marketplace for physical end users to manage risk, but excessive speculation distorts the markets and creates tremendous volatility.

Furthermore, the effect of excessive speculation on small business petroleum marketers is a problem with far-reaching consequences. In recent years, gasoline and heating oil retailers have seen profit margins from fuel sales fall to the lowest point in decades as prices have surged. Small businesses do not benefit from high crude or gasoline prices because they operate in such a competitive environment: the higher the prices climb, the further the margins are compressed. Thus, rising gasoline prices not only hurt motorists, but small businesses as well.

Regarding the position limits rule, it is unfortunate that the U.S. district court ruling vacated the clear intent of the elected branches of government on the new position limits rule, albeit on narrow ground, and sent it back for further consideration.

More than 100 studies have been published showing that excessive speculation has been disruptive to commodity markets.

We would also like to note, in echoing statements that were made earlier relative to the bipartisan process of some of this, that as recently as the 110th Congress, 70 House Republicans voted to approve legislation that would have established across-the-board position limits and provided the CFTC with 100 employees, 100 new employees, to carry out their mission. Of that number, 44 are still Members of the House.

Regarding cross-border derivatives, transactions conducted by offshore affiliates of U.S.-based firms can have a direct and immediate impact on businesses, consumers, and the stability of the American economy. Financial institutions have direct access to the Federal Reserve's discount window and FDIC backing. That is why Congress gave the CFTC enough discretion to go after offshore affiliates. If the CFTC isn't able to effectively regulate U.S. bank foreign affiliates that engage in swap transactions, Title VII of Dodd-Frank will effectively be gutted.

Given the over-the-counter derivatives market has grown exponentially over the last 10 years, a small downpayment for the CFTC to ensure the markets are reflective of supply and demand is critical. The OTC market totals approximately $300 trillion in the United States and another $300 trillion worldwide. We believe the CFTC's budget needs to increase from $205 million to $308 million. We urge the subcommittee to allow the CFTC to do its job and implement the will of the people's branch without further delay.

I thank the subcommittee for the opportunity to testify and I look forward to any questions you may have, Chairman Garrett. Thank you.

[The prepared statement of Mr. DeGesero can be found on page 106 of the appendix.]

Chairman GARRETT. Thank you very much.

Mr. Deutsch, you are recognized for 5 minutes.

STATEMENT OF THOMAS DEUTSCH, EXECUTIVE DIRECTOR, AMERICAN SECURITIZATION FORUM (ASF)

Mr. DEUTSCH. Chairman Garrett and distinguished members of the subcommittee, my name is Tom Deutsch. I am the executive director of the American Securitization Forum. I thank you for the opportunity to participate in the hearing today on behalf of the 330 member institutions of the ASF that represent all the various constituencies in the global structured finance markets, including issuers, investors, financial intermediaries, lenders, trustees, servicers, and rating agencies.

In my testimony today, I address in detail two key unintended consequences of potential outcomes of the implementation of Title VII of the Dodd-Frank Act on the structured finance industry. There are certainly a number of areas of securitization and structured finance that is subject of Dodd-Frank, such as QM, QRM, risk retention, loan level data, conflicts of interest; certainly a litany of issues that we would address in different hearings.

Today's hearing is not one in the summer of 2010 that I would have expected us to participate in, in large part because the use of swaps and derivatives in securitizations are generally of the most plain-vanilla type, such as the use of interest rate or currency swaps to eliminate securitizations investors' exposures to interest rate or currency fluctuations.

Let me provide two basic examples. First, a captive auto finance company, they package a number of auto loans into a securitization to sell to investors. Typically, auto loans are sold to borrowers at a fixed rate; that is, the borrowers want to keep their fixed-rate loans and have managed their daily fluctuation. However, captive finance companies, when they try to sell these securitizations to investors, oftentimes the investors want to have floating-rate notes. So the issuers of those securitizations want to ensure a basic swap to effectively be able to allow the borrower to enter into a fixed-rate loan with the issuer, but at the same time be able to sell to investors. Pension funds, mutual funds, and the like would like to get floating rate notes. In effect, both sides and all three parties win in that transaction. The borrower gets a fixed-rate note, the investor gets a floating-rate purchase, and also the issuer is able to provide as much and maximize the amount of investor appetite for those securities as possible.

Let me provide a second example. That is an English mortgage lender may package a number of home loans that it makes to English homeowners into a securitization to sell to U.S. investors. The English homeowners are required to pay their loans, obviously, in U.K. pounds. The English homeowners are required then to pay those back, but the U.S. institutional investors who purchase the mortgage-backed securities that they are based on, they have to pay their obligations, that is to U.S. pensioners and other investors in mutual funds—they have to pay those back in U.S. dollars.

As such, the U.K. securitizer will enter into a currency swap that will effectively protect the investor from any currency fluctuations in buying a securitization. That way, again, the English homeowner gets their mortgage in U.K. pounds, but ultimately the institutional investor can focus on the credit and prepayment risk of those securities rather than worrying on currency fluctuations.

Now, historically this hasn't been a challenge, and there has been little interaction between the CFTC and securitization, but two recent rule changes and proposals have unfortunately created significant concern for the securitization markets with these: first, that a posting of cash margin may be required for securitization transactions even for the most basic vanilla types; and second, various commodity pool regulations that may trip up and rope in many securitization transactions into those rules.

First, let me address briefly the posting of the cast margin. Our concern is that many securitizations that use these plain-vanilla swaps will, in fact, have to post cash margin into the transaction, and that will take on additional risk for the securitization, but, most importantly, tie up much of the much needed capital for many types of securitization vehicles.

If you look in Appendix I of our written testimony, we provide a very detailed example showing that if posting of cash margin is required for these transaction vehicles, then in scenario 1, where interest rates were to be within 95 percent of their usual fluctuation, nearly 10 percent of the securitization transaction will have to be posted as margin. So as an example, there is $42 billion a year issued in auto ABS in 2011. If 10 percent margin would have to be posted on those transactions, that would be approximately $4 billion that wouldn't be available in credit. That leaves a lot of cars on car lots and a lot of factories idling.

But in scenario 2, where we look at a much higher increase or fluctuations in interest rates, over 20 percent of liquid margin will have to be posted in those transactions, meaning approximately $8 billion of margin would have to be posted for those auto ABS transactions, again, a significantly more restricted credit market just in the auto context alone, let alone in mortgage, credit cards, autos, and the like.

With that, we would also like to thank the CFTC for their work related to commodity pool and alleviating many of the concerns associated with it. I look forward to answering questions as the committee may see fit.

[The prepared statement of Mr. Deutsch can be found on page 112 of the appendix.]

Chairman GARRETT. Thank you.

I now recognize Mr. Giancarlo from GFI, and also the Wholesale Market Brokers Association.

STATEMENT OF J. CHRISTOPHER GIANCARLO, EXECUTIVE VICE PRESIDENT, GFI GROUP INC.; AND CHAIRMAN, WHOLESALE MARKETS BROKERS ASSOCIATION, AMERICAS (WMBAA), ON BEHALF OF WMBAA

Mr. GIANCARLO. I am Chris Giancarlo, executive vice president of GFI Group, an American business and a wholesale broker of swaps and other financial products. I testify today as chairman of the Wholesale Markets Brokers Association, an independent industry body representing the world's largest wholesale brokers, active in every global financial market.

Our member firms were the model for swap execution facilities, or SEFs, under Dodd-Frank. We use voice and electronic trading platforms to execute trades and swaps and other products. Our members plan to register as SEFs and security-based SEFs when final rules are completed.

We stand for swaps regulation that improves transparency, promotes competition, and increases market participant access. We have supported the clearing, execution, and the regulatory reporting mandates of Dodd-Frank through dozens of writings and formal testimony, and we continue that support today.

I would like to briefly discuss: one, the unfinished SEF rulemaking; two, the cross-border impact of Dodd-Frank; and three, the overnight futurization of swaps markets.

I will start with the SEF rulemaking. We are informed that final SEF rules have been presented to the CFTC Commissioners and hopefully may be finalized soon. Chairman Gensler has said that the final rules allow swaps to be executed "through any means of interstate commerce," as set out under Title VII of Dodd-Frank, and our member firms welcome the news.

But, Mr. Chairman, I was pleased to hear Chairman Gensler say a few minutes ago that swaps execution should be technologically neutral, including voice transactions. That neutrality needs to be stated not just in the preamble to the final rules, but in the rules themselves. The rules must be as clear as was the statute. To provide otherwise would be inconsistent with the express provisions of Dodd-Frank, contrary to public comment, and will certainly lead to regulatory uncertainty and market confusion.

Let me tell you now what we are seeing in overseas financial markets. Since the June release of the CFTC cross-border interpretive guidance, U.S. trading firms are being shunned by foreign counterparties to avoid registering with the CFTC. In some cases, two-tiered trading markets are emerging, one where U.S. traders can transact, and one where U.S. traders are prohibited from transacting. As we meet today, we are hearing from foreign firms that they don't want to trade with American firms lest they be caught in CFTC regulation. This development is not good for America's global trading and not good for America's economic interest.

Finally, I will speak about futurization of the swaps markets. From Friday, October 12, 2012, to Monday, October 15th, we saw a complete migration of trading activity in U.S. natural gas and electric power markets from cleared swaps to economically equivalent futures. By Tuesday, almost no swaps were trading in the North American energy markets.

This overnight development in a vital U.S. market happened almost entirely because energy trading firms sought to avoid registering as swaps dealers or major swaps participants. It happened because the CFTC has furthered regulatory arbitrage against one product under its jurisdiction, swaps, in favor of another product, futures. And it happened with little study or understanding by regulators of the unintended consequences on U.S. markets, traders or energy consumers. And it happened certainly without a cost-benefit analysis.

Here are the concerns. First, the futurization of swaps harms the competitive market structure that Dodd-Frank meant to preserve; that is, choice of financial products, choice of methods of trade execution, trading venues and clearinghouses. By contrast, the U.S. futures market, while serving a finite set of highly liquid commodities and financial products, restrains competition by limiting trading methods and having single vertical silos for execution and clearing. The futurization of swaps leads to monopolistic control, reduced customer choice and, inevitably, higher costs of trading and execution.

Second, the futurization of swaps markets increases balance sheet risk for market participants and systemic risk for the U.S. economy. Because futures do not allow for specific exercise dates, they are imperfect hedges and cause market participants to incur basis risk and greater earnings volatility. But futurization also increases systemic risk, because labeling a product as a future and listing it on an exchange results in a lower margin requirement than for a cleared swap even though the economic characteristics of their products may be identical.

Let me repeat that: Calling something a swap future and putting it on exchange results in a lower margin than for the same economically equivalent instrument if it is called a swap.

Regulators have not analyzed what that means to systemic risk. As a result, clearinghouses are forced to absorb more risk, especially during a liquidity crunch or market crisis. While a lower margin may be attractive to some futures traders, it can have dire consequences for the American taxpayer.

Dodd-Frank was designed to promote competition, reduce systemic risk, facilitate clearing, and increase transparency. Congress did not mandate a preference for futures products over swaps, monopolies over competition, or increased risk to trading firms or the economy.

In closing, we call on regulators to finish the SEF rules as Congress intended, to carefully consider their international impact, and to better understand and analyze any further migration to futures.

Thank you very much, and we look forward to your questions.

[The prepared statement of Mr. Giancarlo can be found on page 135 of the appendix.]

Chairman GARRETT. And I thank you.

Finally, from MIT, Mr. Parsons from the Center for Energy and Environmental Policy Research.

STATEMENT OF JOHN E. PARSONS, SENIOR LECTURER, FINANCE GROUP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY (MIT), AND EXECUTIVE DIRECTOR, MIT'S CENTER FOR ENERGY AND ENVIRONMENTAL POLICY RESEARCH

Mr. PARSONS. Thank you. I am John Parsons. I am a member of the finance faculty at MIT Sloan School of Management. I publish research on hedgings, and teach a course on risk management for non-financial corporations, and have consulted with a number of companies on hedging issues as well as other corporate finance issues.

I want to thank Chairman Garrett, Ranking Member Waters, and other members of the subcommittee for allowing me the opportunity to testify here.

All of us share a common objective, I think, of helping in our different ways to craft effective regulation that reduces hedging costs for companies and increases the productivity of the economy.

I submitted my written testimony with the title, "Hit or Miss." I am going to use these remarks basically to describe two broad categories of actions: one that I think misses the mark, that will be ineffective at reducing costs for non-financial companies and potentially have some dangerous side effects; and another broad category of actions that I think has a proven track record of helping to reduce costs for companies, which I would label the hit.

So, first to talk about the miss. In the public discussion of Title VII and the OTC swaps markets, I see that there is a very broad misunderstanding about how companies can avoid the costs of hedging. Many people imagine you can avoid those costs if you can avoid margins. And a lot of congressional action has been targeted to trying to find ways to facilitate non-margin swaps because that will lower costs. I am worried that people think that you can get a free lunch in an area like this.

All non-margin swaps entail credit risk, and all credit risk is costly. Banks know that, derivative dealers of all sorts know that. They handle non-margin swaps accordingly. They examine companies' credit risks, they maintain a folder, so to speak, in the old days, but more currently other means, to keep track of companies' credit risks and they price the credit risk when they sell the swap. They charge for it, the cost is there.

Lobbyists have sponsored studies commissioned to produce large estimates of costs as a result of forcing companies to do margins.

, You have heard the results of one of those studies cited here by Mr. Bopp. All of those studies that I have seen, including the one cited by Mr. Bopp, are preposterous. All of those studies assume away any costs created by credit risk to non-margin swaps. That problem has been publicly stated and criticized. There is no public defense of the inadequacies of those studies. And I would recommend that the Congress look for reliable figures from disinterested parties which can stand up to public scrutiny.

Some legislation which has been aimed at avoiding this cost is misguided at best and dangerous at worst, especially bills which try to direct bank supervisors to ignore the credit risk that is embedded in non-margin swaps. For example, H.R. 2682 is one of those types of bills. It threatens to return us to an unstable and ill-supervised financial system.

Turning now to the hit, I want to talk briefly about central clearing and how it is an effective tool for decreasing costs. Once again, in the public discussion I think there is a lot of misimpression that central clearing is a new, untested mandate originated in Dodd-Frank imposed on a tried-and-true OTC market structure that had evolved to minimize cost. In fact, it is quite the opposite. It is a return to a tried-and-true system, a rediscovery of an important innovation which American financial markets and American industry expanded on throughout the 20th Century to reduce costs. I think that the way we want to look at the problem is to find a way to improve the extent of central clearing, improve the extent to which central clearing can reduce costs, and there are lots of ways to make that implementation better.

So in closing, I hope we can focus on true and effective means for reducing costs to non-financial companies and avoid focusing on ineffective ones. Thank you very much.

[The prepared statement of Dr. Parsons can be found on page 145 of the appendix.]

Chairman GARRETT. And I thank you, Mr. Parsons.

I thank the entire panel. Before I proceed to questions, I ask unanimous consent to make two statements a part of the record: first, the testimony of Terrence Duffy, executive chairman and president of CME Group; and second, testimony of the Companies Supporting Competitive Derivatives Markets. Without objection, it is so ordered.

I now yield myself 5 minutes. I am not necessarily running down the whole list, since I can't get to that in 5 minutes. I will start though, with Mr. Parsons, since the thought is in my mind. So with central clearing, that of course is the way that we are going here, there is, though, another side to the cost factor with central clearing, is there not, and that is, is that now you are centralizing, hence the name, the risk, too. It is combining all of the risk in this one place. And under Dodd-Frank we gave the clearinghouses through Title VIII access now to the discount windows at the same time. So isn't there a potential for an additional cost and/or risk?

Mr. PARSONS. It is true that you now have the risk centralized, but you should be careful you are not just moving risk. Central clearing actually reduces risk overall. That is why so many exchanges at the end of the 19th Century and the beginning of the 20th Century moved to it, because it allowed them to sell more derivatives more effectively at lower cost, because the absolute amount of risk in the system was less.

Chairman GARRETT. Mr. Giancarlo, do you have a comment on that? And then secondly, do you have a comment on what you probably heard earlier today from the Commissioner with regard to CFTC on the SEF rulemaking?

Mr. GIANCARLO. Thank you, Mr. Garrett. We do. Our trade association, the WMBAA, supports central clearing of swaps transactions. I note Mr. Parsons' comment, which I take very well, that non-margin swaps equal credit risk. My concern would be that then it must be equally true that inadequately margined futures would also equal credit risk for clearinghouses. And as you note, with clearinghouses having access to the discount window I wonder whether in a few years, in the next market crisis, we may be back here where the clearinghouses are too-big-to-fail because the margin rules made an arbitrageable situation between swaps and futures, in favor of futures.

Chairman GARRETT. We have already taken care of that with the point on access to the discount window. They will just be able to get whatever they need and so they will never fail.

Mr. GIANCARLO. I think they said that about the big banks at one time.

Chairman GARRETT. Yes, exactly.

Mr. GIANCARLO. As I noted also in my testimony, I was very pleased to hear Chairman Gensler say that swap execution, in accordance with Congress' stated intent, will allow SEFs to use any means of interstate commerce. I think he said it will be technology neutral. And I think it is essential that technology neutrality be recognized in the rule itself so that there is no confusion on this as there are on a number of other rulemakings that have come out.

Chairman GARRETT. Thank you.

Mr. DeGesero, you probably heard my question. I was just curious about your comment with regard to position limits and where the CFTC is going right now with their court case and with their appeal on it, and also down their other track with regard to coming up with a potentially new rule on that. Do you have any thoughts on that?

Mr. DEGESERO. Thoughts regarding the parallel track?

Chairman GARRETT. The parallel track and also what the potential outcome will be on that. Obviously, the court has struck it down initially. I think you commented on that, but I will let you elaborate.

Mr. DEGESERO. I think Chairman Gensler said he needed to leave it to the General Counsel of the CFTC to respond. So I certainly am not qualified to respond to the parallel track question.

Chairman GARRETT. And with regard to their position thus far on the position limits and their appeal to that case, obviously the court struck it down.

Mr. DEGESERO. Right.

Chairman GARRETT. Right. Let me give you an opportunity to—

Mr. DEGESERO. The stated position of the CFTC is that they are appealing that, for which we are thankful. We think the position limits are long overdue, and we think that the court's ruling was completely erroneous. The Petroleum Marketers Association of

America must have testified 15 times, give or take, in the years leading up to the passage of Dodd-Frank. And while not every single one of those hearings was on position limits, it was certainly discussed in Congress.

The ruling is very narrow. Only in Washington are the words "is" and "appropriate" not known. I think it is unequivocal that Congress intended with the timeframes that were put in there and that the court overturned it on something called the Chevron part one or part two test, I think the will of the elected branch was explicit and the court overturned the will of the elected on a very narrow ground and sent it back.

Chairman GARRETT. And, Ms. Cohen, you mentioned the one word that we tried to get through on the previous panel, which was on sequencing, and if I am understanding your testimony correctly, the lack thereof perhaps as far as how the CFTC has handled matters, and I am not putting words in your mouth, versus how the SEC has handled matters. Do you want to elaborate on that?

Ms. COHEN. Sure. Thank you for the question. The CFTC probably more than any global regulator in the world has attempted to meet the 2012 deadline for derivatives reform. But in doing so, they have assembled a confluence of rules that really all go effective at the same time in the next couple of weeks. And we can contrast that to the SEC's approach, where they actually provided to the market a sequencing plan conditioned on certain foundational rules such as what product definitions. That is something the SEC did jointly with the CFTC. Entity definitions, who is a swap dealer, who is a major swap participant, they did that jointly as well.

But unlike the CFTC, the SEC has also said that they will make their cross-border rule a rule and foundational, just like product definitions and entity definitions, so we can take those three foundational pieces of information and build our implementation plan. They then went on to give categories of rules which related one to the other, which really helps effect and implement reform in a practical and thoughtful way.

Chairman GARRETT. Just to close before I yield, we tried to engage the FSOC in this matter as well, since they would presumably have some authority to say let's try to bring these parties together and sequence it or put that together an order, and we got not much of a positive answer back.

With that, I yield back. And I yield to the gentlelady who has her notes all there and ready—yes, there you go, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman. And I just think this is an outstanding panel. I guess I just want to say that Mr. Giancarlo's comment about Mr. Gensler preferring the futures market over the swaps market because of its jurisdiction, I guess I find that rather provocative. And I will let him respond a little bit, but I was more curious about what Mr. Parsons thought about Mr. Giancarlo's comments that this really creates a lot of regulatory arbitrage and unintended consequences. As an economist, I would like for you to comment on his testimony.

Mr. PARSONS. It is a very important problem, and the CFTC is kind of between a rock and a hard place, for two reasons. If you are talking about customized swaps, those are clearly different from futures and can only be dealt with in the OTC swaps markets. But, for example, all of these energy swaps we have been discussing that moved from ICE swaps into futures, those were not customized. Those are standardized instruments, they trade on an exchange effectively, they are cleared.

As long as you are dealing with standardized swaps, and if you require them to satisfy regulations, supervised transparency, and clearing, they are virtually, from an economist point of view, indistinguishable from futures. So now you definitely get to regulatory arbitrage. No matter what the CFTC does, any little difference in the regs for futures and swaps will send those standardized instruments to one or the other. But there is no way, when Congressman Neugebauer was discussing this earlier, he kept referring to Congress' intent. It is impossible for the CFTC to meet the intent of preserving standardized swaps, because once you do the things that Title VII requires—make them transparent, make them cleared—and they are regulated, supervised, which they weren't before, there is no fundamental economic difference with futures, and it is always going to be little regulatory differences that cause things to move one to the other.

Ms. MOORE. I did promise you could weigh in, yes, sir.

Mr. GIANCARLO. Thank you. Two quick points. If in fact all we have seen is a shift from swaps to futures without any change in the liquidity characteristics of the market, which I can vouch for because that is what we have seen and my members have seen, then there should be no difference in margin. There shouldn't be 5-day margin for swaps and 1-day margin for futures.

Second, if Congress intended to have a competitive trading landscape for swaps and if that competitive landscape is now migrating into futures, then we do have to ask ourselves whether the anticompetitive, single-silo, monopolistic structure of the futures market should continue for products that were formerly swaps and that Congress intended to trade through competitive venues and competitive clearinghouses.

Ms. MOORE. Thank you.

Let me ask Mr. Bopp a question regarding the inter-affiliate swaps. Can you speak to how the CFTC rules compare to a bill that we had, H.R. 2779, and whether or not you think that margin and clearing enhances the market for inter-affiliate swaps? Because I am thinking of companies in my jurisdiction who have really indicated to me that inter-affiliate trade, the credit risk really is not there when it is inter-affiliate, it is just a book entry for central risk and hedging purposes. So can you tell me how the CFTC's rule would apply?

Mr. BOPP. Sure. And you are absolutely right, Congresswoman Moore. This is an important issue and your bill is still needed. Now, the CFTC proposed rule is helpful, there is no question. They have created an exemption for inter-affiliate swaps that applies to non-financial end users. The problem is there are two key issues, two problems facing end users that are not addressed by the CFTC rule.

Number one, non-financial end users, there is an eight-step process or an eight-criteria process that non-financial end users must meet. And one of the criteria is posting variation margin between affiliates. Now, again, if you post, if you have to post variation margin between affiliates, the whole point behind an exemption from clearing requirements is defeated because your costs are roughly similar if you have to post variation margin.

Second, though, and very importantly, there are lots of companies, both in your district and throughout the country, that have Treasury hedging centers, and the CFTC rule doesn't do anything to exempt trades. So if you have a non-financial end user with a Treasury hedging center and that hedging center is facing the market, if what that hedging center was set up to do is enter into swaps, that hedging center will be deemed to be a financial entity. So now you have a financial-to-financial swap that is not eligible for the end-user clearing exemption even if the swaps are being entered into for a purely non-financial end user. It is a big problem, I know a number of you are hearing from companies about it, and it is not addressed by the CFTC rule.

Ms. MOORE. Thank you. Are we are going do have another round?

Chairman GARRETT. Maybe.

Ms. MOORE. Maybe.

Chairman GARRETT. The gentleman from Arizona.

Mr. SCHWEIKERT. Mr. Chairman, I am enthusiastically looking forward to the next round. This is one of those moments where there are just so many things I want to ask this panel. I do need to just touch on one thing just because it bothered me.

Mr. Parsons, if I remember in some of your testimony you actually come back and the staff committee preparation for this hearing, so you actually in here quoted the committee's hearing memo. I am not going to ask where you got it, but traditionally that is sort of—that is an internal document that we work on back and forth. It is sort of like your lawyer, somehow you getting my internal lawyer's prep memo. So someone sort of violated the mechanics and the internal rules I think we all live under. And that is as much being shared, so next year's committee knows that we are not supposed to go there. You have all started a conversation that—

Ms. MOORE. Mr. Schweikert, would you yield? Would you yield? I am sorry about this, but they are making me go. You know how staff are.

Mr. SCHWEIKERT. Oh, you are going to leave me.

Ms. MOORE. They are making me go. But I just wanted to know if I could ask unanimous consent to enter in the record something for the ranking member, a statement from Americans for Financial Reform.

Chairman GARRETT. Without objection, it is so ordered.

Ms. MOORE. Thank you. Can you give him back his time, Mr. Chairman?

Chairman GARRETT. More than he wants.

Mr. SCHWEIKERT. I want to hit on an overall theme that I have dealt with for the last 2 years on this committee, and that is the law of unintended consequences, because I have already seen multiple bits of conversation here saying the pop term of regulatory arbitrage. On one hand, we start to have the discussion of swap futures. But my understanding is margin should stay the same because margin is ultimately risk-priced. So in some ways I am not sure the way I was understanding what you are saying is completely fair. But let's first step out to regulatory arbitrage internationally.

Mr. Parsons, you have really smart people around you, the rest of you do, and Mr. Deutsch and I have had this conversation in the past. Do we wake up with our rule sets and first get an international arbitrage? And then second, with things like swap futures, are we even starting to see some movement in our own energy markets internally? And is that just rational economically, is you are going to go to where you perceive either the lowest cost of ultimately doing your trades? Am I barking up the wrong tree? Or first if you sat down with your really smart people, could you first find an international way to arbitrage some of the rule sets and then do you find a domestic way?

Mr. BAILEY. Thank you for the question. Clearly, the regulators have expressed and have endorsed a profound intent to eliminate regulatory arbitrage internationally. And I think you do see that very clearly in the efforts in relation to the margin for uncleared swaps and IOSCO and the regulators coming together. It is difficult to envision, though, that everything will be completely the same across the world. There will be instances of preference, there will be certain entities, be certain participants in the markets, pension plans who have slightly different rule sets that apply to them. And I think it is simply unrealistic to suppose that we are going to get complete harmonization.

Mr. SCHWEIKERT. And this is the hazard of doing these in 5-minute increments. The brilliant young man sitting behind me, we were sort of game theorying this earlier, what if I just routinely turned my swap into slightly customized, all of a sudden now did I just move it to sort of an OTC-type product. Anyone else want to? Am I complicating the simple? Ms. Cohen?

Ms. COHEN. I don't think you are complicating the simple. I think that is something we have to watch very closely. And we are seeing one instance, in the case of futurization, where investors are demonstrating where they think they will get the most efficiency in return. I would make the case in the example of futurization that these are also highly regulated markets, but it is a good example that we will see investor behavior driven by different rule sets. And a particularly good example is probably in the equity and the credit markets, where the CFTC and the SEC really do share jurisdiction of products that are traded often by the same trading desks and the same investor bases, where significantly different rules promulgated by the two regulators will likely encourage migration between the two products. So I think it is a really important question to ask now and to keep asking as the rules are finalized.

Mr. SCHWEIKERT. And this is to everyone on the panel. I actually have a real interest in this, because in sort of our game theory we have worked out what would happen if you have international affiliates? Are there certain things they could be trading that are meant that you keep solely on the book of the international even though ultimately it is trading at domestic risk? What happens if you break up your trading desk or your Treasury management now is sort of broken up through the organization? Does that move you out of some of the end-user rules and the obligations? If I started to customize the design in my hedges, do I get around some of the platform trades? So I am just trying to get my head around where are exposures and where are we going to walk into the law of unintended consequences.

Mr. Chairman I yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from Texas.

Mr. CANSECO. Thank you, Mr. Chairman. And thank you to the members of the panel.

Mr. Bailey, let's talk about the term "U.S. person." How, in your opinion, should it be defined?

Mr. BAILEY. We take the view that you have to be extremely careful in relation to funds and the treatment of funds and whether you are looking at a relationship where the investors themselves are U.S. investors or whether the fund manager is a U.S. person. We think that the CPO definition needs to be very much tidied up. We have questions around whether the principal place of business should be in the definition.

So we really do, at the IIB, we line up closely with the definition that the CFTC arrived at in the no-action letters that preceded October 12th, where they took the 7 prongs that they had in the original proposal and basically cut that down to 4½ prongs. And though that was specifically for the purpose of registration only, we think that as an interim definition that has some merit while the CFTC—

Mr. CANSECO. So you are happy with the CFTC's definition of "U.S. person?"

Mr. BAILEY. This is the definition that they revised on October 12th.

Mr. CANSECO. But in your opinion, how should it be defined, the way the CFTC does it, or how should it be defined?

Mr. BAILEY. How the CFTC had defined it on the October 12th for the purpose solely of what needs to be included in the calculation of whether or not you reach the de minimis trading limit to have to register is close to the appropriate definition that they should use for all the purposes under the statute.

Mr. CANSECO. So do you perceive any problems or have there been any problems over the uncertainty of defining "U.S. person" as it is defined by the CFTC?

Mr. BAILEY. Are you asking in relation to whether the marketplace has continued to be reticent to trade with U.S. persons in that regard?

Mr. CANSECO. Correct. On the definition of "U.S. persons."

Mr. BAILEY. That is an issue on which we only have some anecdotal evidence, and I think it would be difficult to depend on. I defer to Mr. Giancarlo's issue where I think he has stated that he has seen lately the reticence on the part of European institutions in some cases to trade with entities that may possibly fall within a U.S. definition if the CFTC were to adopt the wider definition that they had originally proposed in July. The uncertainty issue is still there.

Mr. CANSECO. Do you have an opinion whether or not a broad definition is a good idea or a bad idea?

Mr. BAILEY. A broad definition brings into play considerable risks in relation to introducing higher levels of conflict, because entities that are present in Europe and Asia would fall within that definition with the result that the local rules may very well apply, would likely apply to them, as well as the U.S. rules, and that puts increased pressure on the need for substitute compliance to resolve that issue.

Mr. CANSECO. I have a short time. Mr. Giancarlo, do you want to weigh in on this U.S. person definition?

Mr. GIANCARLO. We have not taken a view, my organization has not taken a position on that, and I don't wish to take one. All I do wish to say, though, is harmonization is absolutely critical if we are not going to balkanize global trading markets and discriminate against U.S. trading participants.

Mr. CANSECO. Thank you.

Now, Mr. Bopp, I represent a district that is home to a large energy industry as well as farmers and ranchers who use derivatives to manage risk. Why should Congress exempt non-financial companies from the margin requirements?

Mr. BOPP. That is an excellent question. And the answer is because non-financial companies don't engage in the sorts of trades that create risk that would warrant margin requirements. Non-financial companies enter into derivatives transactions to manage risk. And baked into Dodd-Frank is a requirement that if a non-financial company is going to be eligible for the end-user clearing exemption, they can only be eligible if they are hedging commercial risk. And so the types of transactions that they enter in, that end users enter into, and the fact that they are not speculating, they are managing their risk, in other words that the transactions offset risk within the company, all suggest that—not just suggest—but that margin requirements on non-financial companies are not only not needed, but would impose additional costs that simply are just not—that would be detrimental to these companies.

Mr. CANSECO. So do you feel that the actions by regulators have carried out the intent of Congress or do you feel that there is still some ongoing confusion regarding the end-user exemption?

Mr. BOPP. We do not. We do not feel that the actions of regulators have carried out faithfully the intent of Congress. We do think that the CFTC margin rule is better and closer to the intent of Congress than the prudential regulators margin rule. But the prudential regulators margin rule would impose margin requirements on end users. And they believe, the prudential regulators believe that the Dodd-Frank Act, as written, handcuffs them and does not give them enough authority such that they don't have to impose margin requirements on end users. We simply do not believe that regulators should be in the room second-guessing the decisions made by corporate treasurers and their swap dealer counterparties.

Mr. CANSECO. Thank you, Mr. Bopp. I see my time has expired.

Chairman GARRETT. The gentleman's time has expired. We will just run through—I have a couple of questions, but I won't take the whole 5 minutes.

Mr. Deutsch, we have talked earlier about October 12th and prior to that and all the exemptions that have come out from that point in time. Can you speak to your position with regard to the exemptions, which are obviously temporary, right, with regard to commodity pools and basically, as I understand the situation, in securitization, that you basically have swaps within the securitization and the exemption gives you some really temporarily on this but not overall? What does that do to the marketplace now and what relief permanently you would be looking for?

Mr. DEUTSCH. Sure. Over the summer, I think the securitization market kind of put a lot of pieces together and realized that the commodity pool regulations may actually rope in securitizations to be called commodity pool operators which are by definition operated for the purpose of trading in commodity interest. Most plain-vanilla securitizations, auto loan securitizations, credit card, mortgage securitizations, really aren't conceived at all for the purpose of commodity interest, but instead to fund credit fundamentally. We approached the CFTC in June and many follow-up letters and dialogue with the CFTC staff and Commissioners and Chairman Gensler himself to get appropriate relief to make sure it is very clear that securitization should not be roped into those commodity pool regulations.

Chairman GARRETT. Part of the argument there is that securitization is already regulated.

Mr. DEUTSCH. Correct. There is a significant amount of regulations from the SEC and other various parts from, say, Dodd-Frank and otherwise, and particularly the transparency issues, if a securitization has a swap in it the disclosure requirement's required by the SEC, not from the CFTC.

So we are already effectively sort of covered by the transparency-related issues. The real question is, does securitization use swaps for kind of investment exposure to take investment risk? And in most instances they don't take any investment risk, they are really trying to hedge risk for the investor's benefit to eliminate, say, currency or interest rate swaps. So far, we have gotten no-action relief or interpretive guidance both on October 11th and then also most recently this past Friday that provides for some legacy relief from the staff for all outstanding transactions and then extension of the compliance deadline for other transactions until March 31st. So we look forward to working with the CFTC staff on the additional transactions that their relief hasn't covered already. There are certain types of transactions that still may not fall within the four corners of that relief.

But the hope is that these transactions and the market participants simply don't have to start preparing to comply when they won't have to comply, in effect. There are many types of transactions that just clearly aren't commodity pool operators, and so far at this point, we have gotten most of what we need, but I think there are still some key areas to evolve the guidance by March 31st.

Chairman GARRETT. Okay.

One other question. Ms. Cohen, you heard the previous discussion with regard to definition of U.S. personnel. Do you want to share your perspective there?

Ms. COHEN. Absolutely. Thanks again for the question. We do think that there are risks to a "U.S. person" definition that is too broad. One of the risks—we were talking earlier about unintended consequences—is again that you can have a market participant who is a U.S. person, an EU person, and maybe not an SEC U.S.

person, and that market participant could potentially optimize around what person or combination of people they want to be. And that is potentially an unintended consequence.

I think really the guiding principle, I think that the U.S. person definition has to be addressed in two ways. Number one, the immediate need for a clear, consumable definition, and specifically the one to which we have been implementing, so that we can go live with a number of very important rules, such as SDR reporting business conduct that will really position us showing leadership to the rest of the world on key aspects of derivative reform. We need that clarity so that we can start in the next 3 weeks.

And then over time, in consultation with other stakeholders here and around the world, whatever definition of U.S. person is ultimately decided upon has to be something that is clear, consumable, and not debatable from firm to firm. We don't want firms competing on whether or not they see a specific entity as a U.S. person. And I would add that one of the accomplishments of Dodd-Frank that is already under way is that all entities that participate in the financial marketplace register for legal entity identifiers, and when they do that, they register a country of organization. I can go to the Web site, you can go to the Web site, we can all see whether their country of organization is in the United States or not. That is the level of clarity that we need for the "U.S. person" definition.

Chairman GARRETT. So it sounds like where we stand now, we are creating a schizophrenic definition, schizophrenic U.S. person with multiple personalities.

Ms. COHEN. The clients that I talk to every day cite that as their number one confusion.

Chairman GARRETT. Okay. My time is up. The gentleman from Arizona for last questions.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Giancarlo, okay, I am sorry, back to our running through this before. Okay. So on swaps futures what would you change?

Mr. GIANCARLO. We believe, and I just want to clarify my remarks before if they weren't clear, we believe that margins should be the same for economically equivalent swaps or futures. The name should not determine the margin if they are economically equivalent. Perhaps you didn't understand that.

Mr. SCHWEIKERT. And we may have to drill down into that one, because I think I have a couple of articles that talk about, and maybe I need to learn more on sort of the risk side on the margins actually being somewhat equivalent.

Mr. GIANCARLO. But, say, in the North American natural gas and electric power markets, which were formerly swaps and that moved over the course of a weekend into futures, the liquidity in those markets did not change. But what changed from Friday to Monday was the margin that market participants—

Mr. SCHWEIKERT. Was the margin also the fact of having to go do the types of registration?

Mr. GIANCARLO. The registration for non-traditional dealers facing the prospect of registering as dealers drove them into futures, so the regulatory arbitrage drove it. But also, the margin changed. And the point I was making is that we are creating systemic risk if in fact—

Mr. SCHWEIKERT. Back to the original part of the question, what would you change? If you saw this as a problem, what would you fix?

Mr. GIANCARLO. Okay. So a number of things. The first is the margin, as I said. Second, there are a number of other arbitrageable differences. One is in fact that exchanges set their own block trade sizes. Those are commercial entities. They take commercial advantage of that. In swaps the CFTC has taken for itself the right to set block size notwithstanding, I think, the fairly clear language of Dodd-Frank that says that SEFs should be setting block sizes. So now in one case of futures you have exchanges setting block sizes, in the case of swaps, you have the regulator, the non-commercial regulator setting block sizes. And that is going to be another opportunity for arbitrage for market participants in choosing one product over another.

Another area is the timing of trade reporting. Congress established a swap data reporting regime for swaps. That regime doesn't exist in futures. Arguably, that regime is what Congress intended, but now we are seeing products move away from Congress' intention to have that type of reporting regime. There are business conduct rules that apply to swaps that don't apply to futures. So there is a whole series now of implications of that movement from one product to the other, but there is no real change in the economic nature of the products themselves.

Mr. SCHWEIKERT. Okay. And this is for anyone else on the panel, probably Mr. Deutsch. Is this something I should fret about?

Mr. DEUTSCH. I think the margining rules that we focused on are something that we fret about quite consistently and are very concerned about on a go-forward basis, that if securitization transactions, as an example, are required to post margin, particularly liquid margin, in the 10 to 20 percent range on a deal, reducing consumer credit by $4 billion to $8 billion in the auto market today, that would significantly change the auto landscape, we think.

Mr. SCHWEIKERT. Do others on the panel see a migration here? Is this sort of the unintended consequences? Mr. Parsons?

Mr. PARSONS. Yes. I think there is a certain amount of inevitability here. When the Dodd-Frank Act was passed, the OTC swaps market sold itself as doing customized instruments. Now we are learning that a vast amount of what the OTC swaps market does is economically equivalent to what can be done on the futures market. So you have to eventually decide should the swaps regulations be set for a market that is customized, which will be one set of regulations, or should it be set for a market that is standardized. But right now it was done as if they were all customized but they aren't.

Mr. SCHWEIKERT. Yes. And that was almost where I was before in the previous question. Does anyone else think this is worthy of our focus?

Mr. BAILEY. Speaking as Barclays, rather than the IIB, I would just note that it is perhaps a curiosity that a market maker in swap futures doesn't have to register as a swap dealer, which I think was part of the reason why that was such a critical date, the October 12th instance, that it precluded you from having to count obviously those swaps in the tally whether or not you had to register. But I would say that absolutely futures has a place in the future representation of the derivative market for swaps. It is just a question of whether or not it is intellectually consistent with the treatment of other products in the same space.

Mr. SCHWEIKERT. And there becomes my fear of a market that actually seems pretty efficient, the fear of actually doing damage when we are trying to make other things work at the same time, and back to our law of unintended consequences.

Mr. Chairman I yield back. Thank you.

Chairman GARRETT. Thank you.

And the gentleman from Texas with a final word.

Mr. CANSECO. Thank you, Mr. Chairman. Just a few follow-up questions.

Ms. Cohen, with regards to cross-border regulations, do you feel that the SEC and the CFTC should harmonize the cross-border approaches before implementing them?

Ms. COHEN. I think, just like product definitions and entity definitions, cross-border application of the derivative provisions is foundational to implementing derivatives reform. And I would also note that a major area of distinction between the U.S. approach to derivatives reform and the rest of the G-20 is that we do have these two regulators who are responsible for different products, and that creates confusion, more confusion around the rest of the world as they look and try to understand the system to which we are implementing. So I think that there are certain areas where it is much more acute than others that the two regulators coordinate tightly, and cross-border guidance is one of the most significant.

Mr. CANSECO. Thank you. Would anyone else on the panel like to weigh in on this issue?

Mr. Bopp, following up what I was asking earlier, if regulators decide to impose margin and capital requirements on end users do you feel there is a possibility that companies could begin to use markets outside the United States to manage their risk, in other words a flight of business out of the United States?

Mr. BOPP. It is an excellent question, and it is a question that I think our member companies have to think about. We heard from Chairman Gensler that the CFTC is trying to make its rules coherent and consistent with foreign rulemaking as well. If the prudential regulators, if we can bring them in and the rules can become consistent and consistently applied, we are still hopeful that we can get some relief from margin requirements on a regulatory basis and not have to have legislation passed. Now, that said, the legislation is still critical at this point because, as Chairman Bernanke testified earlier this year, the Fed believes that its hands are tied and that it has to impose margin requirements even on non-financial end users.

Mr. CANSECO. So you think that it will jeopardize the flight of business out of the United States and into other markets?

Mr. BOPP. I think that is an option that companies have to think about. And I know that some certainly are giving it some thought. I don't think that it is an option that they want to take advantage of. I think that what companies are hoping for is some rationality, and that congressional intent behind Dodd-Frank will eventually prevail.

Mr. CANSECO. Thank you, Mr. Bopp.

I yield back.

Chairman GARRETT. The gentleman yields back. That concludes the questioning. And I very much thank this entire panel, both for your testimony that you gave here just now and also for your written testimony which we and our staffs have reviewed previous to this. So I thank you for that. I get a lot of different takeaways from this. And it was good that we had this panel following the first panel to see actually how the implementation of Title VII by the CFTC specifically is panning out, and we may be actually getting into that, as I said before, schizophrenia situation on more ways than one as far as this plays out in the weeks and months ahead.

So I thank this panel.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is now adjourned. Good day.

[Whereupon, at 1:50 p.m., the hearing was adjourned.]

A P P E N D I X

December 12, 2012

Testimony of

Keith Bailey

On Behalf Of The

Institute of International Bankers

Before the

U.S. House of Representatives

House Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

"Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act"

December 12, 2012

Chairman Garrett, Ranking Member Waters and members of the Subcommittee. My name is Keith Bailey. I am a Managing Director in the Markets Division of Barclays where I have responsibilities for evaluating and implementing the changes to our derivative businesses globally resulting from the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). I have over twenty five years of experience in the derivatives market, both here in the U.S. and abroad. I am very pleased to be here today to testify on behalf of the Institute of International Bankers (IIB) on the implementation of Title VII of the Dodd-Frank.

The IIB represents internationally headquartered financial institutions from over 35 countries around the world; its members include international banks that operate branches and agencies, as well as bank, securities broker-dealer and futures commission merchant subsidiaries in the United States. In the aggregate, our members' U.S. operations have more than $5 trillion in assets and provide 25% of all commercial and industrial bank loans made in this country and contribute to the depth and liquidity of U.S. financial markets. Our members also contribute more than $50 billion each year to the economies of major cities across the country in the form of employee compensation, sponsorship of local and national charities, tax payments to local, state and federal authorities, as well as other operating and capital expenditures.

In my testimony today I will address the continuing uncertainties surrounding the cross-border application of Title VII's swap dealer requirements as a result of unresolved issues regarding how to interpret the statutory mandate that Dodd-Frank's swaps requirements do not apply outside the United States unless those activities have a "direct and significant" effect on commerce in the United States. I will focus in particular on registration requirements; the compliance challenges facing foreign headquartered banks and their clients resulting from lack of clarity on what may constitute a US person; and the narrow scope of the substituted compliance regime set forth in the cross-border guidance proposed in July by the CFTC.

The IIB wishes to recognize at the outset that both the CFTC and the SEC have had to deal with an enormous number of complex rulemakings, many of which have interlocking dependencies. There has been no lack of effort by the Commissioners and their dedicated staff in facing this challenge and responding to the many requests for relief submitted by the industry. We support the CFTC's choice to address the swap clearing rules as an initial priority and to focus on the reporting requirements early to promote sound and transparent markets. We look forward to continuing to work with our home country regulators and policymakers here in the U.S. to implement these fundamental reforms with the least amount of market disruption.

The Committee's focus on the challenges to the U.S. capital markets in effectively implementing Title VII is most timely. Recently, the CFTC held a meeting of its Global Market Advisory Committee with regulators in attendance from the European Union, Japan, Australia, Canada, Hong Kong and Singapore. These foreign regulators raised serious concerns over the potential for conflicting rules due to the perceived lack of coordination between U.S. market regulators and the extraterritorial application of U.S. rules. As Patrick Pearson, Head of the Financial Market Infrastructure Unit for the European Commission, stated:

> There are a lot of known knowns that we can already draw conclusion on today as to why proposed approaches across the globe simply won't work. They won't mesh. They won't interact. They will cause conflicts. They will cause inconsistencies. They will cause gaps. And in the end the conclusion is many of the G20 requirements and expectations won't be met not because lack of good will, but because we need to take a wider view of how our rules work on a cross-border basis in this global market.

The IIB and its members, which include many of the most active global swap market participants, support effective implementation of the G20 reforms. However, the current uncertainty seen in global markets results in significant part from implementation dates being effective for various requirements before relevant final rules have been published by the market regulator, which prevents market participants from making fully informed decisions regarding to which regulations they are subject and how to be compliant. In my testimony today, I will propose steps that might be taken by the market regulators to provide necessary near-term relief in advance of the regulatory-prescribed December 31, 2012 swap dealer registration deadline, and recommendations on long-term solutions that could provide a clear path forward for global implementation.

The Challenges Surrounding Swap Dealer Registration

The cross-border aspects of swap dealer registration are indicative of more general concerns with the Title VII implementation process that are broadly held by both foreign and domestic firms.[1] It is evident that many IIB member firms' foreign-headquartered parent entity will have to register as a swap dealer.[2] There are, however, many unanswered questions regarding how the applicable requirements of Title VII will apply to their head office swap dealing activities – and in particular how the term "U.S. person" is defined and what "substituted compliance" will entail. For others, the threshold question of whether the foreign parent entity (or a non-U.S. affiliate) will have to register in the US as a swap dealer depends in critical part on whether reliance can be placed on the so-called *de minimis* exception[3], which in turn depends on the answers to key questions such as how the aggregation rule[4] is applied and, again, how the term "U.S. person" is defined for this purpose. None of these matters have been resolved, despite industry-wide efforts seeking such resolution, yet each is fundamental to determining who has to register as a swap dealer; to whom various transaction level requirements will apply under Title VII, and how substituted compliance may be accomplished.

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[1] While my testimony addresses Title VII's swap dealer requirements, it merits noting that significant questions have also arisen regarding whether their swap-related activities may require persons to register as an introducing broker, commodity trading advisor or commodity pool operator, as well as whether a person fits within the definition of an "eligible contract participant" under the CEA.

[2] A survey of our members found that a significant majority of them plan to register their head office as a swap dealer while others are struggling to manage their group's U.S.-facing swap activities within the limits of the *de minimis* threshold.

[3] The *de minimis* exception currently is set at $8 billion in notional amount of swaps, but includes a much lower threshold – $25 million in notional amount of swaps – for swaps with "special entities". In the context of transactions with asset managers whose clients include special entities, a firm may not learn until after the trade that a swap dealing transaction it has entered into with the asset manager has been allocated to a special entity, but it appears that the trade would be treated has having been made with the special entity, thereby posing very difficult compliance challenges for a firm that plans to remain under the *de minimis* threshold.

[4] The aggregation rule requires a non-U.S. entity, in determining whether it qualifies for the swap *de minimis* exception, to aggregate its swap dealing transactions with "U.S. persons", with the transactions of all of its other non-U.S. affiliates that are with "U.S. persons".

Scope of Registration

These uncertainties have real impact on markets. Several European and Asian market participants leading up to October 12 ceased to trade with any counterparty that might possibly fall within the "U.S. person" definition – even in non-U.S. markets and in respect of both U.S. dealers providing liquidity to these market participants and their clients to whom they, in turn, provide liquidity - so as to mitigate the risk of their needing to register.[5]

The CFTC provided an interim definition of "U.S. person" in a no-action letter dated October 12th. This action has been helpful in permitting foreign banks to continue to deal with offshore branches of U.S. swap dealers, or their offshore subsidiaries, without these transactions being counted towards the *de minimis* threshold that would require the foreign bank to register as a swap dealer. However, this relief expires on December 31st. Absent further guidance from the CFTC, uncertainty pervading the market regarding the definition of "U.S. person" will return and once again certain market participants almost surely will restrict their dealings with any counterparty or client, including offshore branches and subsidiaries of U.S. swap dealers, that may prospectively fall within the "U.S. person" definition

Aggregation

Exacerbating the uncertainties resulting from the lack of a final "U.S. person" definition, the CFTC's overly broad "aggregation" requirements have not yet been adequately addressed, thereby seriously impeding firms' determinations of whether one or more of their off-shore affiliates are required to register. While we understand the purpose of the aggregation rule is to prevent evasion, it effectively eliminates the *de minimis* exception for any financial group that

[5] *See, e.g.*, "Banks Opt Out in Swap Row," The Wall Street Journal, October 22, 2012 online edition (http://online.wsj.com/article/SB10001424052970203400604578072221988442386.html).

has already determined to register with the CFTC one or more off-shore swap dealers. The potential consequences are especially anomalous in those foreign jurisdictions which require firms to operate through local subsidiaries. Each affiliate of a non-U.S. registered swap dealer in these countries would themselves become subject to U.S. swap dealer registration if they provided even just one U.S. customer with access to its local market. Left unchanged, the aggregation rule would significantly increase the number of entities subject to swap dealer registration which demonstrably have no "direct and significant" effect on commerce in the United States. In one instance, for example, inclusion in the aggregation rule of swaps by registered swap dealer affiliates within a group would result in the registration of almost 30 group companies, whereas a more reasoned application of the aggregation requirements for the *de minimis* exclusion would reduce the number to not more than 5.

If fear of evasion is the driving factor behind the aggregation rule, then we would submit that anti-evasion rules or the basic *de minimis* threshold test would be sufficient to address the CFTC's concerns. As things stand at present, many non-U.S. entities are incurring the expense of preparing to register as swap dealers with the CFTC, notwithstanding the minimal nexus and impact their swap dealing activities have to the United States.[6] The only way at present an entity that may be subject to registration by reason of the aggregation rule can avoid registration is to cease dealing with counterparties that might be treated as a "U.S. person". We do not believe this result was intended by Congress, and urge the CFTC to address this issue promptly.

[6] For those firms that decide to avoid swap dealing with "U.S. persons" (however defined) altogether, and thus choose to "run off" their U.S. swap positions in place before October 12th and refer any new U.S. business to a member of the group that plans to register, the lack of certainty regarding how these so-called "legacy swaps" will be treated for swap dealer registration purposes adds yet another layer of uncertainty. The CFTC is considering a joint request by the IIB, FIA and SIFMA to provide no-action relief with respect to this matter.

Reporting and EBCS – Post Registration Day One Compliance Hurdles

These registration challenges are compounded to the extent that some aspects of compliance are not entirely within firms' control. For example, the external business conduct rules in effect require swap dealers to "re-onboard" their swaps client that fall within the "U.S. person" definition. ISDA has developed a Protocol to facilitate this process, but many counterparties are unwilling to sign the ISDA Protocol because of the continuing uncertainties regarding the definition of "U.S. person" and how the swap rules may apply extraterritorially.

Such uncertainty is creating two known challenges for compliance purposes in the near-term. First clients may believe that they are out of scope based on their interpretation of the new proposed regulatory "U.S. person" definition, but the swap dealer industry may believe they are in scope. In this case, swap dealers will be unable trade with such clients beginning January 1, 2013 because the clients, believing they are out of scope, will not agree to sign the ISDA Protocol. Second, clients may believe they fall within the scope of "U.S. person" even though it was not the goal of the CFTC to capture them through the definition. This situation creates an even further complexity for a client that elects to apply Dodd-Frank rules/protections, which may conflict with swap dealer regulatory obligations for transactions with the client under other regimes.

Privacy Laws

Local jurisdiction privacy laws are another compliance hurdle outside the scope of an individual firm's control. Currently, certain jurisdiction's laws will not permit data reporting as contemplated under the CFTC's cross-border proposal based on the home country regulator's interpretation of Dodd-Frank's regulatory reporting requirements. Some affected jurisdictions are key economies such as France, Singapore, Luxembourg, South Korea and China. The CFTC's response – simply not trading in such jurisdictions in order to avoid the regulatory conflict – raises fundamental trade constraint issues. This matter calls for further analysis before finalizing any cross-border guidance or at least requires interim relief. Foreign governments recently submitted letters to the CFTC stating that the U.S. regulatory position in this area is potentially inconsistent with the G20 commitments. For example, the definition of "U.S. person" in the CFTC's proposed cross-border guidance may be expansive enough to also cover persons that are French entities for privacy law purposes, such as a fund incorporated in France with U.S. investors. French privacy laws are stringent; a breach carries severe penalties and client consent may not be sufficient. Swap dealers should not be left in the position of having to breach either the CFTC's reporting requirements or French privacy laws. It is essential that global regulators coordinate to address and resolve such conflicting requirements. It is not an issue that can be put on swap dealers alone to solve.

New Regulatory Definition of "U.S. Person"

Overall, the CFTC and SEC have taken different approaches in implementing Title VII. Even though the Commissions have finalized joint rules for foundational definitional elements such as "swap", "security-based swap", "swap dealer" and "security-based swap dealer", there is a divergence in process and timing for the consideration and adoption of rules governing how swap products are offered to clients. With respect to the cross-border aspects of Title VII, there is a very real concern that the CFTC's cross-border application of its rules, including with respect to its definition of "U.S. person" and its adoption of a "substituted compliance" regime, may differ from cross-border application of the SEC's rules, thereby significantly impeding and complicating the compliance efforts of market participants active in trading both swaps and security-based swaps. In addition, the significant difference in compliance timelines may lead to complications in the future, as the systems and processes developed by firms to comply with CFTC rules may have to be re-engineered to comply also with SEC rules.

In addition, we face the prospect that the CFTC and the SEC may adopt final "U.S. person" definitions that are not the same. Equity and credit derivative markets both involve indices and transactions on single names that trade in close relationship at a desk level. The lack of a uniform "U.S. person" definition is likely to fractionalize the market since different rules will apply to different components of the same market.

The CFTC's phase-in rules for the mandatory clearing of swaps provide a vivid illustration of the urgent need for clarity regarding the "U.S. person" definition and its application to cross-border swap dealing transactions. Under these rules, transactions between swap dealers and "active funds" involving any one of a set of interest rate swaps and credit default swaps designated by the CFTC must be centrally cleared starting March 11, 2013.[7] Whether or not an "active fund" is a "U.S. person" is critical to determining whether such a trade must be centrally cleared in accordance with the CFTC's rules. Those "active funds" in Europe and elsewhere outside the United States that are in the "grey zone" as to whether or not they will fall within the "U.S. person" definition, clearly need to know as soon as possible whether or not they are going to be required to clear trades pursuant to the CFTC's rules starting less than three months from today. An expansive "U.S. person" definition will bring into scope many funds outside the United States which heretofore would not expect to be subject to these requirements. "Active Funds" to which the clearing mandate applies because they may be a "U.S. person" but

[7] An "active fund" is a private fund whose swap trading during a prescribed period exceeds a regulatory-prescribed minimum.

which are not ready by March 11 to have their trades in designated swaps cleared in compliance with the CFTC's rules will have to either trade exclusively with non-U.S. swap dealers or not trade such swaps at all until they are able to do so in accordance with the CFTC's rules.

<u>"Substituted Compliance" and the Need for International Coordination</u>

The cross-border implementation of Title VII's requirements involves the overlay of a new regulatory regime on an established global market. This process, accordingly, requires close coordination with initiatives underway in other countries which, at the same time and with the same commitment as the United States, are working diligently to implement the OTC derivative reforms agreed to at the September 2009 G20 Summit. We support the efforts of the global regulatory community and the recent joint statement they published on working toward a solution in the near term to address scope and conflict of law issues.

The CFTC's proposed cross-border guidance in some instances allows for "substituted compliance", an approach which the IIB and its members in general support. However, the manner in which the CFTC conceives of and proposes to apply substituted compliance does not comport with international regulatory expectations of a substituted compliance regime. The CFTC proposes to apply substituted compliance in a manner that appears to be more granular in nature than is the case in other countries. Foreseeable challenges resulting from this approach include the following:

- Non-US regulators may not take a prescriptive view of rulemaking. For instance, the U.K. has a principle-based rule against conflicts of interests, whereas the CFTC has identified specific conflicts and prescribed rules for those (*e.g.*, Chinese walls between clearing and execution businesses).

- The substituted compliance regime needs to allow for the differences in timing with respect to implementing of swap market reforms by various regulators, either by allowing for submissions based on proposed rules or providing additional time.
- Uncertainty remains as to what the substituted compliance process will entail and what the timetable will be. In this regard, the proposed exemption to July of next year is helpful but regulators need to coordinate more closely with each other so that the timing is better aligned, plus the proposed exemption is just that. If the exemptive order is not issued in final form in the very near future, there will be no substituted compliance in any form and U.S.-registered swap dealers will be required to comply with both U.S. and home country entity level requirements.

In addition, clarification is required as to the determination process, and an appropriate timeframe should be put in place that clearly gives firms appropriate time post-determination to either implement entity level requirements or avail themselves of substituted compliance, especially given that substituted compliance may involve large enterprise-wide requirements. Instead of determining substituted compliance on the basis of individual requirements, substituted compliance should be based on a principles-based, holistic evaluation of a jurisdiction's "entity-level" requirements, on the one hand, and "transaction-level" requirements, on the other.[8] Because entity-level and transaction-level regulations have generally been handled separately outside the United States, this would be consistent with an overall approach based on regulatory recognition of emerging global norms in the regulation of OTC derivatives. In addition, it avoids creating a situation in which a local regulator's rules cannot be enforced effectively due to lack of jurisdiction.[9]

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[8] Regarding margin requirements for uncleared swaps, for example, such a principles-based approach calls for recognition of comparable requirements in other jurisdictions, such that where a regulator in one jurisdiction adopts margin requirements for non-centrally-cleared swaps that are comparable to those of a second jurisdiction, the regulator in the second jurisdiction would permit entities organized in the first jurisdiction to comply with the first jurisdiction's requirements in lieu of requiring compliance with its own requirements. Where a comparability finding cannot be made, the situation should be resolved giving due regard to comity principles.

[9] In addition, we note that some foreign regulators have communicated to firms that they reserve the right to ask them to move activities conducted by a local entity that would trigger registration as a swap dealer in the U.S. out of the local entity in order to limit the extent of any extraterritorial conflict with their own rules.

<u>Conflicts of Laws</u>

The risk of conflicts between jurisdictions' laws will remain high until global regulators agree to a process to regulate persons, transactions or entities with respect to cross-border activity where more than one regulatory regime applies. There are many examples of potential and probable conflicts that illustrate the problems presented by the approach taken in the CFTC's proposed cross border guidance.

Application of the clearing and execution mandates provides the most evident example. For example, if an entity based in Europe falls within the "U.S. person" definition, then that entity will very likely be subject to both the U.S. and EU regulation as to which swaps have to clear; on what clearing house they have to be cleared, and on what specific venues such a trade must take place. An overly broad "U.S. person" definition will likely bring into scope many funds managed in the EU. If the U.S. rules require such a trade to clear exclusively on a U.S.-regulated clearing house but the EU rules require that trade to clear exclusively on an EU-.regulated clearing house, then that entity cannot execute that trade without being in breach of one set of rules or the other. Consequently, that trade will not take place, and the entity will have to resort to less optimal ways to eliminate risk. This introduces costs that pass to the ultimate consumer and adversely impact the economy by introducing risk into the system.

Similar conflicts may arise with respect to execution mandates. For example, both the U.S. and EU rules provide for regulatory oversight of the execution protocols for a transaction. However, the U.S. and EU regulations are not technically identical even though they both meet the goals under the G20. Unless the international regulatory community agrees to a principles-based approach for recognizing regulations in foreign markets where there are redundant rules for the same transactions, market participants face the unintended outcome of the inability to execute transaction for products that clients use daily to hedge risk. It is essential that international regulators eliminate these conflicts by recognizing as equivalent each other's trading venues for the purpose of meeting the "trading on platforms" mandate. Any other outcome will result in severe market disruption.

The alternative approach to minimizing these conflicts is to go down the path of subsidiarization, under which, for example, U.S. persons must transact only with a U.S.-incorporated entity and in accordance with U.S. regulation and a European Union client must trade exclusively with a dealer established in the EU under EU regulation and so forth. We believe that such an approach is not a realistic solution and would introduce numerous new systemic risks, create fragmented markets resulting in reduced access to markets and dramatically increase clients' costs.

International Implementation of G20 Commitments for OTC Reform

The potential for cross-border conflict poses very difficult challenges for firms. While the timing of efforts to implement OTC derivatives reform around the world is not entirely coincident, there is substantial alignment among the approaches taken in various countries and intensive implementation efforts are underway. There is an urgent need for harmonization as jurisdictions, which represent the majority of trading activity, work to reach their G20 commitments. The European Market Infrastructure Regulation (EMIR) is now law and final technical standards are expected to be approved by the European Commission by the end of the year with implementation dates during 2014. Mandatory clearing of certain transaction began in Japan on November 1st, and in September the Japanese Diet approved trading platform and market transparency legislation. Thus, there is very substantial progress in key jurisdictions toward implementing a dynamic and effective swaps regulatory regime, and certainly U.S.

authorities should take these developments into account when contemplating the need to extend their requirements outside the United States. European and Japanese regulators have for the time being deliberately not applied their rules on a cross-border basis in an effort to achieve harmonization among jurisdictions. Absent a satisfactory resolution of these cross-border issues, it is entirely possible that the extraterritorial application of U.S. swap regulation may result in other jurisdictions likewise applying their swap regulations extraterritorially to the potential detriment of U.S. firms. For example, it is conceivable that failure to reach a satisfactory resolution of the difficult "substituted compliance" questions raised by the CFTC's cross-border proposals could have very adverse consequences for U.S. firms' ability to trade from the United States with counterparties located in the European Union.

Need for Certainty: An Interim Solution [10]

It would be preferable to place the implementation process on a more stable footing and allow longer implementation periods based on firms' good faith compliance efforts instead of providing abbreviated periods that are virtually certain to result in additional requests for relief as the time period expires. Efforts to implement aspects of Title VII in as expeditious a manner as possible have resulted in confusion in the market and significantly heightened compliance risk. These unintended consequences can be avoided by modifications to the process that the regulators, with Congress' support, should undertake to ensure the law is implemented in a timely manner but with the least disruption to swap dealers' ability to serve their clients' needs. I suggest below how such an approach can be put in place with respect to cross-border issues.

[10] Regarding another matter that is that is creating significant market uncertainty and is critical to foreign banks under Title VII, the IIB would like to thank the Committee for taking action earlier in the year to approve legislation containing a technical fix to Section 716 of Dodd-Frank, the so-called Swap "Push Out" Rule, to provide parity for the uninsured branches and agencies of foreign banks vis-à-vis insured depository institutions. We are now many months closer to the July 2013 deadline for the swap push out, and this matter merits urgent action.

The need for clarification and certainty for firms prior to December 31st cannot be overstated. As mentioned above, already we have seen some foreign firms declare that they will cease doing swaps business with counterparties that might be designated under the CFTC's rules as a "U.S. person". Moreover, counterparties themselves have indicated their reluctance to trade with firms that might be designated as a "U.S. person". The prospect of fragmented liquidity in the market resulting from ongoing uncertainty regarding Title VII's extraterritorial reach is very real. We strongly encourage continued dialogue among the CFTC and its counterparts overseas, but this should not forestall in any way measures that provide interim relief that will enable firms to commence business as registered swap dealers in a manner that avoids cross-border conflicts and facilitates compliance with all applicable requirements. Perfecting a long-term approach to cross-border issues cannot take precedence over finalizing transition relief.

In the current circumstances, firms have made essentially irreversible implementation decisions based on what was proposed, particularly the exemption from entity-level requirements for non-U.S. registrants and the application of transaction-level requirements solely to swaps by such registrants with "U.S. persons". In addition, as noted above, there are very substantial policy and practical issues, most notably in the areas of the "U.S. person" definition and the aggregation component to the swap dealer "*de minimis*" exception, that remain unresolved. Without a satisfactory resolution of these uncertainties, there will be very significant disruption to the markets that may well undermine global coordination efforts.

To address these concerns, the IIB has requested the CFTC to issue an interim exemptive order that would include the following:

- Provide interim relief from the aggregation component to the swap dealer "*de minimis*" exception until next July, so that the CFTC has additional time to consider the nature of any more definitive changes to the rule.

- Adopts an interim "U.S. person" definition, such as the one contained in the CFTC's October 12th no-action letter on this subject, while also recognizing that firms are only in a position to come into good faith compliance with such a definition given that there is now not any time for them systematically to obtain counterparty representations before year-end.
- Provides certainty regarding the entity- vs. transaction-level rule categorization.
- Provide entity-level rule relief for non-U.S. swap dealers.
- Provide transaction-level rule relief for non-U.S. swap dealers trading with non-US persons.
- Does not include a requirement for submission of a detailed compliance plan prior to the ultimate submission of an application for substituted compliance under the final cross-border guidance, since until then the basis for comparability determinations will not yet be defined; and
- Confirms that, if it does not grant substituted compliance for a jurisdiction, the Commission will extend the exemptive order for registrants in that jurisdiction so that they have time to come into compliance.

Such an interim exemptive order would remain in place until the effective date of final cross-border guidance, thereby providing the needed "bridge" between registration as a swap dealer and the determination of the applicable rules. Of equal importance, such an order would facilitate further discussions with all affected parties and provide the opportunity to work out on a coordinated basis an appropriate substituted compliance regime to govern the relationship between the swap dealer rules adopted pursuant to Dodd-Frank and those applicable under the laws of other countries. Likewise, this approach would provide the time for the CFTC and SEC to establish a consistent approach to such key cross-border questions such as the definition of "U.S person" and the parameters of a substituted compliance regime.

In its final form, the cross-border application of Title VII's requirements should adopt a practical approach to defining "U.S. person" – one that provides market participants certainty and can be readily applied, while at the same time ensuring that transactions with a "direct and significant" connection to the United States are appropriately regulated – and a principles-based approach to implementing a robust substituted compliance regime. Equally important, the relevant regulatory authorities – the CFTC, SEC and their counterparts overseas – must work closely together to ensure that the cross-border regulation of swaps around the world strengthens global markets and avoids their fragmentation into inevitably less efficient regional and national markets. In this regard, the IIB welcomes the "Joint Press Statement on Operating Principles and Areas of Exploration in the Regulation of the Cross-Border OTC Derivatives Market" issued last week by the regulatory authorities that participated in the consultative sessions surrounding the recent meeting of the CFTC's Global Markets Advisory Committee as establishing a useful framework to guide the ongoing efforts to achieve this result.

Thank you for the opportunity to testify today on behalf of the IIB and I am happy to answer any questions.

Coalition for Derivatives End-Users

Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House Committee on Financial Services

"Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act"

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December 12, 2012

Mr. Chairman, Ranking Member Waters, other members of the Subcommittee, I want to thank you for inviting the Coalition for Derivatives End-Users to be represented at this important hearing. The Coalition includes more than 300 end-user companies and trade associations and, collectively, we represent thousands of end-users from across the economy. Our members are united in one respect; they use derivatives to manage risk, not create it.

The breadth and diversity of the Coalition demonstrates the widespread use of derivatives by Main Street businesses and helps drive home the real economic consequences of getting derivatives regulation wrong. Many U.S. companies are able to maintain more stable and successful operations through the use of a variety of risk management tools, including derivatives.

Yet, derivatives use by end-users must be put in perspective. End-user trades account for less than 10% of the notional value of the overall derivatives market.

The Coalition has been very engaged throughout the regulatory process, meeting with regulators dozens of times and submitting nearly 20 comment letters. We very much appreciate the receptivity of regulators to hearing our concerns and for taking the time to meet and speak with us on numerous occasions. Our goal is to remind policymakers that end-users rely on derivatives to reduce risk; bring certainty and stability to their businesses; and, ultimately, to benefit their customers.

We also work with Congress—and in particular with your committee—on legislative means to prevent unnecessary regulatory burdens from being imposed on Main Street businesses. On behalf of the Coalition, I would like to take a moment to thank the Financial Services Committee for its hard work in helping to move legislation through the House to address some of the unintended consequences of the Dodd-Frank Act. H.R. 2682, introduced by Cong. Grimm and Peters, was approved unanimously by this Committee and by a 370-24 margin in the full House. The bill creates a narrow exemption from margin requirements for non-financial businesses that use derivatives in their commercial operations. This Committee also gave unanimous approval to H.R. 2779, introduced by Cong. Stivers and Fudge. The bill, which passed the full House 357-36, prevents internal, inter-affiliate trades from being subject to regulatory burdens that were designed to be applied only to market-facing swaps and, when amended, will ensure that companies are not forced to abandon hedging through central risk-mitigation centers. The overwhelmingly bi-partisan and collegial process that led to passage of H.R. 2682 and H.R. 2779 in the House demonstrates that there are changes to the Dodd-Frank Act that make sense and can achieve a consensus, and that can help grow business and improve the economy.

With regulatory compliance deadlines for end-users looming in the next few months, however, the Coalition is concerned with the direction in which certain rules appear to be heading. We are primarily concerned about regulations relating to margin and capital requirements, inter-affiliate trades, treasury hedging centers, and the application of rules across borders. I will touch upon each concern briefly.

The proposed margin requirements—and particularly those proposed by the prudential banking regulators—are especially troubling and would harm Main Street businesses. Congress was clear both throughout the legislative process and in the text of the Dodd-Frank Act that end-users should not be subject to margin requirements because they do not meaningfully contribute to systemic risk. Congress also made clear that imposing margin requirements would unnecessarily impede end-users' ability to efficiently and effectively manage risks. As proposed, however, the rules contradict congressional intent and would impose unnecessary margin requirements on end-users, diverting working capital away from productive business use. A survey conducted by our Coalition found that a 3% initial margin requirement could reduce capital spending by as much as $5.1 to $6.7 billion among S&P 500 companies alone and cost 100,000 to 120,000 jobs.

Capital requirements, too, could make managing risk prohibitively expensive for end-users. Even if margin is not imposed on end-users, overly-aggressive capital requirements could make the exemption pointless. Therefore, the Coalition believes that exposures subject to Basel capital requirements should not be subject to margin requirements or should be subject to substantively less onerous margin requirements than have been proposed by the CFTC.

We are also concerned that inter-affiliate derivatives trades, which take place between affiliated entities within a corporate group, may face the same regulatory burdens as market-facing swaps. There are two serious problems that need addressing. First, under the CFTC's proposed rule, financial end-users would have to clear purely internal trades between affiliates unless end-users posted variation margin between the affiliates or met specific requirements for an exception. If end-users have to post variation margin, there is little point to exempting inter-affiliate trades from clearing requirements, as the costs could be similar. And let's not forget the larger point—internal end-user trades do not create systemic risk and, hence, should not be regulated the same as those trades that do.

Second, many end-users—approximately one-quarter of those we surveyed—execute swaps through an affiliate. This of course makes sense, as many companies find it more efficient to manage their risk centrally, and to have one affiliate trading in the open market, instead of dozens or hundreds of affiliates making trades in uncoordinated fashion. But it appears from the regulators' interpretation of the Dodd-Frank Act that purely non-financial end-users will face a choice; either dismantle their central hedging centers and find a new way to manage risk or clear all of their trades. Stated another way, this problem threatens to deny the end-user clearing exception to end-users because they have chosen to hedge their risk in an efficient, highly-effective and risk-reducing way. It is difficult to believe that this is the result Congress hoped to achieve.

Finally, the proposed cross-border guidance is also a cause for concern for the Coalition. The guidance would impose additional costs on end-users and would diminish their available choices of counterparties. We are also concerned by the CFTC's creation of a new regulated entity found nowhere in the four corners of the Dodd-Frank Act. The term "conduit," as used in the proposed guidance, could be applied to central hedging centers and, again, could force end-users to abandon these efficient structures for executing trades.

Throughout the congressional development of the Dodd-Frank Act and the regulatory process that has followed its passage, the Coalition has advocated for a more transparent derivatives market through the imposition of thoughtful, new regulatory standards that enhance financial stability while avoiding needless costs on end-users. We believe that imposing unnecessary regulation on derivatives end-users, which did not contribute to the financial crisis, would create more economic instability, restrict job growth, decrease productive investment, and hamper U.S. competitiveness in the global economy. In short, end-users should not face the same regulatory burden as those who speculate and create systemic risk.

Thank you, and I am happy to address any questions that you may have.

Testimony of Samara Cohen

Goldman, Sachs & Co.

Subcommittee on Capital Markets and Government Sponsored Enterprises

House Financial Services Committee

December 12, 2012

Executive Summary

The approach regulators adopt to the cross-border application of Title VII of the Dodd-Frank Act will have profound effects on the U.S. and international swap markets. To ensure that this regulatory action achieves the objectives reflected in the G-20 commitments and does not have a negative impact on capital markets or liquidity, we believe it is necessary to clarify and limit the scope of cross-border applicability and to adopt a considered approach to phasing in Title VII outside the United States. The breadth of cross-border applicability reflected in the CFTC's proposed guidance is without precedent. Key parts of the guidance, such as the definition of "U.S. Person" and the methodology for determining whether a non-U.S. entity may be subject to having to register as a swap dealer, lack the clarity necessary to enable market participants to make informed business plans. Finally, the guidance fails to provide a clear implementation sequencing scheme that accords with the work being done to implement the G-20 commitments by regulators and legislators in other jurisdictions. These problems will discourage customers from transacting with U.S. financial institutions and further move that business offshore, decrease efficiency in the swap market and increase systemic risk. A long-term solution is only possible through the CFTC avoiding assertions of jurisdiction beyond what is contemplated under Dodd-Frank, as well as close coordination on both timing and substance with the SEC and regulators in other G-20 jurisdictions. Reports of recent meetings among regulators appear promising. In the short term, with the current implementation date looming on December 31, it is imperative that the CFTC act to limit the application of Title VII requirements to non-U.S. counterparties until an international consensus and solution can be achieved.

Testimony

Chairman Garrett, Ranking Member Waters, and members of the subcommittee. My name is Samara Cohen and I am a Managing Director in the securities division of Goldman Sachs. Having spent 13 years working with a range of market participants to facilitate their access to capital markets and various risk management and investment products, I transitioned in May to focus exclusively on assisting clients and Goldman Sachs prepare for the advent of Dodd-Frank Title VII requirements. In my current role, I interact regularly with market participants that transact in swaps with Goldman Sachs to manage risk, access liquidity and improve returns. As a result, I speak frequently with these market participants about their views and concerns related to the effect of Dodd-Frank on their relationship with U.S. financial institutions. Thank you for inviting me to testify at today's hearing to share those views and concerns with you and answer any questions you may have. We value the Committee's careful and bipartisan examination of the rules implementing Dodd-Frank.

Our Global Business and Support for Dodd-Frank's Goals

Goldman Sachs supports the overarching goals of Dodd-Frank's derivatives provisions, including decreasing systemic risk and increasing transparency. We believe that it is possible to achieve these goals while preserving robust and efficient international swap markets that allow our customers to, among other things, manage their risks. We are committed to effectively and expeditiously implementing Dodd-Frank and have, since its passage, been engaged in an active implementation process that has included creating new technological, operational and compliance systems, devoting substantial resources to build, implement and monitor these systems and educating our clients regarding the effects of global regulatory reform.

While we are a U.S.-based financial institution, our swap business is global. We have swap customers throughout the world and intend to register both U.S.-based and non-U.S.-based entities as swap dealers with the CFTC.[1] Given the significant potential business impact, we and our customers have been carefully monitoring the way that the CFTC and SEC view the cross-border reach of Dodd-Frank's derivatives provisions, including how the U.S. regime compares to and will interact with the regulatory reform efforts underway in other G-20 jurisdictions. As part of this process, over the past several months, we and our clients have identified a number of issues in the CFTC's proposed cross-border guidance and exemptive order that raise significant concerns.

Concerns and Solutions

We encourage G-20 policy makers to strive to achieve a convergence of cross-border regulatory approaches that reflects a common understanding of the desired regulatory outcomes. Applied consistently, a measured and global approach will be a vital tool in safeguarding global financial stability and minimizing opportunities for regulatory arbitrage. If the steps we recommend are not taken, we fear that swap business will migrate, in the short term, away from U.S. financial institutions to other jurisdictions that are putting in place similar regulatory reform initiatives but are not as far advanced in doing so as the United States. We believe that once customers move their business outside the United States, due to this timing mismatch, they may not move the business back, even when other G-20 jurisdictions have put clearing, reporting and other similar mandates in place.

It is important to emphasize that these concerns are not theoretical. The international interdealer swap market felt major disruptions around October 12, 2012, the date on which market participants that engage in swap dealing activity began counting swap dealing transactions to determine whether they would need to register as swap dealers. In the days leading up to Friday, October 12, U.S. financial institutions—including Goldman Sachs—received numerous calls from clients in Europe, Asia, Latin America and other places around the globe informing them that their trading activities with U.S.

[1] The entities we intend to register represent over 90% of our global OTC swap business (as of September 30 measured by notional value, excluding affiliate positions) and virtually 100% of our swap business with U.S. clients and counterparties.

financial institutions would cease that coming Monday due to the uncertainty. Understanding the urgency of such messages, the CFTC issued a series of no-action relief letters on and slightly before October 12, 2012. We appreciate the CFTC's effort in doing so and believe that these no-action letters were able to alleviate the immediate market distress. The key take-away from this experience is that without rules that are clear and implemented on a consistent basis across jurisdictions, market disruptions are possible, if not likely, and market access will be constrained.

Therefore, while a coordinated international approach is being developed it is imperative that the CFTC ensure that it extends the reach of its regulations only to instances that bear a "direct" and "significant" impact to U.S. commerce as contemplated by Dodd-Frank, and that the CFTC take a few key steps to minimize potential disruptions to the swap markets that would undermine liquidity and confidence in the capital markets. First, from now until a final "U.S. person" definition has been finalized and implemented, the CFTC should employ the "U.S. person" definition used in its October 12 no-action relief and apply Dodd-Frank requirements to transactions between registered swap dealers and U.S. person customers. Under this approach, swap regulation involving U.S. customers would commence on December 31 as planned, but would be targeted to the primary U.S. counterparties Title VII was designed to address. Complex provisions currently proposed by the CFTC that differentiate treatment of transactions as having a U.S. nexus based on the location of the swap dealer may not only be unnecessary and duplicative as swap regulation is implemented abroad, but may also have the unintended consequence of creating confusion and uncertainty among market participants, potentially motivating both U.S. and non-U.S. customers to move their business outside the United States.

Concerns with the CFTC's Cross-Border Approach

We have a number of specific concerns around the new and unprecedented concepts included in the CFTC's proposed cross-border guidance, including the regulation of "non-U.S. affiliate conduits," regulation of inter-company booking models, aggregation of positions across affiliates, the impact of parent guarantees and the extremely limited recognition of foreign regulatory regimes through substituted compliance. We have provided detailed descriptions of these concerns and our proposed solutions in our August 27 comment letter to the CFTC. However, I would like to describe in my testimony today four problems we and our clients see with the CFTC's general approach to the cross-border application of the Dodd-Frank Act and the consequences that might result from such an approach.

Jurisdictional Breadth Without Precedent

First, the CFTC has taken a sweeping approach to its jurisdiction beyond U.S. shores that is without precedent. In Dodd-Frank Section 722, Congress limited Title VII's cross-border reach by providing that its CFTC-related derivatives provisions "**shall not apply** to activities outside the United States **unless** those activities have a direct and significant connection with activities in, or effect on, commerce of the United States" or are evasive.[2] Recent public meetings held by the CFTC and others have made it clear that swap market participants and non-U.S. regulators have substantial concerns about this expansive approach. These concerns will inform the ways in which swap market participants operate. For example, local banks in Asia, Europe and South America have expressed concerns directly to U.S. financial institutions that they will have to stop trading with U.S. dealers to avoid CFTC swap dealer registration. The approach may also encourage foreign regulators to be similarly expansive as they craft their own regulatory reform regimes.[3] For example, in recent meetings with the CFTC, foreign regulators have indicated that these proposed rules would not be workable in an international environment.[4]

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[2] Dodd-Frank Section 722(d)(i) (emphasis added).

[3] As CFTC Commissioner Scott O'Malia stated, "Unfortunately, the Proposed Guidance overreaches in many respects and, as a result, steps on the toes of other sovereign nations. Today's Proposed Guidance will likely provoke these nations to develop strict swap rules in retaliation that unfairly and unnecessarily burden U.S. firms." Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, O'Malia Concurring Statement, 77 Fed. Reg. 41214, 41241 (July 12, 2012)

[4] As Fabrizio Planta, Senior Officer, Post-Trading European Securities and Market Authority, said at the CFTC's recent Global Markets Advisory Committee Meeting, "Basically if I may make a parallel to a sport situation, it's like asking a player to be at the same on two different fields, or if we consider the global derivatives market as a baseball field, it's like deciding which rules apply depending on the player that hits the ball. This is not workable, and we as international regulators have the responsibility to find

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U.S. Person Definition

Our second concern is that the CFTC's definition of "U.S. person" is overly broad and unclear. The CFTC's proposed cross-border guidance and exemptive order condition the application of Title VII requirements on whether a swap counterparty is a "U.S. person." As a result, market participants throughout the world must be able to determine, easily and with consistency and certainty, whether they and their counterparties are or are not U.S. persons. Unfortunately, the CFTC has not yet finalized a definition of U.S. person, and the definition that has been proposed is vague and problematic in a number of ways described in our comment letter. In addition, the breadth of the definition makes it nearly certain that some market participants will be both a U.S. person for the purpose of U.S. regulation and an "E.U. person," or its equivalent, for the purpose of E.U. regulation, causing unnecessary overlap and potential conflicts in regulation.

Sequencing

Our third concern relates to the approach the CFTC has taken to sequencing its rules. As SIFMA has noted, cross-border jurisdictional rules are part of the foundation of the Dodd-Frank swap regime – they determine to whom Title VII will apply. However, the CFTC has chosen to finalize its substantive Title VII rules and require compliance with them before specifying to which entities they will apply. As a result, market participants face significant uncertainty as to how swap dealer rules that will begin to go into effect shortly will apply to them. In contrast, the SEC's approach recognizes the need for cross-border clarity as a precondition for firms to make informed decisions about how to implement the new rules and has stated that it will specify the cross-border application of its rules well before requiring compliance.[5]

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mutually acceptable, workable solutions to solve these issues." Global Markets Advisory Committee Meeting, Nov. 7, 2012. Transcript available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/gmac_110712_transcript.pdf.

[5] The SEC has indicated that it "does not expect to require compliance by participants in the U.S. [security-based swap] market with the final rules arising under the Exchange Act before addressing the cross-border aspects of such rules." Statement of General Policy on the Sequencing of Compliance Dates

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While the CFTC's requirements will incur substantial cost, no cost-benefit analysis has been done, as the CFTC chose to propose cross-border interpretations as guidance rather than as a rule subject to the CFTC rulemaking process and a full cost-benefit analysis. In addition, since the cross-border rules were sequenced after the substantive Title VII rules, the cost-benefit analyses of those substantive rules do not take into account the cost of applying the regulations to customers outside the United States. The SEC has indicated it will undertake formal rulemaking, including the requisite cost-benefit analysis, to determine the cross-border application of its security-based swap activity. We strongly believe the CFTC should do the same.

Coordination

Our final concern relates to the fact that the CFTC's cross-border approach has not been developed with a view towards allowing it to operate alongside other non-U.S. regulatory regimes, as is necessary in a global derivatives market. Indeed, we do not anticipate that the CFTC's rules will necessarily reconcile even with those of the SEC. Overlapping regulation will lead to higher costs for firms and the clients they serve, as well as confusion in terms of which rules apply, without any public policy value. To the contrary, this confusion will likely have an adverse impact on the effectiveness of regulation generally. While the CFTC's cross-border guidance makes reference to the possibility that non-U.S. firms that are otherwise subject to Title VII requirements may have the ability to satisfy such requirements through "substituted compliance" with comparable local regulation, the approach to substituted compliance described by the CFTC appears to be quite limited in scope and inconsistent with the practices that the CFTC has observed for decades in its regulation of cross-border futures markets.

We were encouraged by the recent meeting of market regulators from across the globe and were particularly pleased to see those regulators, including representatives of both

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for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 35625, 35631 (June 14, 2012).

the CFTC and SEC, recognizing the necessity of cross-border coordination in the regulation of OTC derivatives. The joint statement issued following that meeting indicated regulatory commitment to cross-border harmonization of particularly problematic requirements, including clearing determinations, cross-border information sharing and enforcement and compliance timing.[6] We urge the CFTC to embrace those commitments and reflect them in future no-action letters, policy statements and rulemakings.

In the short term, the timing mismatch between the CFTC's rulemaking and that of other G-20 jurisdictions will cause swap customers to move their business to jurisdictions where regulations do not yet govern swap transactions. In general, we believe that such business will move to jurisdictions that are planning to implement requirements similar to those in the United States, but on later timetables, because derivatives business needs operational support and legal certainty that is available only in the most developed jurisdictions. That is why most derivatives trading occurs in financial centers such as New York, London, Hong Kong, Tokyo, Germany and Singapore. As a result, we think it is possible for the G-20 and similar jurisdictions to come together and oversee the derivatives market in a comprehensive way without worrying about the business migrating to less regulated jurisdictions. However, for the United States to be part of that solution, it is critical that our regulators avoid unnecessary overreach in asserting jurisdiction in foreign markets and that they coordinate with the G-20 and similar nations to implement comparable rules on the same timeframe.

In the long term, without a more measured approach and close coordination on substance and timing, we fear that derivatives markets will regionalize. Corporations and other

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[6] Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market, *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6439-12. We note that the concerns expressed by participants at the November 28 meeting, including particularly the risks to the markets posed by inconsistent or duplicative rules across jurisdictions, the risk of regulatory arbitrage posed by out-of-sync compliance timing and the need to clarify and harmonize the recognition of other jurisdictions' regulations, including the scope and nature of substituted compliance, are precisely those concerns we wish to emphasize here. We are encouraged by the global recognition of these same concerns and we urge the CFTC to work with its co-regulators across the globe to assuage these identified risks.

customers will choose to transact only in their local jurisdictions to avoid duplicative and conflicting regulatory requirements. Regionalization would result in a number of negative consequences. First, regionalization would cause a significant amount of U.S. swap market business to move offshore, threatening U.S. revenues and jobs. Second, regionalization would make it harder for customers to find inexpensive and efficient ways to access markets and manage the risks that they incur as part of their ordinary businesses. Third, regionalization has the potential to increase, rather than decrease, systemic risk, as market participants will not be able to manage their risks globally.

The Solution

The problems described above are not easy to solve, nor can they be solved unilaterally or quickly. Instead, a solution that satisfies Dodd-Frank's goals but maintains a robust and competitive international swap market in which customers can efficiently hedge risks, access liquidity and deliver sound returns to their shareholders will require continued close coordination between the U.S. regulators, and among the U.S. regulators and their foreign counterparts. This coordination will need to relate to both the substance of the rules and their timing. The solution will need to provide clarity to market participants as to which rules apply to any specific transaction, avoid overlapping jurisdiction and be respectful of the jurisdictional limitations embodied in the Dodd-Frank Act, as well as in the commitments of the G-20 leaders to global regulatory reform.

We understand that the development of such a cross-border approach may take time. As a result, we recommend against the CFTC unilaterally finalizing cross-border guidance in advance of December 31. However, in the interim, it is critical that the CFTC address the industry's immediate concerns to avoid harmful and potentially permanent disruptions to the swap markets on and around December 31. Importantly, our recommendation is limited to the cross-border application of the Dodd-Frank Act; we fully support the application of Title VII's requirements to trading with U.S. persons effective on December 31.

Potential Short-Term Problems

Without prompt action, the market disruptions and dislocations around December 31 could be more permanent and significant than those leading up to October 12. October 12 was a date relevant to the financial community in determining whether dealers would have to register with the CFTC. December 31, however, relates to the application of Title VII requirements to customers, including corporations, mutual funds, pension plans and the other investment advisors. Unlike the dealers subject to the October 12 date, last minute no-action relief may not mitigate these concerns from customers that are not as willing or able to move business back to U.S. based financial institutions once they have left.

Solutions

There are a number of steps the CFTC should take immediately to avoid further movement of swap business away from U.S. financial institutions as December 31 approaches:

- **U.S. Person Definition and Application to Customers.** First, the CFTC should, as requested by industry representatives such as SIFMA, permit market participants to use for all Title VII compliance obligations the simplified form of the "U.S. person" definition in the CFTC's October 12 registration no-action letter. This definition is simple and clear, but still captures the vast majority of entities that market participants generally consider "U.S. persons." To give market participants time to understand the final definition and determine their status, this interim definition should govern until 90 days after the CFTC has been able to coordinate with U.S. and foreign regulators and final guidance, including a final definition of U.S. person, is published. During this period, and while a coordinated international approach is being developed, the CFTC should apply Dodd-Frank requirements to transactions between registered swap dealers and U.S. person customers.

- **No-Action Requests.** Second, the CFTC should take prompt action on a number of no-action requests that industry groups have submitted in response to specific problems that have been identified by the industry and customers. As I have mentioned, we greatly appreciated the October 12 no-action relief, which was a great help to the affected market participants. We also greatly appreciate other no-action relief that has recently been issued by the CFTC. The anticipated effects of December 31 will be much greater, however, and will reach a much larger range of market participants with less flexible business models. To avoid the permanent loss of business in the United States, we believe early and comprehensive action is required. Non-dealer market participants need to understand what Dodd-Frank requirements pertain to them, and once they do, be given time to comply.[7]

Conclusion

Goldman Sachs is committed to working with Congress, regulators and industry participants to ensure that extraterritoriality concerns with respect to Title VII regulation and implementation are addressed appropriately, both with respect to the immediate problems that may arise around December 31 and the more permanent issues that U.S. and international regulators need to solve. I appreciate the opportunity to testify and look forward to answering any questions you may have.

[7] The documentation requirements related to the CFTC's external business conduct rule set provide a good example. About 40% of our clients are organized outside the United States but may be subject to the Dodd-Frank rules depending on the definition of "U.S. Person." Their expectation is that they will not be subject but, absent further clarity, we may not be able offer market access to those clients on January 2 if they have not come into compliance.

Testimony on Title VII Implementation

by Robert Cook
Director, Division of Trading & Markets, U.S. Securities and Exchange Commission

**Before the Capital Markets and Government Sponsored Enterprises Subcommittee of the Committee on Financial Services
U.S. House of Representatives**

December 12, 2012

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee:

I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission regarding the Commissions' ongoing implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").

As you know, Title VII creates an entirely new regulatory regime for over-the-counter ("OTC") derivatives. To that end, it directs the Commission and the Commodity Futures Trading Commission ("CFTC") to write a number of rules necessary to implement the statutory regime. Since the Dodd-Frank Act was enacted in July 2010, the Commission has proposed substantially all of the rules required by Title VII, and in some cases has adopted final rules. We are continuing to work diligently to implement all provisions of Title VII, and to coordinate our efforts with the CFTC and other regulators here and overseas.

My testimony today will provide an overview of these efforts to implement Title VII, emphasizing the Commission's activities since Chairman Schapiro last testified before this Subcommittee in April, as well as the Commission's efforts to address the application of the security-based swap provisions of Title VII in the cross-border context.

Background

Title VII of the Dodd-Frank Act

Title VII of the Dodd-Frank Act mandates the oversight of the OTC derivatives marketplace and requires that the Commission and the CFTC write rules to address, among other things:

- mandatory clearing;
- the operation of security-based swap and swap execution facilities and data repositories;
- capital and margin requirements and business conduct standards for security-based swap and swap dealers and major participants; and
- regulatory access to — and public transparency for — information regarding security-based swap and swap transactions.

Under the Dodd-Frank Act, regulatory authority over swaps is divided between the Commission and the CFTC. The law assigns the Commission the authority to regulate "security-based swaps." The CFTC has primary regulatory authority over "swaps," which represent the overwhelming majority of the overall market for OTC derivatives subject to Title VII.

With respect to the Commission's efforts, the Title VII rulemakings are designed to improve transparency and reduce counterparty and systemic risks by, among other things, facilitating the centralized clearing of security-based swaps. They also are designed to enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. By promoting transparency, efficiency, and stability, this framework is intended to foster a more nimble and competitive security-based swap market and enhance regulatory oversight and monitoring of this market by facilitating improved access to comprehensive data on security-based swap transactions.

Ongoing Regulatory Coordination with the CFTC and Other Regulators

In implementing Title VII, the staff of the Commission is in regular contact with the staffs of the CFTC, Federal Reserve Board, and other federal regulators. In particular, Commission staff has consulted and coordinated extensively with CFTC staff in the development of the joint definitional rules required under Title VII.

Commission staff also engages in extensive interagency discussions concerning rules to implement Title VII that are not required to be adopted jointly. Although the timing and sequencing of the CFTC's and Commission's proposal and adoption of these rules have varied, the objective of consistent and comparable requirements continues to guide the Commission's efforts.

The Dodd-Frank Act also specifically requires that the Commission, the CFTC, and the prudential regulators "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives. Accordingly, the Commission is actively working on a bilateral and multilateral basis with our fellow regulators abroad to address the regulation of OTC derivatives.

Through these discussions and our participation in various international task forces and working groups, we have gathered extensive information about foreign regulatory reform efforts, identified potential gaps, overlaps, and conflicts between U.S. and foreign regulatory regimes, and encouraged foreign regulators to develop rules and standards complementary to our own under the Dodd-Frank Act. Such efforts include frequent communications and meetings with the European Union and other major foreign regulatory jurisdictions in Asia and the Americas. Representatives from the Commission also participate in the Financial Stability Board's Working Group on OTC Derivatives Regulation, of which a Commission representative serves as one of the co-chairs on behalf of the International Organization of Securities Commissions ("IOSCO"). A Commission representative also serves as one of the four co-chairs of the IOSCO Task Force on OTC Derivatives Regulation. In addition, senior representatives from the Commission, the CFTC, and a number of foreign regulators have met numerous times, most recently in late

November, to discuss cross-border issues related to the implementation of new legislation and rules to govern the OTC derivatives markets in their respective jurisdictions.

As we continue with the adoption of the Title VII rules, we remain committed to consulting with other regulators at home and abroad in an effort to foster the development of common frameworks and to help ensure a level playing field for market participants consistent with the requirements of the Act.

Title VII Implementation to Date

Since Chairman Schapiro last testified before this Subcommittee in April, the Commission has continued its efforts to adopt final rules under Title VII. In addition, the Commission proposed substantially all of the core rules required by Title VII.

Adoption of Key Definitional Rules

In July, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product definitions under Title VII. This effort follows the Commission's work on the entity definitions rules, which the Commission adopted jointly with the CFTC in April. The completion of these joint rulemakings is a foundational step toward the complete implementation of Title VII. However, this step did not trigger compliance with other rules the Commission is adopting under Title VII. Instead, the compliance dates applicable to each final rule will be set forth in the adopting release for the applicable rule. In this way, the Commission is better able to provide for an orderly implementation of the various Title VII rules.

The first joint rulemaking addresses certain product definitions and further defines the terms "swap," "security-based swap," and "security-based swap agreement," and adopts rules regarding the regulation of "mixed swaps" and the books and records requirements for security-based swap agreements. The product definitions rulemaking includes three general categories of rules and interpretations:

- First, it sets out rules and interpretations that will assist market participants in determining whether particular agreements, contracts, and transactions are subject to Title VII.

- Second, it sets out rules and interpretations that will assist market participants in determining whether a particular Title VII instrument is a swap subject to CFTC regulation, a security-based swap subject to Commission regulation, or a mixed swap subject to regulation by both the CFTC and the Commission.

- Third, it sets out rules and interpretations that provide a regulatory framework for mixed swaps, require market participants to maintain the same books and records for security-based swap agreements as they would under the CFTC's books and records requirements for swaps, and establishes a process that will allow market participants to request a determination from the Commission and CFTC of whether a product is a swap, a security-based swap, or both (i.e., a mixed swap). In addition, the rules establish a process by which persons may request modified regulatory treatment for mixed swaps by joint order of the Commission and CFTC.

The second joint rulemaking addresses certain entity definitions, further defines the term "security-based swap dealer", and adopts interpretations providing guidance as to how the dealer-trader distinction applies to activities involving security-based swaps. This guidance describes what constitutes dealing activity and distinguishes dealing from non-dealing activities such as hedging.

The rulemaking also implements the Dodd-Frank Act's statutory *de minimis* exception to the security-based swap dealer definition in a way that is tailored to reflect the different types of security-based swaps. To do so, the rulemaking exempts those entities or individuals who engage in dealing activity in security-based swaps below a certain notional dollar amount over a one-year period. The rule includes a phase-in of the exemption over time in a way designed to promote the orderly implementation of Title VII.

Additionally, the rulemaking implements the Dodd-Frank Act's "major security-based swap participant" definition through the use of three objective tests.

As with other Commission rulemaking efforts, the Commission's Division of Risk, Strategy, and Financial Innovation ("RSFI") was extensively involved in the Commission's development of both of these rule sets. In particular, RSFI's analysis of single-name credit default swap data was especially informative in the development of the entity definition rules. This analysis provided critically important information regarding potential dealing activity in the credit default swap market, which helped the Commission shape the final rules and evaluate their potential economic consequences.

Adoption of Rules related to Clearing Infrastructure

In addition to the key definitional rules, the Commission has adopted rules under Title VII relating to clearing infrastructure. In October, the Commission adopted a rule that establishes standards for how registered clearing agencies, including clearing agencies that clear security-based swaps, should manage their risks and run their operations. The rule is designed to help ensure that clearing agencies will be able to fulfill their responsibilities in the multi-trillion dollar derivatives market as well as in more traditional securities markets. In particular, the rule requires registered clearing agencies that provide central counterparty services to maintain certain standards with respect to risk management and operations. Among other things, the rule sets standards with respect to measurement and management of credit exposures, margin requirements, financial resources, and margin model validation. The rule also establishes certain recordkeeping and financial disclosure requirements for all registered clearing agencies, as well as several new operational standards for these entities.

In June, the Commission adopted rules that establish procedures for its review of certain actions undertaken by clearing agencies. These rules detail how clearing agencies will provide information to the Commission about the security-based swaps the clearing agencies plan to accept for clearing, which will then be used by the Commission to aid in determining whether those security-based swaps are required to be cleared. The adopted rules also include rules requiring clearing agencies that are designated as "systemically important" under Title VIII of the Dodd-Frank Act to submit advance notice of changes to their rules, procedures, or operations if the changes could materially affect the nature or level of risk at those clearing agencies.

Proposal of Capital, Margin, and Segregation Requirements

In October, the Commission proposed capital, margin, and segregation requirements for security-based swap dealers and major security-based swap participants. With the completion of this proposal, the Commission has now proposed substantially all of the rules required by Title VII of the Dodd-Frank Act. The Commission proposed to:

- set minimum capital requirements for nonbank security-based swap dealers and nonbank major security-based swap participants;
- establish margin requirements for nonbank security-based swap dealers and nonbank major security-based swap participants with respect to non-cleared security-based swaps; and
- establish segregation requirements for security-based swap dealers and notification requirements with respect to segregation for security-based swap dealers and major security-based swap participants.

In addition, the rulemaking proposed certain risk management requirements for security-based swap dealers.

Issuance of Implementation Policy Statement

In addition to its work to propose and adopt Title VII rules, the Commission issued a policy statement in June describing and requesting public comment on the order in which it expects to require compliance by market participants with the final Title VII rules. The Commission's approach aims to avoid the disruption and cost that could result if compliance with all of the rules were required simultaneously or haphazardly. More generally, the policy statement is part of our overall commitment to making sure that market participants know what the "rules of the road" are before requiring compliance with those rules.

The implementation policy statement is divided into five broad categories of final rules to be adopted by the Commission and explains how the compliance dates of these rules would be sequenced in relative terms by describing the dependencies that exist within and among the categories. The statement emphasizes that those subject to the new regulatory requirements arising from these rules will be given adequate, but not excessive, time to come into compliance with them.

In addition, the statement discusses the timing of the expiration of temporary relief the Commission previously granted security-based swap market participants from certain provisions of the federal securities laws. The expiration of much of this relief is tied to the effective or compliance dates of certain rules to be adopted pursuant to Title VII.

Market participants have provided comments on the sequencing set out in the policy statement, and we are taking those into account as we work toward completing the Title VII adoption process.

Next Steps for Implementation of Title VII

Application of Title VII in the Cross-Border Context

In the near term, we intend to propose rules and interpretive guidance to address the international implications of the security-based swap provisions of Title VII. With very limited exceptions, the Commission has not addressed the application of the security-based swap provisions of Title VII in the cross-border context in its proposed or final rules. Rather than addressing these issues in a piecemeal fashion through each of the various substantive rulemakings implementing Title VII, the Commission stated in its implementation policy statement that it was instead planning to address them holistically in a single proposing release. We believe this approach will provide investors, market participants, foreign regulators, and other interested parties with an opportunity to consider, as an integrated whole, the Commission's proposed approach to the application of the security-based swap provisions of Title VII in the cross-border context.

The cross-border release will involve notice-and-comment rulemaking, not only interpretive guidance. As a rulemaking proposal, the release will consider investor protection and incorporate an economic analysis that considers the effects of the proposal on efficiency, competition, and capital formation. Although the rulemaking approach takes more time, we believe there are a number of benefits that will make this approach worth the effort—including, among others, a full articulation of the rationales for, and consideration of any reasonable alternative to, particular approaches.

As indicated previously by Chairman Schapiro, we expect the scope of the effort to be broad. The proposal will address the application of Title VII in the cross-border context with respect to each of the major registration categories covered by Title VII for security-based swaps: security-based swap dealers; major security-based swap participants; security-based swap clearing agencies; security-based swap data repositories; and security-based swap execution facilities. It also will address the application of Title VII in connection with reporting and dissemination, clearing, and trade execution, as well as the sharing of information with regulators and related preservation of confidentiality with respect to data collected and maintained by security-based swap data repositories.

We are very conscious of the challenges associated with developing a new regulatory regime for a pre-existing market. In the traditional securities space, the Commission has a long history of addressing cross-border issues, going back over 40 years. However, unlike in the traditional securities markets, where the Commission has had the opportunity to consider cross-border issues incrementally, the Dodd-Frank Act requires us to develop a completely new regulatory regime all at once for a pre-existing market, as well as determine how to apply the regime to cross-border transactions. These challenges are particularly heightened in the context of the security-based swap market as a result of its already global nature.

In light of these considerations, the development of our cross-border proposal is necessarily being informed by our discussions with our fellow regulators in other jurisdictions, as well as the CFTC, as described above. We also are paying close attention to comments on the CFTC's proposed cross-border guidance.

Additional Steps

In addition to proposing rules and interpretive guidance designed to address the international implications of Title VII, the Commission expects to propose rules relating to books and records and reporting requirements for security-based swap dealers and major security-based swap participants. The Commission also is working to address petitions with the SEC and the CFTC seeking exemptive relief to permit portfolio margining of cleared customer credit default swap positions that use both swaps and security-based swaps. In addition, the Commission expects to consider the application of mandatory clearing requirements to single-name credit default swaps, starting with those that were first cleared prior to the enactment of the Dodd-Frank Act.

Finally, the Commission staff continues to work diligently to develop recommendations for the Commission to adopt final rules in each of the remaining areas required by Title VII where rules have been proposed, but have not yet been adopted.

Conclusion

The Dodd-Frank Act provides the Commission with important tools to better meet the challenges of today's financial marketplace and fulfill its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As the Commission and its staff continue with the implementation of Title VII, we look forward to continuing to work closely with Congress, our fellow regulators both home and abroad, and members of the public. Thank you for the opportunity to share our progress and current thinking on the implementation of Title VII. I will be happy to answer any questions.

PMAA PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Fuel Merchants Association of New Jersey

nefi NEW ENGLAND FUEL INSTITUTE www.NEFI.com

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Springfield, New Jersey

On behalf of the
Petroleum Marketers Association of America (PMAA), the
New England Fuel Institute (NEFI) and the Fuel Merchants Association
of New Jersey (FMA)

Testimony for the
House Financial Services Committee
Subcommittee on Capital Markets and Government
United States House of Representatives
Washington, DC
December 12, 2012

Honorable Chairman Garrett, Ranking Member Waters and distinguished members of the subcommittee, thank you for the invitation to testify today. I appreciate the opportunity to provide some insight into Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and why it needs to proceed without delay to address the needs of bona-fide end-users and consumers.

I. Introduction

My name is Eric DeGesero and I'm the Executive Vice President of the Fuel Merchants Association of New Jersey. Founded in 1933, FMA represents small businessmen and women who distribute heating oil, gasoline and diesel fuel in the state. Our members distribute heating oil to residential, commercial and industrial customers and distribute branded and unbranded gasoline and diesel fuel to service stations they own, and to service stations they supply, as well as to state and local governments and commercial fleets.

I am submitting this testimony on behalf of the Petroleum Marketers Association of America ("PMAA"). PMAA is a national federation of 48 state and regional trade associations representing over 8,000 independent petroleum marketing companies. These companies own 60,000 convenience store/gasoline stations and supply motor fuels, including gasoline and diesel fuel, to an additional 40,000 stores. PMAA members also sell at retail 90 percent of the home heating oil consumed in the United States.

Joining PMAA in these comments is the New England Fuel Institute ("NEFI"). NEFI is a member of PMAA and an independent trade association representing approximately 1,200 home heating businesses including heating oil, kerosene and propane dealers and related services companies, most of which are small, multi-generational family owned- and operated-businesses. Many PMAA and NEFI members also market lubricants, jet fuels and racing fuels, as well as renewable fuels such as biofuels and other alternative energy products.

We first want to commend the CFTC for its dedication to moving forward with prudent futures and swaps market rules and regulations which will bring greater transparency and fairness for all commodity market participants. Bona-fide end users of commodities, many of which are my members, feel that the futures and swaps markets are not serving the best interests for what they were created for – bona-fide end users to manage risk and price discovery. Therefore, we strongly support Title VII because it promotes the free exchange of commodity futures on open, well-regulated and transparent exchanges.

II. Why Title VII?

Title VII is important because it:

1. Brings across the board transparency and clearing requirements.
2. Limits excessive speculation on energy trades.
3. Enhances prohibitions and prosecution of fraud, manipulation and abusive trading practices.
4. Promotes greater consumer protections.

Mr. Chairman, it's imperative that the CFTC move forward with Title VII's rules and regulations to provide certainty to end users and market makers which will allow them to adjust their business models accordingly. PMAA, NEFI and FMA member companies have endured years of wild price swings due to excessive speculation which has increased hedging costs and have hurt the ability for them to provide stable commodity prices to their customers. Title VII will return oversight and order to the futures market and bring stable, open and competitive markets that serve the needs of bona fide hedgers over speculative traders.

While the rules may not be perfect, they are a welcome start in overturning a law implemented in 2000 which watered down oversight and exempted Wall Street from position limits and other requirements that ensure transparency and competition and prevent fraud, manipulation and excessive speculation. A combination of deregulation at the CFTC coupled with passage of the Commodity Futures Modernization Act (CFMA) of 2000 and insufficient CFTC funding allowed for trading activity to move to under-regulated off-shore trading platforms, free from speculative position limits. Before passage of the CFMA, commercial hedgers comprised about 60-90 percent of the open interest for commodities. Today, 60-90 percent is purely speculative/financial trading. This level of speculation is excessive and undermines risk mitigation and price discovery mechanisms, exacerbates market volatility and unhinges markets from supply and demand fundamentals. For the first time, Dodd-Frank requires all swaps, whether cleared or uncleared, to be reported to swap data repositories. This is an important step to help the CFTC capture the trillions of dollars traded in the opaque swaps market.

<u>Commodity futures markets were established as a tool for true physical hedgers to manage risk – they weren't set up strictly for investment banks to dominate the marketplace</u>. This is a subject we believe gets lost in the discussion from both parties. Hedge funds, sovereign wealth funds and other institutional investors continue to heavily invest in derivatives contracts for crude oil and refined petroleum products, and enjoy little or no controls, such as tough limits on speculative positions. Investment-only speculators that engage in a "buy and hold strategy" serve no purpose in the commodity markets other than to diminish its role as a tool for managing risk and discovering a fair market price for physical hedgers such as petroleum marketers, airlines and farmers. Without sufficient oversight and aggregate position limits from Title VII, commodity end-users such as petroleum marketers, airlines, farmers and trucking companies will continue to be held to the whims of Wall Street speculators.

<u>Legitimate physical commodity hedgers should be protected from these regulations.</u> PMAA, NEFI and FMA members believe that the CFTC struck the right balance between distinguishing commodity end-users and those in the market purely to speculate. This is not to say that we are opposed to speculation. We need speculation in the marketplace for physical end-users to manage risk, but excessive speculation distorts the market and creates tremendous volatility.

To mitigate highly leveraged speculative commodity bets and promote stability in the futures market, Title VII requires over-the-counter (OTC) commodity trades to be cleared through a central clearing house. For instance, if a large investment bank is purely in the market to leverage its commodity futures holdings, then it should be held to mandatory clearing and margin requirements to ensure that it has the cash up front to back up its trade. We wholeheartedly agree that centralized clearing will bring transparency and fairness to the market. Efforts to derail the clearing requirement through legislative and/or regulatory action will maintain the status quo and continue to handcuff the U.S. financial system.

III. The High Cost of Oil and Refined Products Hurt Petroleum Marketers

The effect of excessive speculation on small business petroleum marketers is a problem with far reaching consequences. In recent years, gasoline and heating oil retailers saw profit margins from fuel sales fall to their lowest point in decades as oil prices surged. Petroleum marketers do not benefit from high crude oil or gasoline prices. Because they operate in such a competitive environment, the higher prices climb, the further margins are squeezed. Thus, rising gasoline prices not only hurt motorists, but petroleum marketers as well. Of the 160,000 U.S. retail gasoline locations, 99 percent are owned by independent businesses, not the major oil companies. The major integrated oil companies have essentially removed themselves from the retail gasoline business because they see that the retail environment is not very profitable for gasoline sales.

In order to remain competitive, retail station owners offer the lowest price for motor fuels so that they generate enough customer traffic inside the store where station owners can make a modest profit by offering drink and food items. Because petroleum marketers and station owners must pay for the inventory they sell, their lines of credit approach their limit due to the high costs of gasoline, heating oil and diesel when crude prices go up. This creates a credit crisis with marketers' banks, which creates liquidity problems and may force petroleum marketers and station owners to close up shop.

IV. Excessive Speculation Causes Volatility and Price Spikes at the Pump

Large purchases of crude oil futures contracts by speculators have created an additional paper demand for oil which drives up the prices of oil for future delivery. This has the same effect that additional demand for contracts for the delivery of a physical barrel today drives up the price for oil on the spot market. Basically, a futures contract bought by a speculator has the same effect on demand for a barrel that results from the purchase of a futures contract by a petroleum marketer. The very definition of cash-settled contracts as "look-alikes" means that what occurs in the financially-settled swaps markets directly affects what occurs in the physical market.

In recent years, excessive speculation on oil futures exchanges has driven prices at the pump. In April 2011, Goldman Sachs warned clients to lock-in trading profits before oil and other markets reversed suggesting speculators were boosting crude prices as much as $27 a barrel which translates in upwards of 40-60 cents-per-gallon at the pump. Goldman noted that every one million barrels of oil held by speculators contributed to an 8-10 cent rise in oil price. This comment came as the CFTC found that speculators made up more than 70 percent of the open interest of positions held overnight in crude oil futures, whereas, physical end users, made up less than 30 percent. Additionally, the CFTC reported in July 2011 that almost 95 percent of U.S. crude oil futures volume was generated by day trading.

V. Position Limits

It is unfortunate that the U.S. District Court vacated the new position limits rule, albeit on narrow grounds, and sent it back to the CFTC for further consideration. However, the District Court did not question the CFTC's authority to address excessive speculation. The court merely concluded that the statute was ambiguous on the question of whether the agency must set speculative position limits and that the agency failed to address this ambiguity. We believe the court's reasoning is flawed and that the Congressional mandate to impose position limits was unambiguous for a number of compelling reasons, not the least of which is that Congress required position limits to be imposed "within 180 days" for energy and "within 270 days" for agricultural commodities, and that a study be conducted and presented to Congress on the final rule's effect on markets.

There is more than adequate evidence that excessive speculation has been disruptive to commodity markets. More than 100 studies, reports and analyses on such findings have been published by academic institutions, central banks, market experts and governmental organizations (online at http://bit.ly/ListStdys).

The CFTC final position limits rule would have capped spot month holdings of the NYMEX Sweet Light Crude, NYMEX Gasoline Blend stock, NYMEX Heating Oil, and NYMEX Hub Natural Gas at 25 percent of deliverable supply. The all-months combined position limit regime would not be implemented until the CFTC had collected a year's worth of swaps data. While we believe the position limits final rule should have capped speculative oil trades at lower levels, we agreed that it was a necessary first step in tackling the futures/swaps market which has grown exponentially over the last 10 years.

Finally, it's unfortunate that the partisan tone has only amplified regarding position limits. As recently as the 110th Congress, nearly 70 House Republicans voted to approve legislation (H.R.6604) that would have established across-the-board position limits and even provided the CFTC with 100 new employees to carry out the its mission. Of these Republicans, 44 still serve in the House of Representatives.

VI. The CFTC Must Enforce Cross-Border Regulations

Derivatives transactions conducted by off-shore affiliates of U.S.-based firms can have a direct and immediate impact on American businesses and consumers and the stability of the economy. Some areas of cross-border application authority are clearer than others. For instance, transactions with overseas affiliates that are guaranteed by a U.S. entity clearly must be subject to Dodd-Frank given that what happens offshore could potentially put the American taxpayer at risk, especially when a U.S. bank's foreign affiliate has direct access to the Federal Reserve's discount window and FDIC backing. Furthermore, failure to conduct prudent regulation and oversight of said transactions can open the door to regulatory arbitrage and encourage firms to relocate U.S. jobs and business operations overseas.

Congress gave the CFTC enough discretion to go after off-shore affiliates. In order to fulfill its mission to protect U.S. market participants and to ensure market stability and confidence, it is essential that the Commission move forward with its proposed cross-border guidance documents. The approach set forth in these documents will provide certainty to regulated entities; allow foreign regulators additional time to finalize new swaps market rules; and permit CFTC Commissioners to continue their multilateral negotiations with their overseas counterparts on jurisdictional issues, regulatory harmonization, data sharing agreements and cross-border enforcement. If the CFTC isn't able to effectively regulate U.S. bank foreign affiliates that engage in swap transactions, then Title VII of Dodd-Frank will effectively be gutted thereby impacting implementation of dealer oversight, the clearing mandate and real-time reporting.

VII. The CFTC Needs Adequate Funding

Given that the over-the-counter (OTC) derivatives market has grown exponentially over the last 10 years, a small down payment for the CFTC to ensure that these markets are reflective of supply and demand fundamentals is critical. Currently, the U.S. OTC market totals $300 trillion with another $300 trillion traded world-wide. The CFTC's $205 million budget is inadequate to provide comprehensive oversight especially since the agency is operating below early 1990s funding levels when the OTC market was in its infant stages.

PMAA and NEFI support a $308 million appropriation for future fiscal years and oppose any number that falls short of meeting this request.

VIII. Conclusion

It's critical that regulators get the futures/swaps market under control for the benefit of the physical end-user and consumer. Therefore, we urge this subcommittee to allow the CFTC to do its job and implement pending rulemakings without further delay. Reliable futures markets are crucial to the entire petroleum industry and consumers. Again, I want to thank the Subcommittee for the opportunity to testify today. I will be happy to answer any questions that you may have at this time.

American SECURITIZATION FORUM®

Statement of:

Tom Deutsch
Executive Director
American Securitization Forum

Testimony before the:

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Public Hearing on:

Challenges Facing the U.S. Capital Markets to
Effectively Implement Title VII of the Dodd-Frank Act

December 12, 2012

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Introduction

Chairman Garrett, Ranking Member Waters, and distinguished Members of the Subcommittee, I thank you for this opportunity to testify here today on behalf of the 330 member institutions of the American Securitization Forum[1] (ASF) that represent all the various constituencies in the global structured finance markets, including issuers, investors, financial intermediaries, lenders, trustees, servicers and rating agencies.

In the testimony that follows, we address in detail two key issues—commodity pools and margin requirements—that the implementation of Title VII of the Dodd-Frank Act poses for the structured finance industry. However, we would not have expected in the summer of 2010 for securitization to be a topic of conversation at this type of hearing, as we did not think that commodity pool and margin regulations were intended to apply to most securitizations.

Most of the uses of derivatives in securitization transactions are of the most plain-vanilla type, such as the use of interest rate or currency swaps to eliminate securitization investors' exposure to interest rate or currency fluctuations. For example, a captive auto finance company may package a number of auto loans into a securitization to sell to investors. Typically, auto loans are fixed rate loans, since car buyers usually want certainty about their monthly car payments. However, captive finance companies often find that some institutional investors in their auto securitizations want to buy floating rate securities. As such, the lender will cause the securitization vehicle to enter into a fixed-to-floating interest rate swap to accommodate the desirable issuance of floating rate securities to investors, while still providing desirable fixed rate loans to borrowers.

To provide another example, an English mortgage lender may package a number of the loans it made to English homeowners into a securitization to sell to U.S. investors. The English homeowners are required to pay their loans back in English pounds, but the U.S. institutional investors have to pay back their obligations to U.S. pensioners and mutual fund investors in U.S. dollars. When the English lender causes the securitization vehicle to enter into a basic currency swap, they effectively negate the currency risk to investors, but instead allow investors to focus their expertise on credit and prepayment risks of the mortgage loans.

In both of these examples, all parties to the transactions—borrowers, issuers and investors—benefit greatly from the plain-vanilla swaps in the deals. But because of recent proposals, the presence of these basic swaps triggers two potential compliance challenges for some of the transaction parties that may hurt all of the beneficiaries of the deal.

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

I. **First, the securitization transaction may be required to post cash margin and take on the risk of margin calls, which would result in higher costs for consumers without tangible benefit; and**

II. **Second, the securitization transaction may have been treated as a "commodity pool" and hence be required to comply with costly regulations not designed to improve investor or prudential regulation of this type of transaction.**

To avoid having to comply with costly regulations that have no benefit to investors, foreign issuers may choose to avoid U.S. regulations and not make their products available to U.S. investors. Alternatively, U.S. issuers selling part of their offerings to overseas investors may not have as competitive pricing as their foreign counterparts. In the two below sections, we discuss in more detail these inadvertent and unnecessary outcomes.

I. Clearing Mandate and Margin Requirements

The clearing mandate and margin requirements for uncleared swaps, as proposed, would create tall, and perhaps insurmountable, hurdles for many securitizations. These rules were proposed by the CFTC on April 28, 2011[2] and by the Prudential Regulators on May 11, 2011.[3] The comment periods were later reopened to allow additional comment in light of the July 6, 2012 consultative document on margin requirements for non-centrally cleared derivatives published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO).[4] ASF provided detailed comments[5] to each of these proposed rules, but final rules for margin requirements for uncleared swaps have not yet been finalized. Clearing determinations for interest rate swaps have just been made and the clearing requirement would begin to apply in June 2013 and other swap clearing determinations are expected in the future.

Our strong concern is that many securitizations that use "plain vanilla" interest rate and currency swaps to hedge mismatches between their assets and their liabilities may be required to clear the swaps they enter into after the applicable effective date of the clearing mandate. For uncleared swaps, they may be required to post cash margin and to take on the risk of margin calls, which would be challenging for typical securitization structures given some of their core features.

A. Posting Liquid Margin

Securitizations generally provide robust collateral for their swap exposures, eliminating the need for posting margin. These provisions generally include a security interest in all of the

[2] *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf.
[3] *See* http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf.
[4] *See* http://www.bis.org/publ/bcbs226.pdf.
[5] *See* ASF's July 11, 2011 swap margin comment letter at:
http://www.americansecuritization.com/uploadedfiles/asfswapmarginletter20110711.pdf, and ASF's September 20, ASF's September 20, 2012 swap margin comment letter at:
http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=8163.

assets of the securitization[6] and/or a position in the cash distribution waterfall that ranks equal to or ahead of the interest due to the most senior class of securities. Because the entire securitization pool is pledged or otherwise available, the swap dealer has access to a much larger pool of assets than would be posted under clearinghouse rules or under the uncleared margin rules, potentially providing even greater protection. The securitization assets are generally financial assets that by their terms convert into cash in a finite period of time—in other words, assets such as credit card receivables and auto loans that are paid over time by their borrowers. Adverse events that trigger the prepayment of the securitization obligations would also typically trigger a termination event under the swap. Securitizations do not, however, post liquid margin. Moreover, it is common for securitizations to allocate cash collections only once per month to investors, swap counterparties, trustees and other service providers. Accordingly, these vehicles generally would not have available funds to meet daily margin calls. We view a shift from the broad collateral currently provided to a liquid margin requirement as presenting a significant challenge to the use of both cleared and uncleared swaps in securitizations.

Appendix I reflects the potential costs of a liquid margin requirement for an interest rate swap related to an auto loan securitization. By detailing two basic scenarios, we show that creating a margin reserve will significantly reduce the amount of funding to make new loans obtained by the securitization sponsor. In Scenario 1, where interest rates are within expectations based on historical movements, the amount of available funding obtained through the securitization vehicle would be reduced by approximately **9.83%**, since that amount is what would be the "total required collateral" outcome in the chart. In Scenario 2, where interest rates rise 1.5 times the historical rate movement, available funding would be even more substantially reduced by **21.13%**. Accordingly, requiring the posting of liquid margin can have dramatic real economy effects on the availability of auto financing and hence on automobile sales because issuers will have to respond to this lower funding availability by either increasing borrower costs or decreasing credit availability.

Margin requirements for uncleared swaps also present issues, even if the posted margin is segregated. In addition to making the securitizations less efficient, by requiring them to maintain cash positions to provide security even though such security is already provided by the pledge of their financial assets, there is a real concern that they will not have cash on hand to meet daily margin calls, even if they set up cash reserves. If they address this issue with a letter of credit or other liquidity backstop, the effect would be to shift risk within the financial system but not to reduce it.

B. Contractual Concerns

Furthermore, certain types of securitization provisions, including non-petition clauses, limited recourse provisions and ratings-based termination events, are generally not consistent with a clearing model in which derivatives clearing organizations apply standardized legal terms to their agreements.

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[6] This is similar to the way in which commercial end-users secure their swap positions using the same collateral package that secures their credit agreements. Indeed, securitization vehicles are end-users in the context of swaps, and differ from commercial end-users only in that many of them may be considered financial entities.

1. Bankruptcy Provisions

Certain contractual provisions in securitizations are intended to preserve the bankruptcy-remote aspects of the structure. Bankruptcy-remote structures are an important aspect of many securitizations in that they help ensure that allocations will be made under the contractual waterfall on which investors have based their investment decisions, rather than under potentially different bankruptcy provisions. They also help to ensure that the entity transferring assets to the securitization will not subsequently be able to claim that those assets should be part of a consolidated bankruptcy of the transferor and the securitization entity, which would expose the securitization investors to enterprise risks beyond those related solely to the assets. One required provision to achieve this is a non-petition clause, in which every party to any agreement with the securitization vehicle agrees that it will not join a petition to commence involuntary bankruptcy proceedings against the entity. Another is a limited recourse clause, under which these parties agree that they will not have claims against the vehicle beyond the amounts available to make payments to them under the distribution waterfall, to ensure that the securitization does not become insolvent.

2. Credit Rating Triggers

Another standard set of provisions in securitization swaps is intended to preserve the credit rating of the securities, again preserving investor expectations. For example, a transaction with fixed rate assets may require an interest rate swap to protect its ability to make floating rate payments to investors in highly rated debt. If the swap counterparty does not have a sufficiently high credit rating, some portion of the interest rate risk will be borne by the securitization investors. Accordingly, swap counterparties typically are required to agree that they may be replaced if their credit rating falls below required levels.

3. Alternate Approaches Should be Permitted

We are very concerned that both clearing and posting of margin for uncleared swaps may make the use of swaps by securitization unworkable, either by exposing the vehicle to risks that are inconsistent with the credit quality of the issued securities or by creating significant financial costs that change the economics of the transactions in ways that make them undesirable and do not add meaningful protection to their counterparties. We believe that alternate approaches should be permitted to preserve the use of swaps by securitizations.

II. Inadvertent Commodity Pool Regulation

We want to begin this section by commending the Commodity Futures Trading Commission (CFTC) and its Staff for their ongoing efforts to be responsive to our requests[7] for relief from the market challenges created by the inadvertent possible regulation of many securitization vehicles as "commodity pools" due to the swaps positions they hold. In its most basic form, a commodity pool is an enterprise in which investor funds are combined for the purpose of actively trading in futures contracts, such as in oil and gas. Securitization trusts, by comparison, are passive entities that are not operated "for the purpose of trading" in swaps, but rather for the purpose of funding consumer and business credit, such as auto loans and equipment leases. Securitizations issue fixed-income securities and do not provide allocations of accrued profits and losses to investors in a manner comparable to commodity pools. Thus, the purposes of commodity pool regulation are not applicable to securitization, and many of the compliance burdens, including disclosure of audited financial statements and net asset value, are simply not relevant to securitization investors. Securitization disclosure is already broadly regulated by the Securities and Exchange Commission (SEC) through Regulation AB and other rulemakings, and Dodd-Frank added additional regulations including risk retention, conflicts of interest, representation and warranties disclosure, and due diligence requirements. For these reasons, ASF has been actively engaged with the CFTC over the last six months to determine the best way to distinguish securitization vehicles from commodity pools without creating an overly broad exclusion.

Through a series of interpretative releases and no-action letters[8] that reference existing provisions promulgated by the SEC to address similar issues, the CFTC, as of this past Friday, has excluded nearly all securitization vehicles that use swaps only for hedging or credit enhancement purposes from the definition of "commodity pool." In addition, the CFTC has granted broad no-action relief to the operators of "legacy" securitizations—those formed before October 12, 2012, when the definition of the term "swap" became effective. Such relief acknowledges that even the very few legacy securitizations that may have indicia of commodity pools would have little ability to comply with new regulations given their passivity and amortizing nature.

Furthermore, we appreciate that the CFTC recognized for legacy securitizations that the added costs of compliance with additional regulation would largely have been unnecessarily borne by investors. The CFTC has also delayed registration requirements for the operators of remaining vehicles until March 31, 2013 to allow industry participants sufficient time to evaluate their structures.

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[7] *See* ASF's August 17, 2012 commodity pool relief request letter at:
http://www.americansecuritization.com/uploadedFiles/ASF_Commodity_Pool_Exclusion_Request_8_17_12.pdf,
ASF's October 5, 2012 commodity pool relief request letter at:
http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=8241,
ASF's November 15, 2012 commodity pool relief request letter at:
http://www.americansecuritization.com/WorkArea/DownloadAsset.aspx?id=8453.

[8] *See* CFTC's October 11, 2012 relief letter to ASF at:
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-14.pdf and
CFTC's December 7, 2012 relief letter at:
http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-45.pdf.

Although we believe that the actions of the CFTC to date address most of the industry's concerns in light of the new statutory mandate, there remains uncertainty that some securitization parties may still inappropriately be roped into regulation as "commodity pool operators," even after accounting for the two recent CFTC relief letters. We look forward to working with the CFTC prior to the new March 31, 2013 compliance date to address the remaining issues or transactions that may be outside the coverage of the CFTC's most recent December 7, 2013 letter.

Conclusion

ASF greatly appreciates the invitation to appear before this Subcommittee to share our views related to these current issues. I look forward to answering any questions the Subcommittee may have.

Thank you.

Appendix I

Auto Loan Securitization with Swap

Scenario 1

Budgeting for collateral reserve allocated at time zero

95th percentile historical interest rate movement

	t=1	t=2	t=3	t=4
Size	$100.00	$100.00	$100.00	$100.00
Duration at inception	4.25	4.25	4.25	4.25
Required upfront	2%	2%	2%	2%
Required upfront $	$2.00	$2.00	$2.00	$2.00
95% interest rate movement	2.87%	4.65%	5.37%	5.25%
Remaining duration at that time	3.25	2.25	1.25	0.25
Remaining balance at that time	$81.94	$62.97	$43.01	$22.04
Swap 95% mtm movement	$7.63	$6.59	$2.89	$0.29
Collateral haircut	98%	98%	98%	98%
Total required collateral	**$9.83**	**$8.77**	**$4.99**	**$2.34**
Effective existing overcollateralization	8.3x	7.2x	8.6x	9.4x
Funding cost (bps)	50	50	50	50
Collateral earnings (bps)	0	0	0	0
Negative carry (bps)	-50	-50	-50	-50
Total net running collateral cost $	-$0.05	-$0.04	-$0.02	-$0.01
Total net running collateral cost (bps)	**-4.92**	**-4.38**	**-2.49**	**-1.17**

Scenario 2

Budgeting for collateral reserve allocated at time zero

1.5x maximum historical interest rate movement

	t=1	t=2	t=3	t=4
Size	$100.00	$100.00	$100.00	$100.00
Duration at inception	4.25	4.25	4.25	4.25
Required upfront	2%	2%	2%	2%
Required upfront $	$2.00	$2.00	$2.00	$2.00
Max x 1.5 interest rate movement	7.02%	7.94%	9.09%	10.69%
Remaining duration at that time	3.25	2.25	1.25	0.25
Remaining balance at that time	$81.94	$62.97	$43.01	$22.04
Swap max x 1.5 mtm movement	$18.71	$11.24	$4.89	$0.59
Collateral haircut	98%	98%	98%	98%
Total required collateral	**$21.13**	**$13.51**	**$7.03**	**$2.64**
Effective existing overcollateralization	3.9x	4.7x	6.1x	8.3x
Funding cost (bps)	50	50	50	50
Collateral earnings (bps)	0	0	0	0
Negative carry (bps)	-50	-50	-50	-50
Total net running collateral cost $	-$0.11	-$0.07	-$0.04	-$0.01
Total net running collateral cost (bps)	**-10.57**	**-6.76**	**-3.52**	**-1.32**

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS

AND GOVERNMENT SPONSORED ENTERPRISES

WASHINGTON, DC

December 12, 2012

Good morning Chairman Garrett, Ranking Member Waters and members of the Subcommittee. I thank you for inviting me to today's hearing on implementation of Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) swaps market reforms. I would like to thank Robert Cook from the Securities and Exchange Commission (SEC). I'd also like to thank my friend, Chairman Mary Schapiro, who has been a terrific partner. Our agencies have consistently coordinated on this reform effort. I also want to thank my fellow Commissioners and the CFTC staff for their hard work and dedication.

The New Era of Swaps Market Reform

Swaps market reform is now becoming a reality. The marketplace is increasingly shifting to implementation of the common-sense rules of the road that Congress included in the Dodd-Frank Act.

The financial crisis cost eight million American jobs, millions of people lost their homes, and thousands of businesses closed their doors – in part because of the unregulated swaps market. In the aftermath of the crisis, President Obama convened the G-20 leaders in Pittsburgh in 2009. They came to an international consensus that the opaque swaps market should be brought into the light through transparency and oversight, and that standardized swaps between financial entities should be centrally cleared by the end of 2012.

In 2010, Congress and President Obama came together to pass the historic Dodd-Frank Act. The key objectives of the law's swaps provisions are:

- Lowering the risk of the interconnected financial system by bringing standardized swaps into centralized clearing;
- Bringing public transparency to the marketplace; and
- Ensuring that swap dealers and major swap participants are specifically regulated for their swaps activity.

The CFTC has made significant progress in each of these areas. October 12, given the completed foundational definition rules, marked the new era of swaps market reform. As a result of completed reforms:

- Standardized swaps between financial entities will be cleared starting in March, fulfilling the U.S. commitment at the G-20 meeting in Pittsburgh;

- Initial data reporting to regulators has begun and will be expanded as swap dealers report their transactions. The public will benefit from real-time reporting early next year; and
- Swap dealers have begun the process of registering, and we anticipate many dealers will do so later this month.

With 42 finalized swaps market reforms, the CFTC has completed about 80 percent of the Dodd-Frank swaps rules. We are seeking to consider and finalize the remaining rules in the first half of 2013. I believe it's also critical that we continue our efforts to put in place aggregate speculative position limits across futures and swaps on physical commodities, as Congress directed the CFTC to do.

Throughout this process, the CFTC has worked toward a smooth transition to a transparent, regulated swaps marketplace and has phased in the timing for compliance to give market participants appropriate time to adjust.

I will now go into further detail on the Commission's swaps market reform efforts.

Lowering Risk and Democratizing the Market through Clearing

Central clearing, the first building block of Dodd-Frank reform, lowers the risk of the highly interconnected financial system. It also broadens access to many more market participants, as they no longer will have to individually determine counterparty credit risk.

Now clearinghouses will stand between buyers and sellers. This broadened access through central clearing will help promote greater competition and lower costs to users of swaps.

Clearinghouses have lowered risk for the public and fostered competition in the futures markets since the late 19th century. Now central clearing will do the same for the swaps market.

A key milestone was reached last month with the adoption of the first clearing requirement determinations. This follows through on the U.S. commitment at the G-20 meeting that standardized swaps between financial entities should be brought into central clearing by the end of 2012. The vast majority of interest rate swaps and credit default index swaps will be brought into central clearing. Swap dealers and the largest hedge funds will be required to clear in March, and compliance will be phased in for other market participants through the summer of 2013. Consistent with congressional intent, the CFTC finalized rules to ensure that end-users using swaps to hedge or mitigate commercial risk will not be required to bring swaps into central clearing. The CFTC will continue working with market participants on implementation.

Promoting Transparency

Transparency, the second building block of reform, lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition. It provides critical pricing information to businesses across the country that use swaps markets to lock in a price or hedge a risk.

Bright lights have begun to shine on the swaps market. As a result, swaps transactions are being reported to regulators through swap data repositories. The public also will benefit from real-time reporting of the price and volume of transactions beginning in early 2013, based on rules the CFTC completed in 2011. In addition, the daily valuation over the life of uncleared swaps will be provided to each counterparty. For cleared swaps, it will be provided to the public as well. With these transparency reforms, the public and regulators will have their first full window into the swaps marketplace, a fundamental shift that Congress included in the Dodd-Frank Act.

Looking ahead, Commissioners are now reviewing final rules that would allow market participants to view the prices of available bids and offers. These reforms on trading platforms called swap execution facilities (SEFs) and minimum block sizes will bring pre-trade transparency to the swaps market, further enhancing liquidity and price competition. These rules will build on the democratization of the swaps market that comes with the clearing of standardized swaps.

Promoting Market Integrity and Lowering Risk through Swap Dealer Oversight

Comprehensive oversight of swap dealers, the third building block of reform, will promote market integrity and lower their risk to taxpayers and the rest of the economy.

As the result of CFTC rules completed in the first half of this year, swap dealers have begun the process of registering and, for the first time, will come under comprehensive oversight. We anticipate many dealers will register by the end of this month.

Once swaps dealers register, they will report their trades with U.S. persons to both regulators and the public. In addition, they will implement crucial back office standards that lower risk and increase integrity. These include promoting the timely confirmation of trades and documentation of the trading relationship. Swap dealers also will be required to implement sales practice standards that prohibit fraud, treat customers fairly and improve transparency. These reforms will be phased in next year.

We are collaborating closely internationally on a global approach to margin requirements for uncleared swaps through the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). I would anticipate that the CFTC, in consultation with European regulators, would take up the margin rules, as well as related rules on capital, next year with the benefit of this international work.

International Coordination on Swaps Market Reform

In enacting financial reform, Congress recognized the basic lessons of modern finance and the 2008 crisis. During a default or crisis, risk knows no geographic border. If a run starts on one part of a modern financial institution, almost regardless of where it is around the globe, it invariably means a funding and liquidity crisis rapidly spreads to the entire consolidated entity. Then finance, rather than serving the rest of the economy, can threaten the rest of the economy.

To give financial institutions and market participants operating outside the U.S. guidance on the cross-border application of Dodd-Frank, the CFTC in June sought public consultation on its interpretation of the Dodd-Frank cross-border provisions. The guidance is a balanced, measured approach, consistent with the cross-border provisions in Dodd-Frank and Congress' recognition that risk easily crosses borders.

Under the guidance, foreign firms that do more than a de minimis amount of swap-dealing activity with U.S. persons will register with the CFTC two months after crossing the de minimis threshold. Many will do so shortly, with others following later.

For firms that do register with the CFTC, we are very committed to allowing for substituted compliance, or permitting market participants to comply with Dodd-Frank through complying with comparable and comprehensive foreign regulatory requirements.

The guidance includes a tiered approach for foreign swap dealer requirements, which was developed in consultation with foreign regulators and market participants. Some requirements would be considered entity-level, such as for capital, chief compliance officer and swap data recordkeeping. Some requirements would be considered transaction-level, such as clearing, margin, real-time public reporting, trade execution, trading documentation and sales practices.

Entity-level requirements would apply to all registered swap dealers, but in certain circumstances, foreign swap dealers could meet these requirements through substituted compliance. In a separate release, the Commission proposed phased compliance regarding entity-level requirements until July 2013. Such phased compliance will allow time for the CFTC, other regulators and market participants to continue coordinating on regulation of cross-border swaps activity.

Foreign swap dealers would comply with Dodd-Frank for transaction-level requirements facing U.S. persons. The timing of transaction-level compliance with U.S. persons will be determined according to the generally applicable schedule of each of the CFTC's rules. The timing of compliance would be phased, however, for transactions facing guaranteed affiliates of U.S. persons, as well as foreign branches of U.S. persons, until next summer.

Pending further action on the cross-border guidance, the CFTC issued time-limited relief to certain foreign legal entities regarding the counting of swaps toward the de minimis swap-dealing threshold.

The CFTC also will continue to engage with our international counterparts through bilateral and multilateral discussions on reform and cross-border swaps activity. We are bound to have some differences, given our different cultures and political systems, but we've made great progress internationally on an aligned approach to reform. We are committed to working through any instances where the CFTC is made aware of a conflict between U.S. law and that of another jurisdiction.

International regulators met in New York in late November and had a very productive meeting regarding the CFTC's guidance and how other jurisdictions are handling cross-border application of swaps market reform.

The regulators and policymakers at the meeting agreed to a joint statement regarding our progress so far. In short, the statement said:

- Authorities should consult with each other prior to making final determinations regarding which derivatives products will be subject to required clearing;
- Robust supervisory cooperation arrangements should be established;
- Authorities should have appropriate access to data held in trade repositories;
- The application of reforms to market participants should be clear, and jurisdictions should consider reasonable, time-limited transition periods so that market participants have adequate time to comply; and
- The authorities agreed to continue working together, including on substituted compliance, and to meet regularly, starting in early 2013.

Market Implementation of Swaps Market Reform

As we near the end of 2012, market participants are moving to implementation of swaps market reform.

Given the magnitude of the crisis, Congress gave the CFTC but one year to complete implementing rules.

The CFTC, however, has been working to complete these rules in a deliberative way - not against a clock. We have been careful to consider significant public input, as well as the costs and benefits of each rule. CFTC Commissioners and staff have met nearly 2,000 times with members of the public, and we have held 19 public roundtables on important issues related to Dodd-Frank reform. The agency has received nearly 37,000 comment letters on matters related to reform. Our rules also have benefited from close consultation with domestic and international regulators and policy makers.

The CFTC has been working on smoothing the transition from a marketplace that lacked regulation to a new era of transparency and common-sense oversight. We have consulted broadly on appropriately phasing in reforms over time. In the spring of last year, we put out a concepts document for public comment and held a roundtable with the SEC on phased implementation. Subsequently, we proposed and finalized rules on implementation phasing. For instance, the clearing determinations will be phased in depending on the type market participant in March, then June, then September of 2013. Other reforms include built-in phasing. For instance, data reporting requirements are phased in depending on asset classes and market participants. Clearinghouses began reporting for interest rate and credit derivatives on October 12. Swap dealers will follow when they register. Reporting for foreign exchange, equity swaps and physical commodity swaps (including agricultural and energy swaps) begins in February 2013 for swap dealers and major swap participants. Reporting for all other market participants begins in April 2013. Extensive information on the compliance schedules for each of the CFTC's reforms is available on our website.

Market Participant Inquiries

Now that the market is moving to implementation, it's the natural order of things that market participants have questions and have come to us for further guidance. As it is sometimes the case with human nature, the agency receives many inquiries as compliance deadlines approach.

The Commission has sought to ensure that market participants have time to prepare. It has now been two and a half years since the Dodd-Frank Act passed. It has been a year or more since many CFTC rules have been finalized. In particular, the data rules that will largely go into effect in January were adopted by the Commission in 2011. The swap dealer definition and registration rules were completed in the first half of this year.

The CFTC, however, still welcomes inquiries from market participants, as some fine-tuning is expected. Prior to the milestone of October 12 when the foundational definition rules became effective, my fellow commissioners and I, along with CFTC staff, listened to market participants and thoughtfully sorted through issues as they were brought to our attention. We will continue to do so as we approach other important milestones in the future.

For example, CFTC staff issued a number of time-limited no-action letters while the Commission considers related exemptive petitions. These include exemptive petitions for electricity-related transactions on markets administered by Regional Transmission Organizations and Independent System Operators, as well as transactions among rural electric cooperatives and municipal-owned utilities.

Similarly, yesterday, CFTC staff issued a time-limited no-action letter to allow certain swap trading facilities and trading platforms to continue operating while the Commission completes its final rules for SEFs.

CFTC staff has also issued a number of interpretations and no-action letters regarding the definition of U.S. person and what swap dealing activity would be counted toward the de minimis swap-dealing threshold.

In addition, staff has issued interpretations and letters with regard to registration with the CFTC as commodity pool operators. Before October 12, relief was provided for equity real estate investment trusts, which are real estate investment trusts that own and operate real property; and certain securitization vehicles that issue securities backed by financial assets, are regulated by the SEC and do not use swaps to generate investment exposure.

We also sought public comment regarding other entities with inquiries about commodity pool operator registration. After October 12, guidance was provided for additional securitization vehicles. These letters addressed "legacy" securitization vehicles, backed by cash or synthetic assets, that have not and will not issue securities after October 12, 2012; and mortgage real estate investment trusts, which primarily invest in mortgage-backed securities and mortgages on residential and commercial property. In addition, these letters addressed family offices that are exempt from SEC regulation as investment advisers; business development companies that only engage in a minimal amount of commodity interest trading; and funds of funds on a time-limited basis while staff considers additional guidance for those vehicles.

We have also addressed a number of issues related to data. CFTC staff set a common date for compliance with the data reporting requirement so that a swap dealer that registers early will be subject to this requirement on the same day as one that registers later. We further phased compliance for swaps dealers to report data regarding certain swaps due to disruptions caused by Hurricane Sandy. We also provided additional time for foreign market participants on the reporting of identifying counterparty information in jurisdictions where secrecy or blocking laws forbid such reporting.

Staff is still considering a number of other specific requests for phased compliance. For instance, to facilitate compliance with new documentation requirements, the International Swaps and Derivatives Association (ISDA) has sponsored a number of documentation protocols for its members and other market participants. The Commission is considering the ISDA and its member firms' petition for additional time to complete the protocol process or any bilateral amendments to trading documentation.

The CFTC makes all of these interpretations, guidance and no-action letters public through our website and press releases.

Resources

With the market moving to implementation, additional resources for the CFTC are all the more essential. We need resources for the people and technology necessary for effective market surveillance and to enhance customer protection programs. We need resources to handle the incoming registration requests from many new market participants. We need resources to answer all of the questions from market participants on implementation of reform.

At 703 on-board staff, the CFTC's hardworking team is just 10 percent more in numbers than at our peak in the 1990s. Yet since that time, the futures market has grown more than five-fold, and the swaps market is eight times larger than the futures market.

Picture the NFL expanding eightfold to play more than 100 football games in a weekend without increasing the number of referees. This would leave just one referee per game, and, in some cases, no referee. Imagine the mayhem on the field, the resulting injuries to players, and the loss of confidence fans would have in the integrity of the game.

Given this reality, the President has requested additional resources for both staff and investments in technology for this agency. People and technological resources are critical for the CFTC to properly oversee the futures and swaps markets.

Conclusion

The common-sense rules of the road for the swaps market that Congress laid out in the Dodd-Frank Act are now the order of the day. Standardized swaps between financial entities will be cleared starting in March. Initial data reporting to regulators has begun, and the public will benefit from real-time reporting next year. We anticipate many swap dealers will register at the end of this month. I thank you and look forward to your questions.

Testimony

Before
The House Financial Services Subcommittee
On Capital Markets and Government Sponsored Enterprises

"Challenges Facing the U.S. Capital Markets
to Effectively Implement Title VII of the Dodd-Frank Act"

December 12, 2012

J. Christopher Giancarlo

Executive Vice President,
GFI Group Inc.

Chairman,
Wholesale Markets Brokers Association, Americas

Introduction

Thank you, Chairman Garrett, Ranking Member Waters, and members of the Subcommittee for providing this opportunity to participate in today's hearing.

My name is Chris Giancarlo. I am Executive Vice President of GFI Group Inc. ("GFI"), an American business and employer that operates around the globe as a wholesale broker of swaps and other financial products. I am also the Chairman of the Wholesale Markets Brokers Association, Americas (the "WMBAA"),[1] an independent industry body representing the world's largest wholesale brokers operating in the North American wholesale markets across a broad range of financial products. I am testifying today on behalf of the WMBAA.

I welcome the opportunity to discuss with you issues related to the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

WMBAA member firms have generations of experience operating at the center of the global wholesale financial markets by aggregating and disseminating prices and fostering trading liquidity for financial institutions around the world. Each business day, wholesale brokers, sometimes called "inter dealer" brokers, are busy facilitating the execution of hundreds of thousands of transactions corresponding to an average of $5 trillion in size across the range of foreign exchange, interest rate, sovereign, U.S. Treasury, credit, equity, and commodity asset classes in both cash and derivative instruments.

WMBAA members assist institutional clients in transacting both exchange-listed and unlisted products. They also operate trading platforms for instruments that are traded "over-the-counter" ("OTC") such as swaps and other derivatives. They support financial markets by gathering and spreading bids and offers and completing trades as trusted intermediaries.

Importance of U.S. Competitiveness in a Global Market

In the past four years, trading in both exchange-traded and OTC equity and fixed income derivatives has declined substantially. With futures and swaps markets trading at a cyclical low, opportunities are reduced for hedging risk. U.S. lending and investment have similarly decreased, as seen in the pared extension of credit by American banks and sharply lower trading volumes on U.S. stock exchanges.

Further, Asian and European capital markets are competing with New York and Chicago for trading liquidity and customers. WMBAA members are concerned that certain trading is moving away from U.S. trading counterparties and U.S. markets. Certain proposed regulations restrict U.S. market participants from utilizing the full range of services provided by knowledgeable and neutral intermediaries to find trading partners in products in which liquidity is scarce and pricing is wide. U.S. market participants will be placed at a disadvantage as compared to foreign trading

[1] The five founding members of the WMBAA are BGC Partners, GFI Group, ICAP, Tradition, and Tullett Prebon. The WMBA was formed to promote the quality and standards of our industry and the role of wholesale brokers in world financial markets. For more information, please see www.wmbaa.org.

firms that can use such services, and certain capital markets will move away from the United States.

The United States needs healthy financial markets, including sound, transparent, and liquid swaps markets. Instead of furthering the growth of U.S. swaps markets, regulatory uncertainty is impeding recovery, and several proposed rules would impose practices that are incompatible with the efficient trading of swaps in the United States. Such rules are causing a restructuring of the U.S. swaps marketplace and the roles, risks, and rewards of its participants. As a result, the implementation of the Dodd-Frank Act will be protracted while swaps markets, and U.S. capital markets generally, remain in confusion, hindering American economic revival and job creation.

Proposed SEF Rulemakings

Regulators are currently in the process of drafting detailed regulations related to swap execution facilities ("SEFs"). Chairman Gensler recently reached out to entities that are expected to seek registration as SEFs, including the members of the WMBAA. He indicated that he has distributed draft final SEF rules to his fellow Commissioners, which may be finalized in the coming weeks or months. He further indicated that the final rules can be expected to be changed to ensure that all modes of trade execution through a SEF can be undertaken "through any means of interstate commerce," so long that it can be verified that it is a true intermediated trade and not just a one-to-one negotiated transaction. The members of the WMBAA welcome this effort to align the regulations with the statute. By doing so, the rules would permit a wider array of modes of execution, including voice execution.

However, it is our understanding that these essential changes are only addressed in the "preamble" to the rule and not in the regulation itself. The rule text, Section 37.9, which will be relied upon as the law of the land, is reportedly silent on this point. If adopted, the CFTC would promulgate a rule that is inconsistent with the Dodd-Frank Act and contrary to the hundreds of comment letters filed, which would seriously handicap U.S. financial markets to the benefit of our international competitors. The CFTC must be clear and unambiguous in the final regulations that "any means of interstate commerce," including voice, is permitted for SEF execution of all swaps.

We have waited nearly 24 months for final rules since the initial proposals were first published for public comment in January 2011. Let there be no question: the WMBAA supports the CFTC and SEC in finalizing SEF rules, as it will allow U.S. swaps markets and their customers to finally proceed with business under a clear regulatory framework that has been unknown for over two years. However, those rules must take into account the statutory provisions of the Dodd-Frank Act and honor Congressional intent. We remain hopeful that comments received from market participants and policy makers will assist the SEC and CFTC in formulating final rules that track the law and promote competition and transparency in U.S. financial markets.

The WMBAA stands for a swaps regulatory regime that improves regulatory transparency, promotes competition, and increases market participant access. We have supported the clearing, execution, and regulatory reporting mandates of the Dodd-Frank Act through dozens of public writings and formal Congressional and regulatory testimony. We continue that support today.

These rules will impact not only the large banks and swap dealers that make markets in swaps or the hedge funds that trade them. These rules will also impact American businesses and end users that use swaps to lessen their balance sheet risk to better manage their capital for growth and their ability to invest in jobs. In other words, these rules will affect not only Wall Street, but the economic conditions on Main Streets across the country and around the world.

We are, however, concerned that certain proposed SEF provisions are overly proscriptive, may harm market liquidity, increase trading costs, and drive trading in some swaps products offshore.

It is critically important that the CFTC and the SEC implement the key swaps reforms of the Dodd-Frank Act, including central clearing, regulated execution, and enhanced transparency, with balance and proportion. Regulators should adopt a flexible, principles-based approach that respects the importance of these markets to U.S. economic recovery and provides SEFs with reasonable discretion to develop and implement appropriate rules to carry out their obligations.

WMBAA Suggestions Regarding the Proposed SEF Rule

As noted in the WMBAA's various comment letters to the CFTC, the WMBAA has identified the following as highest priority areas for attention.

Permit Multiple Modes of Trade Execution, Including Voice Execution. The SEF definition in the Dodd-Frank Act makes clear that trade execution through a SEF is permitted "through any means of interstate commerce." Congress was unambiguous that multiple modes of trade execution are permitted for clearable swaps made available for trading, so long as post-trade capture and reporting can be done electronically.

This approach is consistent with the many methods of trade execution utilized by WMBAA members in global markets today, including: electronic, central limit order book platforms; request for quote systems ("RFQ"); electronic work up features; electronic matching and auction-based trading sessions; traditional voice execution; and a combination of voice and electronic systems ("hybrid systems"). Congress clearly demonstrated its appreciation of this market structure through the plain language of the statutory text, the iterations of the SEF definition which resulted in the final language, and the numerous meetings with WMBAA members and Congressional staff.

The CFTC's proposed SEF rule, in Section 37.9, however, would: (1) restrict modes of swap execution for cleared, non-block transactions to solely two "means of interstate commerce"—central limit order book and RFQ; and (2) permit voice-based systems only with respect to block trades and certain other illiquid or bespoke swap transactions.

As a preliminary matter, block trades should not be tied to modes of execution. Though the CFTC's proposed SEF rule defines the terms "Permitted" and "Required" transactions according to, in part, whether they are block trades, the statutory text of the Dodd-Frank Act does not tie block trades to modes of execution. Rather, the statute references block trades in terms of delayed public dissemination of certain trades of size.

The restrictions in the CFTC's proposed rule would contravene the explicit language of the statute. This approach would inappropriately impair markets that rely on voice-based or hybrid systems by hindering the creation of liquidity and unnecessarily frustrating market participants. As WMBAA members provide both pre- and post-trade transparency regardless of execution method, such limitations on customer choice are not needed to enhance regulatory and market transparency. WMBAA members fully support requirements that all transactions of any means be subject to a complete time-stamped audit trail of the process of the trade for purposes of regulatory supervision.

Accordingly, the CFTC should clarify in its final rule that "any means of interstate commerce" includes the full range of swaps execution methodology, expressly including voice execution.

Remove the "15 Second Rule." A 15 second timing delay before a trader can execute against a customer's order, or a SEF can execute two customers against each other, is not contemplated by the Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Act, nor is it supported by legislative history. This concept will create uncertainty and risk in the market and jeopardize the CFTC's balance of the need for pre-trade transparency with the market's liquidity needs.

Further, this requirement does not appear to be consistent with the protection of investors. A broad range of financial market participants, including asset management firms acting within their statutory fiduciary duty to America's state and local government pension funds, endowments, ERISA funds, 401(k) and other retirement funds, have voiced their opposition to this requirement.

The 15 second delay ignores the unique nature of the swaps markets and will have a detrimental impact on liquidity. The CFTC, therefore, should remove the "15 second rule" and allow flexibility suited to the quality of liquidity in a given instrument.

Clarify that Impartial Access Extends to Market Participants Only. The CFTC should delete the provision in the proposed rules providing impartial access to SEFs for independent software vendors ("ISVs"). This requirement is beyond the legal authority granted in the CEA and expands the impartial access statute beyond "market participants" to include entities lacking any intent to transact in swaps. Further, the rule fails to clearly define what constitutes an ISV.

The proposed rules might allow competing SEFs to qualify as ISVs and have unfair access to competitors' systems or platforms, producing a result contrary to the Dodd-Frank Act's goal of promoting a thriving marketplace of competing swap execution venues. The resulting competitive harm to SEF registrants is unwarranted. There is no congressional intent or legislative history to indicate that the term "market participants" should be read beyond the commonly understood definition as used by the industry today.

Withdraw the DCM 85 Percent Volume Requirement. The CFTC has proposed amendments to designated contract market ("DCM") Core Principle 9 that would establish a minimum on-exchange trading threshold of 85 percent. The proposed rule would not assure price improvement or materially enhance pre-trade price transparency. Rather, it would create unnecessary market disruption and increase trading costs. In place of the proposed rule, the CFTC should adopt a flexible approach that takes into account available trading liquidity and favors customer choice of venue and mode of swaps execution.

CFTC Cross-Border Interpretive Guidance

In addition to the SEF rules, the CFTC's other proposed rules have had troubling extraterritorial impacts as well. In fact, the "interpretive guidance" approved by the CFTC in June of this year received tremendous international criticism and resulted in real-world harm to many U.S. firms. In particular, the guidance included an expansive proposed definition of the term "U.S. person,"[2] and described the manner in which the Commission proposed to consider whether a non-U.S. person is a swap dealer or major swap participant. The proposed guidance also interpreted a provision of the CEA regarding activities with a "direct and significant connection with activities in, or effect on, commerce of the United States."

Let me be more specific. We are pleased to note that global regulators met recently in New York and pledged to harmonize their regulatory reform efforts. We wish them success. Nevertheless, from our perspective as operators of global trading platforms, we are currently observing that U.S. trading firms are being shunned by foreign counterparties in order to avoid having to register with the CFTC as swap dealers. For example, Singapore's DBS Group and Sweden's Nordea Bank are the first major institutions to publicly declare that they would not register with U.S. regulators to trade swaps. Additional firms have indicated a similar preference in private and have ceased trading with U.S. persons. In terms of the interest rate swaps market in Asia, a "two-tiered" market appears to be developing in response to the proposed U.S. extraterritoriality regulations. Through pre-trade requests, certain Asian banks are declining to transact with U.S. counterparties located anywhere, while others are willing to trade with a U.S. counterparty located in a foreign office but not a U.S. counterparty located in the United States. All of these Asian banks have indicated the intention to avoid being ensnared in the CFTC's extraterritoriality rules.

In light of these developments, if the CFTC regulation is promulgated as proposed, U.S. firms will be placed at a significant disadvantage in the event of a market crisis. Under the current CFTC proposed guidance, the market tier that excludes U.S. persons will not be subject to CFTC regulations and will be able to execute trades through the full spectrum of hybrid brokerage

[2] The CFTC's proposed definition of the term "U.S. person" would include, but not be limited to: (i) Any natural person who is a resident of the United States; (ii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing, in each case that is either (A) organized or incorporated under the laws of the United States or having its principal place of business in the United States ("legal entity") or (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a U.S. person; (iii) any individual account (discretionary or not) where the beneficial owner is a U.S. person; (iv) any commodity pool, pooled account, or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a U.S. person(s); (v) any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the CEA; (vi) a pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States; and (vii) an estate or trust, the income of which is subject to United States income tax regardless of source.

trading methods, including voice brokering. Conversely, the tier that includes U.S. persons as counterparties will be severely limited in modes of execution, including using voice execution that is vital during periods of market disruption or financial panic. During any such market crisis, liquidity will move to the market tier that excludes U.S. persons where counterparties will be free to access voice brokers to hedge their positions while U.S. traders and firms will be at risk and unable to access liquidity.

"Futurization of the Swaps Market"

I would like to alert you to another development with great implications for the health of U.S. capital markets. Immediately upon the October 12 effective date for certain CFTC regulations, we observed an overnight migration of trading activity in U.S. natural gas and electric power markets from cleared swaps to economically equivalent futures products. In itself, this event was unprecedented in that a vital U.S. market changed its entire trading activity largely to avoid pending regulatory structure rather than for significant commercial or economic advantage or public good. More broadly, however, it suggests even greater migration and potential disruption to U.S. capital markets if replicated in other swaps products. We fear all of this is happening with very little study and oversight by the regulators on these new and game-changing products.

As members of this Subcommittee know, in crafting Title VII of the Dodd-Frank Act, Congress established a swaps regulatory structure that would reduce systematic risk, promote central counterparty clearing, increase transparency, and preserve competitive U.S. markets for swaps trading. Congress, however, did not mandate a preference for futures products over swaps or monopolistic silos for trading and clearing over competitive multi-venue trading platforms and fungible clearing.

Notwithstanding the clarity of Congress's intention, the CFTC has furthered regulatory arbitrage against one product under its jurisdiction—swaps—in favor of the other—futures. The opportunity for arbitrage between swaps and futures results from a range of factors, including differences in the calculation and setting of block trade sizes, timing of trade reporting, tax treatment, counterparty registration, cross-border trading, business conduct rules, and, importantly, the cost of margin and capital that will create inexplicable and potentially systemically dangerous differences in the treatment of managing identical risks in different markets. While the migration resulted from the combination of these arbitrage factors, the primary impetus came from the desire of U.S. non-bank energy traders to avoid cleared swaps trades from being counted toward a numeric threshold that would force them to register as "swap dealers" or "major swap participants." Taking advantage of the current uncertainty as to the timing and substance of final swaps rules and exploiting the above arbitrage opportunities, futures exchanges are rolling out a series of swap future products that are economically equivalent to swaps, but allow market participants to avoid swaps regulation entirely.

All of this is happening while WMBAA member firms, and other companies with experience fostering liquidity, wait patiently for the CFTC to complete its SEF rules. It is nearly two years since publication of the proposed rule, and our companies cannot begin to operate under the new Dodd-Frank Act regime until these regulations are adopted. Until then, we remain at a regulatory disadvantage simply because there are no final rules. While we wait, confusion reigns among our customers whose market making activities are vital to U.S. capital markets and American prosperity.

The "Futurization" of Swaps Markets Harms Competition. Today, the U.S. swaps market offers a broad choice of financial products, methods of trade execution, trading venues and clearinghouses. Under the Dodd-Frank Act, Congress wisely enhanced the competitive nature of the swaps market by mandating impartial access to swaps clearing, thereby assuring product fungibility. The U.S. futures market, while working very well for a finite set of highly liquid commodities and financial products, restrains competition by limiting methods of execution and having single vertical silos for execution and clearing.

Unlike SEFs, exchanges control the size of block trades for futures contracts and deny impartial access to clearing. This allows exchanges to limit their customers' choice of execution venue. The U.S. Department of Justice has deemed the structure of the U.S. futures market to be one marked by vertical monopolies.[3] The unabated "futurization" of the swaps market entrenches the vertical monopolies of the futures industry and thwarts Congress's envisioned landscape of competing SEFs and impartial access to swaps clearing.[4] The movement of trading from swaps to futures is a movement toward monopolistic control, reduced customer choice and, inevitably, higher costs of trading and execution. The result will reduce the competitiveness of U.S. capital markets against foreign competitors.

The Dodd-Frank Act rejected the vertical silo model for the swaps market in favor of a market place with competitive clearing, execution, and trade reporting, ensuring that derivatives clearing organizations ("DCOs") would not use that central role to act in an anti-competitive manner.[5] The statute goes further and ensures that DCOs provide "nondiscriminatory access to clearing" for trades executed on a SEF because SEFs will compete with affiliates of the DCOs. These protections do not exist in the futures market.

The "Futurization" of Swaps Markets Does Not Improve Transparency. Congress intended to reduce systemic risk in the swaps markets by increasing transparency. To that end, Title VII explicitly requires swap transactions to be reported in real-time to the public and to licensed swap data repositories. Additionally, it requires swap dealers and major swap participants to register with regulators, assuring direct trading supervision and accountability. In contrast, there is no statutory mandate for the real-time reporting of futures trades to the public or to registered data repositories, nor is there any requirement for the direct registration, supervision, and accountability of traders of futures products. As a result, the migration of swaps markets to futures products will not enhance market transparency, contrary to the Congressional objective set forth in the Dodd-Frank Act.

[3] Comments of the Department of Justice before the Department of the Treasury, Review of the Regulatory Structure Associated With Financial Institutions, January 31, 2008.

[4] http://www.risk.net/risk-magazine/news/2224931/risk-usa-futurisation-trend-could-hurt-sefs-says-cftcs-chilton ("Attempts to convert over-the-counter derivatives into listed products may hurt swap execution facilities").

[5] Notwithstanding the Dodd-Frank Act's rejection of vertical monopolies in trading of swaps products, there are still issues of monopolistic practices. CME's proposed rule 1001 would require that swaps cleared by its clearing house be reported to CME's affiliated swap data repository ("SDR") notwithstanding customer preference to report to a competing SDR.

<u>The "Futurization" of Swaps Markets Increases Balance Sheet Risk for Market Participants.</u> Swap futures are imperfect hedges that will cause market participants to incur basis risk. Swap futures do not allow for specific exercise dates, unlike swaps which are infinitely customizable. If a corporation is forced to use futures rather than cleared swaps (whether by regulatory fiat or lack of swaps liquidity), the non-availability of specific exercise dates may create basis risk for the company and make it ineligible for hedge accounting treatment. The result would be greater earnings volatility. Further, upon expiration of swap futures contracts, market participants may be forced to "roll" expiring contracts into new contracts to maintain their hedging, exposing them to additional market risk. This would lead to more volatile markets, especially in times of market uncertainty and crisis.

<u>The "Futurization" of Swaps Markets Also Lessens Customer Protections.</u> With cleared swaps, a customer of a given Futures Commission Merchant ("FCM") is protected from the risk that a second customer of the same FCM will go bankrupt causing the FCM to fail, which would draw the first customer's funds into the liquidation. This segregation of one customer's margin from another is only available for cleared swaps and not for futures. By migrating cleared swaps to futures, the customer is deprived of the protections that were specifically included in the Dodd-Frank Act.

<u>The "Futurization" of Swaps Market Increases Systemic Risk.</u> The CFTC has determined that DCOs must utilize a one-day liquidation time horizon for futures and a five-day liquidation time horizon for most swaps.[6] Labeling a product as a "future" and listing it on a DCM results in more favorable margin treatment over a product called a "swap" even though the economic characteristics of such products may be identical. The name of a product's execution venue (*e.g.* DCM or SEF) should not impact the margin requirements of two economically similar cleared instruments. Instead, that calculation should be based on observable market conditions of liquidity and volatility. By holding lower margin for a swap future with the exact same risk as its economically equivalent swap, clearinghouses are forced to absorb more risk, especially during a liquidity crunch or a downgrade of its clearing members. Instead, products brought to the market as futures should have the same margin, tax treatment, and reporting requirements as swaps managing the same risk.

As the "futurization" of the swaps markets harms competition and transparency and increases balance sheet and systemic risk, we call on regulators, legislators, and policy makers to provide thorough research-based market analysis and customer-based supervision. This development is overwhelmingly driven by regulatory arbitrage rather than a commercial opportunity, and would allow market participants to select one regulatory framework over another for economically equivalent products. Such a market switch should not be permitted due to regulatory omission. Regulators must take full charge and responsibility for the development and the resulting unintended consequences.

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[6] 76 FR 69438 Rule 39.13(g)(ii), November 8, 2011 (*Derivatives Clearing Organization General Provisions and Core Principles*).

Conclusion

The WMBAA understands that the CFTC Commissioners are considering a draft set of final rules related to SEFs, block trading, "made available to trade," and extraterritoriality, which include significant modifications from the initial proposed rules. The SEF rules must make clear—in the rule itself and the preamble—that trades can be done "through any means of interstate commerce." The rules should dispense with the so-called "15 Second Rule," which would harm swaps market liquidity without benefitting market participants or market safety. The rules should also withdraw the 85 percent threshold for DCM Core Principle 9, which would diminish trading liquidity and limit customer choice of mode and execution venue.

Once these SEF rules are approved by the Commissioners and published in the Federal Register, the WMBAA members will navigate the process of compliance with the various rules, including requirements for registration, trade execution, block trading, margin setting, and trade reporting.

The final rules must be designed and implemented in a manner that helps to preserve the existence of sound, efficient, liquid, and more transparent financial markets. In this regard, the final rules must be consistent with the plain language of the Dodd-Frank Act, as deviations from the statutory text will hinder the growth of efficient capital and financial markets that are essential for the nation's recovery.

We call on the CFTC, the SEC, and non-U.S. financial market regulators to continue their crucial work to harmonize global regulatory reform efforts. As global intermediaries that operate across international markets, we sound the alarm regarding the development of two-tiered markets—one that includes U.S. counterparties and another that excludes U.S. counterparties—solely on the basis of avoiding overly restrictive U.S. regulations. As this development will be detrimental for U.S. trading interests and for the U.S. economy, policy makers must be vigilant to prevent its further growth.

Finally, we call on regulators and policy makers, including members of this Subcommittee, to give full and effective consideration to the "futurization" of the swaps markets, the harm it will cause to competition and transparency, and the risk it will incur to corporate balance sheets and U.S. capital markets. Such a migration of markets should not be driven merely to avoid one regulatory framework without a thorough, research-based understanding of the likely consequences.

Thank you for the invitation to participate in today's hearing.

Hit or Miss: Regulating Derivative Markets to Reduce Hedging Costs at Non-Financial Companies

Dr. John E. Parsons
Massachusetts Institute of Technology

Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, in a Hearing on "Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act"

December 12, 2012

My name is John E. Parsons. I am a Senior Lecturer in the Finance Group at the MIT Sloan School of Management and the Head of the MBA Finance Track. I am also the Executive Director of the MIT Center for Energy and Environmental Policy Research. I have a Ph.D. in Economics from Northwestern University. At MIT I teach a course on risk management for non-financial companies, the so-called end-users or commercial hedgers, and I co-author a blog on the subject, bettingthebusiness.com. I have published research on theoretical and applied problems in hedging and risk management, and I have been a consultant to many non-financial companies on hedging problems of various kinds, as well as on other financial issues.

Executive Summary

Derivative markets are an important tool enabling non-financial companies to reduce their risk and manage their financing. Effective regulation of these markets can lower companies hedging costs and help improve productivity. Ineffective regulation can raise costs and reduce productivity. In this testimony, I address what type of action is likely to be effective in reducing hedging costs at non-financial companies and what type of action is likely to be ineffective or counterproductive.

One component of the cost a non-financial company pays to hedge risk using derivatives arises from the company's own credit risk tied to that derivative trade. No regulation or legislation can reduce

this cost. Regulations and legislation targeted to avoiding or reducing this cost are misguided at best and dangerous at worst. For example, legislation that directs bank regulators to turn a blind eye to the credit risk embedded in non-margined derivatives is dangerous. It cannot reduce the cost of hedging, but it can undermine the soundness of the financial system and impose great costs on taxpayers. Ultimately, non-financial companies suffer, too, from a less stable financial system.

A second component of the cost a non-financial company pays to hedge risk using derivatives arises from the financial system's cost to provide the derivative. Wise regulation of the derivative marketplace can reduce this cost. This is where regulatory and legislative attention should be directed. In particular, central counterparty clearing is an important and historically proven innovation that reduces the financial system's total cost of providing derivatives to hedge commercial risks. The Dodd-Frank Act's re-imposition of central counterparty clearing on a large fraction of derivative trades lowers the cost of hedging by non-financial companies. How successfully central counterparty clearing lowers the cost depends upon the details of its implementation. Wise regulatory supervision can help to maximize the benefits derived from central counterparty clearing.

Opponents of reforming the derivatives markets have commissioned several studies to allege large costs from expanding central counterparty clearing. The cost estimates in these studies have been repeatedly and thoroughly discredited. They all attribute to central counterparty clearing a cost that is also present without central counterparty clearing, albeit in different form. They all completely ignore how central counterparty clearing lowers the total cost of the financial system.

Margins and the Cost of Hedging by Non-Financial Companies

When a non-financial company uses derivatives to hedge commercial risk, the derivative trade generates some credit risk which is costly. That risk is inherent to the derivative trade, regardless of the different form the trade can take.[1] If the derivative trade is not margined, then the credit risk is embedded in the derivative. If the derivative trade is margined, then the credit risk is separated from the derivative and appears in the line of credit used to finance the margin. For any given company, whether a derivative is margined or not changes <u>*where*</u> the credit risk appears, but does not change how much credit risk is produced by the derivative trade.

[1] "Hedging and Liquidity." With Antonio S. Mello. Review of Financial Studies 13, No. 1 (Spring 2000): 127–53.

It is easy to misunderstand the relationship between the practice of margining and the cost of trading derivatives. Because the credit risk in a non-margined derivative is embedded in the derivative, and because the cost is paid implicitly through the price terms for the derivative, it is easy to overlook the cost. The practice of margining forces a separate accounting for the credit risk and makes the cost paid for this credit risk explicit. Consequently, many people mistakenly think that the practice of margining creates a new cost.

This misunderstanding shows up in the memorandum prepared by the Committee Staff in preparation for this hearing. That memo states that "imposing margin requirements on end-users that are not financial firms would divert capital from operating budgets, leaving end-users with less capital from operating budgets, leaving end-users with less capital for investment and job creation." This claim is simply not true. Margin requirements do not drain a company's capital. If a company has enough debt capacity that the derivative seller will extend it the implicit line of credit, the company also has enough debt capacity that a bank or other financial institution will extend it the explicit line of credit to fund the required margin. A requirement to margin derivatives does not drain any capital from non-financial companies: instead, the requirement only forces the credit to be extended explicitly. The amount of credit required to trade the derivative is determined by the company's specific risks, by the specific risks of the derivative, and by their interaction. The practice of margining does not change or add to the capital requirement.

My colleague, Antonio Mello, and I have expanded on the points made here in much greater length in our paper "Margins, Liquidity and the Cost of Hedging."[2] In that paper, we provide a simple example of a non-financial company hedging the price of oil. We show that the cost of hedging is the same using a non-margined derivative and a margined derivative. We show that the credit embedded in the non-margined derivative is the same as the credit used to finance the margined derivative. Margining adds zero cost to the non-financial company hedging with the oil derivative when attention is paid to both the explicit and the implicit costs paid by the company.

The lobbying around the rulemaking for the Dodd-Frank Act has yielded a number of studies designed to show that a margin mandate would impose a large cost on non-financial companies and the economy. Unfortunately, none of these studies are credible. A typical example is the April 2010 study by

[2] "Margins, Liquidity and the Cost of Hedging." With Antonio S. Mello. Center for Energy and Environmental Policy Research Working Paper #2012-005, May 2012.
web.mit.edu/ceepr/www/publications/workingpapers/2012-005.pdf

Keybridge Research, commissioned by the Coalition for Derivatives End-Users, which purported to show a cost to the economy of $5-$6 billion annually in capital spending and a loss of 100,000-120,000 jobs. However, this study starts by assuming away any costs associated with the credit risk embedded in a non-margined derivative. To a first approximation, the cost of the credit risk embedded in a non-margined derivative is equal to the cost of the credit line needed to fund the margin on a derivative, so the study's estimated cost of margining is entirely a consequence of this fallacious assumption.[3]

A number of bills have been proposed in Congress which seek to reduce the cost of hedging at non-financial companies by legislating the terms for selling margined or non-margined derivatives. In particular, some bills direct bank regulators to turn a blind eye to the credit risk embedded in non-margined derivatives.[4] This is dangerous. A prudently managed bank will have policies, procedures and controls to assess how much total credit risk it has in its portfolio of non-margined derivatives. If our bank supervisors are doing their job, they will require the bank to recognize this credit risk and finance the bank correspondingly. Turning a blind eye does not eliminate the credit risk. The risk is there. Ignoring it can only undermine the soundness of the financial system. Ultimately, it is taxpayers who bear the cost of making the financial system vulnerable. A poorly supervised financial system also hurts non-financial companies. Attempting to lower costs by hiding or ignoring or mismanaging risks does not produce any real benefit for the U.S. economy.

Central Counterparty Clearing Reduces the Cost of Trading Derivatives

Many people who are unfamiliar with the long history of derivatives markets in the US think of the Dodd-Frank Act's reform of the OTC derivatives markets as a regulatory gamble that imposes new, untested rules on the markets. Exactly the opposite is true. The main spirit behind the Dodd-Frank Act's reform of the OTC derivatives market is to return the country to a framework that had served the country so well throughout the 20th century.

[3] "An Analysis of the Coalition for Derivatives End-Users' Survey on Over-the-Counter Derivatives," Prepared by Keybridge Research for the Coalition for Derivatives End-Users, February 11, 2011. Another example of a similarly flawed study is "Cost-Benefit Analysis of the CFTC's Proposed Swap Dealer Definition," Prepared by NERA Economic Consulting for the Working Group of Commercial Energy Firms, December 20, 2011.
[4] Example bills are discussed in these blog entries:
bettingthebusiness.com/2012/08/02/turn-a-blind-eye-to-credit-risk/
bettingthebusiness.com/2011/10/06/it%E2%80%99s-not-all-about-end-users/

One element of this framework is central counterparty clearing.[5] Far from being a new and untested regulation, central counterparty clearing is a landmark innovation of late 19th century derivative markets. It is an innovation that enabled the successful growth of derivatives trade in the U.S. throughout most of the 20th century. Central counterparty clearing was introduced to the U.S. in 1896 by the Minneapolis Grain Exchange, home to derivative trade in grains.[6] This innovation helped to reduce the aggregate amount of risk in the system and therefore lowered the amount of capital required to manage derivative markets. This lowered the cost charged to non-financial companies hedging with derivatives. Central counterparty clearing also improved access to the derivative market, keeping the market competitive and growing. Established derivative exchanges in other cities gradually recognized these advantages of central counterparty clearing and copied this innovation. As new futures exchanges were established, central counterparty clearing was often the chosen structure right from the start. This was the case at the Chicago Mercantile Exchange, established in 1919 for trade in butter, eggs and other products. In 1925, the Chicago Board of Trade, which was the largest derivatives exchange at the time, switched to central counterparty clearing. From that date forward, central counterparty clearing reigned as the standard practice for derivatives trading in the U.S., and remained so for the next 50 years. This was an era that worked well for commercial enterprises looking to hedge their business risks, and an era that worked well for a growing US economy.

When the OTC swap market developed in the late 20th century, it was originally a useful venue for innovative and custom designed derivatives that were ill-suited to trade on exchanges and to central counterparty clearing. This market was exempt from regulatory supervision, and financial institutions quickly used it to host trade in all kinds of standardized and standardizable derivatives, not just innovative or custom designs. It quickly became the dominant derivative marketplace. Because the OTC swap market used bilateral clearing, this shift away from traditional, regulated derivative markets also entailed a shift away from central counterparty clearing.

The Dodd-Frank Act's mandate that the majority of derivative trades once again be traded using central counterparty clearing represents a return to a tested innovation in market structure. American finance and industry has great experience in perfecting this regulatory innovation over many decades, and further improvements are possible. The studies cited earlier which advertise an incredibly large cost

[5] A good reference on the mechanics of central counterparty clearing is the Staff Report from the Federal Reserve Bank of New York, "Policy Perspectives on OTC Derivatives Market Infrastructure, by Darrell Duffie, Ada Li and Theo Lubke, No. 424, January 2010.

[6] At the time, the Exchange was known as the Minneapolis Chamber of Commerce.

to margining derivatives all ignore the benefits of central counterparty clearing and how it reduces the total cost to the system.

How successfully central counterparty clearing succeeds in reducing the total amount of credit risk in the system does depend upon how it is implemented—for example, by maximizing the amount of transactions in the system that can be netted out.[7] But exemptions from clearing requirements do not facilitate reducing the total risk in the system. Congressional attention should be focused on maximizing the benefits of central counterparty clearing by maximizing the effective amount of netting, and not on manufacturing new or expanded exemptions to central counterparty clearing.

Conclusion

Derivative markets are a useful innovation that promise non-financial companies a way to better manage many risks and more efficiently finance themselves. When derivatives markets are well managed and supervised, they contribute to economic productivity. But, when poorly managed and supervised, the potential of these markets is unrealized and, worse still, they pose grave danger to the economy. The financial crisis of 2007-2008 serves as a clear example of the terrible economic and social damage that can follow from a poorly supervised financial system, including poorly managed derivative markets. Many non-financial companies were forced to dramatically cut investments and reduce output due to the financial crisis. As the implementation of Title VII of the Dodd-Frank Act is reviewed, it is important that we focus our attention on proven innovations in regulating derivatives markets, such as central counterparty clearing. It is equally important that we reject options that pretend to lower costs by ignoring those costs.

[7] Some examples for how the success of central counterparty clearing can vary are contained in the Staff Report from the Federal Reserve Bank of New York, "Policy Perspectives on OTC Derivatives Market Infrastructure, by Darrell Duffie, Ada Li and Theo Lubke, No. 424, January 2010.

WRITTEN TESTIMONY
OF
COMPANIES SUPPORTING COMPETITIVE DERIVATIVES MARKETS
FOR THE
CAPITAL MARKETS AND GSEs SUBCOMITTEE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

December 12, 2012

Chairman Garrett, Ranking Member Waters, thank you for the opportunity to submit written testimony on the economic and market implications of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The companies[1] supporting competitive derivatives markets are composed of individual market participants who support the intention of Congress to bring transparency to and reduce systemic risk in the futures, options, and swaps markets.

Responding to public outrage fueled by the financial crisis in 2008, world leaders convened for a G-20 meeting in Pittsburgh in September 2009, and agreed that the $700 Trillion global over-the-counter swap markets must be regulated, not eliminated. In July 2010, Congress passed and the President signed Dodd-Frank into law to do just that. While some lobbied for the end of the swaps market in favor of futures products, Congress concluded that it was important to preserve the $300 trillion U.S. swaps market which had grown organically for almost 30 years. Congress carefully drafted each provision of Title VII of Dodd-Frank and directed the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) to implement it with two specific goals in mind: reduce systemic risk in the U.S. swaps market through measured regulation and preserve the role of swaps in the U.S. economy. We vigorously support and respect those goals.

Congress intended to reduce systemic risk in the swaps markets by increasing transparency. To that end, Title VII explicitly requires swap transactions to be reported to data repositories, it requires certain swaps to be traded on regulated platforms to promote the goal of pre-trade price transparency, it requires post-trade reporting of swap transactions to the public in

[1] The individual companies who support competitive derivatives markets include the following market participants: GFI Group Inc., ICAP, Tradition, Parity Energy, Inc., Tradeweb Markets LLC, Thomson Reuters Corporation, and Bloomberg, L.P.

real-time, and it contemplates that swaps should be able to be traded on regulated platforms and cleared at any clearinghouse willing to accept them. While the specific implementation of these policies was left to the CFTC and SEC, Congress went to great lengths to set forth a regulatory structure designed to reduce risk, increase transparency, and preserve the character of the U.S. swaps markets. Congress understood that regulating the U.S. swaps markets would be among the most significant market structure undertakings since 1934.

So where are we now? After nearly 2 ½ years of rulemaking, the CFTC's cumulative approach to swaps regulation has imposed such high costs on the industry that the U.S. swaps market is on the verge of becoming too costly and too regulated (particularly as compared with futures) to be a viable means for end user to hedge and manage their financing risk.[2] The overwhelming differences between swaps and futures rules on determining block trade sizes, real-time reporting, registration, cross-border trades, business conduct, and potentially, most important, the cost of margin and capital is threatening to strangle the U.S. swaps market in favor of the futures market through the technicality of a "swap future".[3]

It appears that by simply changing the name of the product from a swap to a swap future, market participants can avoid swap regulation entirely. In its attempt to regulate the swaps market in a different manner than the futures market with respect to economically equivalent financial instruments, the CFTC created regulatory arbitrage between the only two products under its jurisdiction: swaps and futures. By creating an unequal playing field between economically equivalent swaps and futures, the CFTC's swap regime may find itself directly at odds with Congress' intent to preserve the U.S. swaps market.[4]

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[2] A number of buy-side market participants are concerned about reaching the $8 billion de minimus swap dealer safe harbor notional amount and being classified as a swap dealer simply because they are required to include the notional value of cleared swaps in the de minimus calculation. Our view is that cleared swaps should not count towards the de minimus amount.

[3] http://cftc.gov/PressRoom/SpeechesTestimony/opaomalia-18; ("Given the inconsistency in the Commission's interpretation of its own rules, the lack of regulatory certainty and the increased cost of compliance with the Commission swaps regulations, including the complicated and controversial swap dealer definition rules, swap customers have turned to futures markets for regulatory certainty. ICE will become the first exchange to take such a step ahead of new financial regulations, but I suspect they will not be the last"). http://www.cmegroup.com/trading/interest-rates/introducing-deliverable-interest-rate-swap-futures-webinar.html; http://ir.theice.com/releasedetail.cfm?ReleaseID=713717.

[4] A 10 year plain vanilla interest rate swap and a 10 year swap future represent the same risk instrument, yet the swap future is subject to an entirely different, less transparent, more opaque and less expensive regulatory framework than the 10 year interest rate swap. See also http://www.risk.net/risk-magazine/news/2208965/ice-move-from-swaps-to-futures-unlikely-to-be-last-says-o-malia; ("While I certainly don't believe it was the intent of Congress or the commission to draft rules that would drive people out of the swaps market, the regulatory uncertainty was so great that energy markets voted with their pocket-books and moved their trading business from the regulatory nightmare of swaps markets to the … futures markets").

Does it serve the public interest when the federal government, through a regulatory framework, effectively creates a mandate that swaps be converted into swaps futures? Does it bring additional transparency or the reduction of systemic risk to the broader derivatives markets? On close examination, we believe the answer is "no".

First, does the conversion of swaps to swap futures enhance competition? The answer is no. Swap futures are not subject to the same trading fungibility and open access clearing requirements that Congress requires of swaps; thus, the vertical monopoly of the futures industry is further entrenched and competition from swap execution facilities (SEFs) and new derivatives clearing organizations is greatly reduced.[5] Importantly, by removing choice of product and venue farmers, corporates, pension funds, insurance companies, and consumers will be subject to increasingly higher costs for execution and clearing. Competition has been further impacted by the delay in the SEF rules as compared with the rules for exchanges.[6] In the absence of a SEF framework and infrastructure, the marketplace is moving away from that uncertainty toward the existing exchange and swap future paradigm – effectively giving the vertical silos an even more entrenched monopoly.

Second, does the conversion lead to greater transparency? The answer is no. Swap transactions are required to be reported to a data repository that regulators can access to conduct market surveillance and systemic risk oversight. Swap futures contracts are not. Swap transactions are statutorily subject to real-time post trade reporting on a publicly accessible data repository website. Swap futures contracts are not. These differences ensure that, unlike the swaps markets, only those entities or individuals with the resources to afford real-time data for swap futures contracts will have access to it. In addition, commercially operated exchanges control the size of block trades for futures contracts, unlike swaps where the block size is set by the CFTC and SEC. The inevitable result will be differing minimum block sizes between swap

[5] http://www.risk.net/risk-magazine/news/2224931/risk-usa-futurisation-trend-could-hurt-sefs-says-cftcs-chilton ("Attempts to convert over-the-counter derivatives into listed products may hurt swap execution facilities")
[6] http://cftc.gov/PressRoom/SpeechesTestimony/opaomalia-20 ("Unfortunately, the Commission's rulemakings have already disincentivized trading on swaps venues by implementing burdensome swap dealer registration rules and disadvantageous margin requirements for swaps. As a result, energy traders fled from the swaps market to the standardized futures markets in October, a transition dubbed "futurization," just ahead of the effective date for swaps regulations.").

futures and swaps, with futures exchanges looking to gain commercial advantage. Certain market participants will look to arbitrage the differing block sizes to conduct transactions off-exchange or off-SEF depending on where they can access greater trading opacity outside the broader liquidity pool.[7] As a result, whether a derivative instrument is called a swap or a swap future and not its underlying risk profile will determine its price transparency.[8] In short, the CFTC's rules, with respect to economically equivalent instruments, favor the futures markets over the swaps markets, and the CFTC (or Congress) must address these differences. As currently constructed, these rules undermine the benefits to the public that Congress intended for Title VII.[9]

Third, does this conversion protect those Congress intended to protect? All of the transparent business conduct protections that the consumer advocate groups fought so hard to include in Title VII to protect pension funds, schools, and municipalities (Special Entities) from the risks of swap transactions can be legally evaded using an interest rate swap future.[10] There is no obligation for a Special Entity to engage a fiduciary-like advisor to act on its behalf to detail the risks or costs associated with the use of an interest rate swap future. There is no obligation to disclose conflicts of interest when marketing an interest rate swap future to a Special Entity. Again, by simply changing the name of the product, the taxpayer, retiree, and ordinary citizen are left completely unprotected from some of the risks that Title VII was designed to prevent. As the Consumer Federation of America and the Americans for Financial Reform rightly noted in a comment letter to the CFTC, "with the adoption of the business conduct provisions of the act, Congress clearly intended not just to provide greater transparency, though that is important, but also to transform the nature of the relationships, particularly with regard to special entities."[11]

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[7] If futures exchanges can set lower block sizes than SEFs, it essentially gives the exchanges the ability to offer an off-exchange request-for-quote ("RFQ") to one (1) on swap futures, whereas as an RFQ to one (1) on a SEF for an economically equivalent swap with similar volume would not be permitted. RFQ functionality allows a market participant to determine how many counterparties it would like to receive quotes from prior to determining whether to execute a market transaction. In addition to block trading arbitrage, this also results in regulatory arbitrage among methods of execution.

[8] http://cftc.gov/PressRoom/SpeechesTestimony/opagensler-124 (According to Chairman Gensler, "[t]ransparency lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition. ").

[9] Moreover, Title VII also requires swap dealers and "major swap participants" to register with the CFTC, which provides direct transparent supervision and accountability of trading and risk management practices. In sharp contrast, there is no such requirement for most traders of futures products.

[10] *Id.* ("The product brochure for CME Group's new swap futures contract - which starts life as a future but delivers into an OTC swap - advertises the product as a way for users to "sidestep many of the challenges that may be associated with OTC derivatives in the current market environment").

[11] http://www.consumerfed.org/pdfs/cftc-business-conduct-standards-comment-letter.pdf

We would suggest that the differences between swaps and swap futures have made certain that will not happen.

Fourth, has the conversion reduced systemic risk in the broader derivatives markets? We would argue that it has not. Swap futures are imperfect hedges and they will cause market participants to self-insure the basis risk that the swap future does not hedge. This outcome promotes a buildup of the same type of opaque unregulated balance sheet risk that plagued numerous entities during the 2008 crisis, and it will be dispersed throughout the system.[12] Additionally, because futures contracts expire and market participants are forced to "roll" the expiring contract on the expiration date into a new contract to maintain the hedge, they are now exposed to market risk and the possibility that high frequency traders will time the roll and cause the price of the contract to increase. This will lead to more volatile credit markets, which can exacerbate systemic risk and negative feedback loops in times of market uncertainty and crisis.

We would also highlight that the unequal margin requirements that the CFTC set forth for economically equivalent swaps and futures will lead to an increase in concentrated risk. A financial swap requires a 5-day margin and a financial swap future requires a 1-day margin.[13] Why? If the risk to the U.S. financial system is the same, then why are economically equivalent products treated differently. By requiring clearinghouses to hold lower margin for a swap future with the exact same risk as its economically equivalent swap, the CFTC is not reducing risk in the system; its policies are actually forcing the clearinghouse to absorb more risk. In a liquidity crunch or a downgrade of its clearing members, a clearinghouse will require more, not less collateral, to protect itself from cascading defaults, and this problem is exacerbated if the required margin held at the clearinghouse was inadequate to begin with. Margining the swap future at one day could aggravate risk to clearinghouses, market participants, and the U.S. financial system during the exact time when the system can least afford it: episodes of market uncertainty and crisis.

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[12] http://www.ft.com/intl/cms/s/0/cadeef74-2377-11e2-a46b-00144feabdc0.html, "U.S. Swaps Shake-up Set to Boost Exchanges" ("This migration raises the prospect that once interest rates or energy prices change rapidly, many investors may be caught out by relying on a future rather than a customized swap that better matches their portfolio's risk.").

[13] 76 FR 69438 Rule 39.13(g)(ii), November 8, 2011 (*Derivatives Clearing Organization General Provisions and Core Principles*).

Fifth, does the conversion benefit Main Street consumers? The answer again is no. The Main Street consumer's insurance company, or the firefighter's, policeman's and teacher's pension fund, or the farmer, or the corporation that is the single employer in a town that previously used swaps are all worse off. They have lost access to pre-trade price transparency, they have a ten (10) minute delay on post-trade price transparency unless they pay hundreds of thousands of dollars to obtain access to it in real-time, they have imperfect hedges that expose them to market volatility, price volatility, and high frequency trading strategies, they are forced to pay increasingly higher costs to trade and clear their derivative contracts because there is limited price competition, and they could be forced to bailout a clearinghouse in a crisis because the margin levels are insufficient.[14]

Sixth, how does the conversion impact the jurisdiction of this Committee? Subtitle A of Title VII clearly sets out that the CFTC regulates swaps, futures, and options[15] and Subtitle B of Title VII states that the SEC will regulate security-based swaps, which include equity swaps, single name credit default swaps, and narrow-based indexes composed of less than 10 entities.[16] Swap futures are futures, and therefore, they are regulated by the CFTC, not the SEC. If almost all of the security-based swaps that this Committee worked so diligently to make certain were under the purview of the SEC are converted to swap futures, which is highly likely given the economics of the contracts, it is possible that this Committee could lose a large amount of its jurisdiction over the swaps market going forward. We find that outcome problematic and squarely against the Congressional intent expressed in Subtitle B of Title VII.

We cannot overstate the impact this conversion is having on the U.S. swaps market, and this is not a hypothetical concern. To illustrate this point, one has to look no further than the energy swap market in the U.S., where almost all of the transaction volume has left the OTC swap market and is now being executed through various energy swap futures contracts.[17] The

[14] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010), see Title VIII.
[15] *Id.* See Title VII-Subtitle A.
[16] *Id.* See Title VII-Subtitle B, see also CFTC Final Products Rule: 77 FR 30596, May 23, 2012 (*Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant''*).
[17] https://www.theice.com/publicdocs/ICE_Swaps_to_Futures_FAQ.pdf ("All of ICE's cleared OTC energy swaps and options will be transitioned to exchange-listed futures and options... The transition of existing open interest in cleared OTC swaps and options (cash-settled) positions will take place over the weekend of October 13-14, 2012.")

market's move from energy swaps to energy swap futures was a direct response to the CFTC's swap regulations.[18] We are elevating our concerns to your Committee because this market transformation is taking place without public comment or a regulatory impact study that analyzes how the conversion will affect systemic risk, transparency, competitiveness, market participant choice, consumer protections and the other important public policy issues Congress sought to address in Title VII. As a result, we fear that Dodd-Frank's goals of reducing systemic risk through transparency and preserving the U.S. swaps market are becoming increasingly more difficult to achieve.

We urge Congress to think about the following questions as it continues to carry out its important Constitutional oversight authority: (1) is the swap future good for the stability of the U.S. financial system?; (2) should Congress require the CFTC to revisit each rule that created the unequal playing field between swaps and swap futures?; and (3) should Congress revisit Title VII to level the playing field by (A) imposing the same statutory requirements on futures contracts as it has on swaps?, and/or (B) mandating that swap futures be regulated as swaps?. At the very least, we would ask Congress to mandate that (1) regulators require any new product proposals by exchanges that convert swaps, as regulated by Title VII of Dodd Frank, into swap futures to be subject to the transparency of the public comment process before further products impacting this conversation are permitted to proceed, and (2) the Government Accountability Office (GAO) be directed to immediately conduct an impact study that analyzes how the conversion from swaps to swap futures will affect systemic risk, transparency, competitiveness, market participant choice, consumer protections, and the other important public policy issues Congress sought to address in Title VII.

We thank the Committee for the opportunity to present our concerns.

[18] Id. (http://www.risk.net/risk-magazine/news/2208965/ice-move-from-swaps-to-futures-unlikely-to-be-last-says-o-malia. ("Other participants agree the decision by Ice to move the date of its transition reflects regulatory uncertainty for swaps - and even suggest the decision demonstrates energy traders think the regulatory framework is unworkable. "Ice and its customers have rejected swap regulation. They believe the CFTC's swap regulation is so unworkable that they are transforming their market and their products from swaps to futures. That is a huge vote of no confidence in the CFTC's regulation," says Mark Young, a partner specializing in derivatives regulation at law firm Skadden, Arps, Slate, Meagher & Flom in Washington, DC. "The CFTC piled a wealth of unnecessary elements into its swap regulation. Its rules are too confusing, too costly, and Ice is essentially telling the CFTC that it has gone too far and people would rather trade futures instead of swaps. That is a very big deal." he adds.").

Written Testimony of
Terrence A. Duffy
Executive Chairman and President, CME Group, Inc.
For the
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives
December 12, 2012

Chairman Garrett, Ranking Member Waters, I appreciate the opportunity to submit written testimony for the hearing today on "Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act." I am submitting this testimony to correct a number of inaccurate statements and implications contained in the testimony of one of the other witnesses before you today.

As the Committee knows, one objective of the Dodd-Frank Act ("Dodd-Frank") was to bring regulatory oversight to the unregulated OTC swap market. Many of the operational and risk safeguards established by futures exchanges were imposed on the OTC swaps market. These include reducing systemic risk through centralized clearing and enhancing transparency through a reporting regime that was intended to provide regulators with data analogous to that which they already received from the regulated futures market.

CME passionately believes in free markets. Congress gave customers the choice of trading in the OTC market, on a swap execution facility or on a designated contract market. Each trading arena carries its own regulatory burdens. It is a disservice to those customers for a participant in one of those markets to promote its private interests at the expense of customers who are quite capable of making a choice that best fits their needs. It would also be a disservice to those customers to accept the argument of two of the testimonies submitted to the Subcommittee today that customers should be denied access to innovative futures products that respond to their market and risk mitigation until the regulators have finalized their rules for swaps.

In the pages that follow, I correct some of the inaccurate statements in testimony submitted for today's hearing.

First, GFI says "Immediately upon the October 12 effective date for certain CFTC regulations, we observed an overnight migration of trading activity in U.S. natural gas and electric power markets from cleared swaps to economically equivalent futures products." This is false. NYMEX's natural gas and electric power contracts have always been listed for trading and clearing as futures.

Second, GFI says "There is no statutory mandate for the real-time reporting of futures trades to the public or to registered data repositories, nor is there any requirement for the direct registration, supervision, and accountability of traders of futures products." This is false. Futures do have real-time reporting rules. U.S. listed futures contracts trade by a two-sided public auction process -- whether in a central limit order book or in a trading pit -- where all market participants have the transparency of executable prices in the market. Real time prices are streamed to hundreds of thousands of subscribers and the financial press. Moreover, futures contracts have always been required to be cleared. All futures contracts are cleared and every derivatives clearing house functions as a data repository for the CFTC and other regulators.

Third, GFI says "The CFTC has determined that DCOs must utilize a one-day liquidation time horizon for futures and a five-day liquidation time horizon for most swaps." This is false. Under final CFTC regulations, a DCO may margin financial futures and commodity futures and swaps with a minimum of one-day liquidation time and financial swaps with a minimum of five-day liquidation time. The DCO has an obligation to set margins at a level appropriate for the risk profile of the instrument – which may exceed these minimum levels. For example, if a swap futures contract has the risk characteristics of a typical OTC swap, which is not likely, a DCO would be required to impose a similar level of margin. CME's Clearing House margins many of its futures products with a liquidation time greater than one day. Prior to Dodd-Frank or the CFTC's final margin rules, financial swaps were margined by several clearing houses across the globe utilizing a liquidation time of 5-days or greater.

Fourth, GFI makes a number of incorrect assertions about swap futures. Among these is the statement that "Swap futures do not allow for specific exercise dates, unlike swaps which are infinitely customizable." This is neither true nor relevant. While futures have historically been characterized as standardized (as opposed to "infinitely customizable"), cleared instruments that are traded primarily by means of transparent, open and competitive execution resulting in deep, liquid markets with tight bid ask spreads and high turnover, futures markets also offer futures to the day and flexible futures. The standardized features of these products are the very features that make futures easy to port or liquidate in a default situation. This helps to explain the differential in margin coverage for easily liquidated contracts versus those that are thinly traded and have low turnover.

Fifth, GFI's statement that, "The U.S. Department of Justice has deemed the structure of the U.S. futures market to be one marked by vertical monopolies" is not just false, but an outright fabrication. The DOJ expressed no concern respecting the structure of energy markets about which GFI is complaining. The DOJ never referred to any segment of the market as a "vertical monopoly." While the DOJ suggested structural changes to certain financial markets to expand entry, it never accused any participant of any violation of law.

We have similar concerns about the testimony of "Companies Supporting Competitive Derivatives Markets," a coalition that includes GFI and others. Their written submission to the Committee is based on the erroneous assertion that swap futures are in fact swaps that are converted for trading and clearing into futures, thereby avoiding swap regulation and suggest that such products remove customer choice. ("Importantly, by removing choice of product and venue farmers, corporates, pension funds, insurance companies, and consumers will be subject to increasingly higher costs for execution and clearing. Competition has been further impacted by the delay in the SEF rules as compared with the rules for exchanges.") This is not the case.

Innovation and the availability of new products at multiple trading venues and cleared by different clearing houses does not remove customer choice, rather it increases customer choice. For example, CME recently introduced a deliverable swap futures product, which is a fully standardized futures product that is listed for trading in our central limit order book – which matches buyers and sellers anonymously by best bid and offer. This futures product is no different than any other futures product listed in our market – whether it be a corn futures or a treasury futures contract—where a market participant agrees to buy or sell a futures contract based on what they believe to be the price of the underlying commodity at some future date. It is subject to the full panoply of futures regulation. Moreover, we anticipate that market participants will not exit the interest rate swap market, which is the underlying commodity for this new product.

I thank the Committee for its time and attention to this important matter and would be happy to further discuss the subject of this hearing or any other issues related to the futures markets.

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STATEMENT FOR THE RECORD

House Financial Services Committee Hearing Entitled "Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd Frank Act", December 12, 2012

There are many issues that may arise in today's hearing on the implementation of Title VII of the Dodd-Frank Act. But perhaps the most important is the question of the cross-border or extra-territorial application of the Dodd-Frank Act's derivatives provisions. Strong extra-territorial enforcement of derivatives reforms is absolutely central to protecting the U.S. economy and U.S. taxpayers from the risk of unregulated derivatives markets.

Americans for Financial Reform has previously commented on this issue in detail to the Commodity Futures Trading Commission (CFTC).[1] However, for the purposes of the hearing AFR would like to provide a summary of some of the key points.[2]

Without Cross-Border Applicability, There is No Effective Derivatives Regulation

Modern financial markets are inherently global in scope. Profits and losses experienced in overseas affiliates return to affect the parent company and the U.S. economy.

We have learned this lesson in many crises, most recently in the massive derivatives losses experienced at JP Morgan's London office, and most painfully in the world financial collapse of 2008. Nowhere is the globalization of financial markets more evident than in the derivatives market. As CFTC Chair Gary Gensler has stated with respect to the extraterritoriality issue:

"Swaps executed offshore by U.S. financial institutions can send risk straight back to our shores. It was true with the London and Cayman Islands affiliates of AIG, Lehman Brothers, Citigroup and Bear Stearns. A decade earlier, it was true, as well, with Long-Term Capital Management. The nature of modern finance is that large financial institutions set up hundreds, if not thousands of ''legal entities'' around the globe... Many of these far-flung legal entities, however, are still highly connected back to their U.S. affiliates."

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[1] See Americans for Financial Reform, "Comment Letter On The Cross-Border Applications of Certain Provisions of the Dodd-Frank Act", August 27, 2012. Available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/08/AFR-CFTC-Cross-Border-Comment-letter-8-27-12.pdf

[2] AFR is a coalition of more than 250 national, state, local groups who have come together to advocate for reform of the financial sector. Members of the AFR include consumer, civil rights, investor, retiree, labor, religious and business groups along with prominent independent experts.

Chairman Gensler's statements are confirmed by extensive experience and data. Bloomberg News has documented that large Wall Street banks routinely transact well over half of their swaps business through foreign subsidiaries.[3] Furthermore, these large institutions manage their revenues as integrated global entities, making little distinction based on the locations of gains and losses. As Professor Richard Herring of the Wharton School has stated:[4]

> "Despite their corporate complexity, LCFIs [Large Complex Financial Institutions] tend to be managed in an integrated fashion along lines of business with only minimal regard for legal entities, national borders or functional regulatory authorities. Moreover, there are often substantial interconnections among the separate entities within the financial group."

Exempting derivatives transactions conducted through international subsidiaries from Dodd-Frank requirements would make central derivatives reforms unenforceable. U.S. companies could simply route their derivatives transactions through foreign subsidiaries, evading regulation, and then transfer cash flows back to the U.S. parent company. Such transfers would be simple for the institutions, because as the above quote points out, major Wall Street banks are managed as global entities. It is well known and well documented that major banks, like other international corporations, manage liquidity on a global scale and freely move funding across borders in response to the needs of various subsidiaries and the home office.[5] Revenues from global subsidiaries are generally swept back to the central corporate treasury for distribution, often on a daily basis. Professor Herring has described how this process worked at Lehmann Brothers, and how it complicated attempts at resolution of the bank:[6]

> "But the fundamental problem was that LB [Lehman Brothers] was managed as an integrated entity with minimal regard for the legal entities that would need to be taken through the bankruptcy process. LBHI [Lehman Brothers Holdings, Incorporated] issued the vast majority of unsecured debt and invested the funds in most of its regulated and unregulated subsidiaries. This is a common approach to managing a global corporation, designed to facilitate control over global operations, while reducing funding, capital and

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[3] See Brush, Silla, "Goldman Sachs Among Banks Lobbying To Exempt Half of Swaps From Dodd Frank", Bloomberg News, January 30, 2012.

[4] Page 217, Herring, R. and J. Carmassi, "The Structure of International Financial Conglomerates: Complexity and Its Implications for Systemic Risk," Chapter 8 in the *Oxford Handbook of Banking*, edited by A. Berger, D. Molyneux, and J. Wilson, Oxford University Press, 2010.

[5] For one of many recent studies documenting this, see e.g. Cetorelli, N. and Goldberg, L., "Banking Globalization, Monetary Transmission, and the Lending Channel", Forthcoming, Journal of Finance.

[6] Page 225, Herring, R. and J. Carmassi, "The Structure of International Financial Conglomerates: Complexity and Its Implications for Systemic Risk," Chapter 8 in the *Oxford Handbook of Banking*, edited by A. Berger, D. Molyneux, and J. Wilson, Oxford University Press, 2010.

> tax costs....LBHI lent to its operating subsidiaries at the beginning of each day and then swept the cash back to LBHI at the end of each day."

Exempting any of the subsidiaries of a global bank from derivatives oversight could thus effectively allow banks to avoid regulation on any derivatives transactions they chose. This would perpetuate the unregulated derivatives markets that were at the heart of the financial crisis, and undermine the core purposes of Title VII of the Dodd-Frank Act. The failure to properly enforce derivatives reforms internationally would expose U.S. taxpayers to the risks of a financial crisis triggered by unregulated derivatives activities conducted in foreign regulatory havens.

U.S. Rules Must Not Be Delayed Until The Rest of the World Has Equivalent Rules

All of the G-20 nations have agreed in principle to a similar set of derivatives reforms, including requirements for central clearing, transparency, and exchange trading. In 2009 the G-20 nations jointly committed to implementing these reforms by the close of 2012.[7] Unfortunately, there is only one national regulator that appears prepared to meet this commitment. That regulator is the U.S. CFTC. Other countries are facing significant delays. The latest reports from Europe are that implementation of European Union derivatives rules will be delayed until at least mid-2014.[8]

The CFTC has already proposed to delay extraterritorial application of many U.S. derivatives rules through mid-2013 in order to accommodate the concerns of foreign regulators. But creating further open-ended delays in U.S. derivatives rules will leave U.S. taxpayers exposed to risks taken in foreign subsidiaries of Wall Street banks for many years to come. Over two years have passed since the Dodd-Frank Act became law, and further delays in implementing derivatives rules are unacceptable. The effort to postpone full implementation of U.S. derivatives reforms until some indefinite date when other nations complete their rules is just the latest of a set of delaying tactics that have been used by large banks to prevent completion of financial reforms.

Timely Implementation of Derivatives Reforms Is Not A Threat to U.S. Competitiveness

Some in the financial industry have argued that U.S. implementation of derivatives reforms is a threat to competitiveness. The claim is that foreign entities will refuse to engage in derivatives business with the foreign subsidiaries of U.S. banks if they know that such transactions will subject them to new requirements such as clearing, exchange trading, and capital requirements. In addition, foreign banks in Europe and other jurisdictions may refuse to do derivatives transactions with U.S. commercial counterparties if this would subject them to registration as a swaps dealer in U.S. markets.

These arguments are deeply misguided, for several reasons. First, they appear to prioritize the profits of financial entities located in foreign countries over the creation of U.S. jobs and the

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[7] See Financial Stability Board, "Progress of Financial Regulatory Reforms", April 16, 2012.
[8] Stafford, Phillip, "Europe Dallies on Derivatives Regulation", Financial Times, December 4, 2012.

stability of the U.S. economy. It would be a grave error to expose the U.S. economy to the risk of financial instability simply so that the Singapore or London subsidiary of a Wall Street bank can do unregulated derivatives transactions with foreign counterparties. This is especially true since an exemption for foreign subsidiaries would tend to benefit the economy of the foreign jurisdiction where those subsidiaries are located at the expense of the United States. Likewise, creating exemptions that permit U.S. commercial counterparties to perform unregulated derivatives transactions with foreign banks would privilege those foreign banks above regulated US institutions.

Industry arguments also ignore the benefits of global leadership in derivatives reform. As discussed above, the major G-20 nations have all agreed to implement derivatives reforms similar to those proposed in the Dodd-Frank Act. While these reforms have been delayed in other nations, in the long term we can expect that they will eventually be implemented in most jurisdictions. As the global derivatives market transitions toward greater oversight, ensuring that U.S. companies have a head start and greater experience in complying with the rules should eventually result in a competitive advantage for U.S. firms. And in the case of any foreign jurisdictions which defy the G-20 consensus and refuse to implement derivatives reform, we should clearly act to prevent exposure of the U.S. financial system to unregulated transactions in these jurisdictions.

Finally, the argument ignores the potential competitive advantages to be gained by improving the stability and reliability of U.S. derivatives markets through new reforms. Derivatives reforms require better risk management and greater loss reserves. These changes will mean that U.S. banks will provide more protection and stability for derivatives counterparties and customers, which is a competitive advantage. The U.S. financial sector has gained its international reputation due to our global leadership in creating stable and transparent markets. Indeed, it was over 150 years ago that the U.S. pioneered the derivatives clearinghouse. This was a major positive innovation in establishing robust and valuable marketplaces for commodities as well as key financial markets. Although permitting regulatory loopholes such as extra-territorial exemptions may create short-term profits, in the long run the greatest threat to the U.S. competitive edge is a repetition of the deregulation that led to the disastrous financial crisis of 2008.

Any 'Substituted Compliance' Regime Must Ensure That Foreign Rules Are Truly Comparable To U.S. Rules

The CFTC has indicated that it will permit 'substituted compliance' with U.S. derivatives rules. Under substituted compliance, foreign subsidiaries of U.S. banks (and in some cases subsidiaries of foreign banks dealing with U.S. persons) will be able to satisfy U.S. requirements by complying with the rules in their local jurisdiction.

The danger raised by substituted compliance is that banks may seek out locations where regulation is weak and then attempt to use the inadequate foreign regulations to satisfy U.S. requirements. This means that it is crucial that any substituted compliance regime be strictly limited to jurisdictions that have genuinely comparable rules to the U.S. both in nature and in enforcement. Otherwise, we will see the emergence of regulatory havens that play a role similar to the role the Cayman Islands and other offshore jurisdictions have played as tax havens. Unless it is backed up by a real and thorough process to determine genuine comparability between regulatory regimes, substituted compliance is simply a form of disguised deregulation.

Regulators must maintain a commitment to genuine comparability determination using a thorough process that carefully compares both the nature and enforcement of rules in foreign jurisdictions to those of the United States. Some in industry have called for a 'principles based' comparability procedure, where substituted compliance is permitted in any jurisdiction that has agreed in principle to oversee derivatives markets. Such calls for 'principle based' comparability are simply an effort at backdoor deregulation, as they do not ensure that regulations are genuinely equivalent.

Clearly there can be no substituted compliance until foreign jurisdictions actually complete and implement their rules. Foreign rules cannot be substituted for U.S. rules where foreign rules do not yet exist. As discussed above, foreign jurisdictions lag years behind the U.S. in implementing derivatives rules. The U.S. must therefore be prepared to implement derivatives reforms rapidly and institute any substituted compliance at a later date, once foreign governments have fully implemented their rules.

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company

- Home Actions
- Housing Counseling Services
- Home Defender's League
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal

- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Affiliates

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS

- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY

- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

SPENCER BACHUS, AL, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, DC 20515

BARNEY FRANK, MA, RANKING MEMBER

September 21, 2012

Honorable Timothy F. Geithner
Secretary
U. S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Dear Secretary Geithner and Chairman Gensler:

I write to urge you to coordinate the development and implementation of rule-makings that impact entities engaged in foreign exchange swap transactions.

As you know, Treasury has the authority under Wall Street Reform to exempt foreign exchange (FX) swaps activity from being considered with respect to registration and other requirements. I take no position on whether Treasury should or should not exempt such activity. But a lack of coordination between your two agencies could place some companies engaged in such activities in an unnecessarily difficult and potentially costly position.

Treasury has not yet made a final decision on the potential FX exemption. But, effective October 12, the CFTC will begin to determine whether companies meet the threshold of swaps activity which would require them to register. Unless Treasury acts before that date, FX swaps will count toward the threshold, requiring some companies solely or primarily engaged in FX swaps activity to incur the time and expense of registering when they might not be ultimately required to do so. If Treasury ultimately plans to provide an exemption, it would be a complete waste of time, effort and resources to force companies which will ultimately be exempt to go through the registration process, restructure their activities, or even withdraw from the FX market solely because of inconsistencies between your two agencies' timetables.

Moreover, this uncertainty may be having an adverse competitive impact. The lack of clarity surrounding the exemption significantly advantages larger organizations engaged in a wide range of swaps activity, which will clearly have to register in any event, over smaller entities for which FX swaps may be a far more significant part of their operations. Some large market participants are suggesting that competitors that do not intend to register will be forced to exit the market for FX products and may be taking market share by capitalizing on this uncertainty, resulting in some smaller market participants potentially exiting the market unnecessarily.

Please work quickly and collaboratively to avoid unnecessary costs and burdens as industry moves to comply with the new rules. The effective and efficient implementation of these important rules should not be jeopardized by an inability of agencies to work together.

Barney Frank

BARNEY FRANK
Ranking Member

United States Senate

COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, DC 20510-6000
202-224-2035

December 16, 2010

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: CFTC's Implementation of Position Limits

Dear Chairman Gensler:

I am writing in regard to the expanded powers granted by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to the Commodity Futures Trading Commission ("CFTC") with respect to position limits. As you know, the CFTC is authorized to set aggregate position limits "as appropriate" across all markets. In the past, the CFTC has examined position limits as a means of preventing excessive speculation or sudden price fluctuations in the commodities markets. I support this authority. Going forward, I urge the CFTC to continue to keep these important twin goals in mind as it considers and initially sets position limits, so that investors who are fully collateralized and may pose little or no systemic risk are not arbitrarily limited and that we do not negatively impact valuable market liquidity.

I am mindful of the CFTC's discretion to set aggregate position limits by "group or class of traders." Further, Dodd-Frank encourages the CFTC to consider how position limits may impact particular classes of persons or swaps. As the CFTC seeks to implement position limits, I urge the CFTC not to unnecessarily disadvantage market participants that invest in diversified and unleveraged commodity indices. These investors often serve as an important, fully collateralized source of liquidity. At the same time, they are natural counterparties to producers who are seeking to reduce their commodity price risk. In this vein, as I have said previously, it is "my expectation that the CFTC will address the soundness of prudential investing by pension funds, index funds and other institutional investors in unleveraged indices of commodities that may also serve to provide agricultural and other commodity contracts with the necessary liquidity to assist in price discovery and hedging for the commercial users of such contracts."

In addition to enhancing liquidity and facilitating greater price discovery for commercial end-users, diversified, unleveraged index funds are an effective way to diversify their portfolios and hedge against inflation. Unnecessary position limits placed on mutual fund investors could limit their investment options, potentially substantially reduce market liquidity, and impede price discovery. Such limits might also have the unintended consequence of forcing investors to rely on higher-cost managers with little experience, insufficient compliance and trade flow infrastructure, and limited risk management capabilities associated with effectively managing commodity index risk.

Such a comprehensive approach to setting position limits would not be contrary to the public interest or to the purposes of the Commodity Exchange Act and Dodd-Frank. In drafting the position limits provision, Congress sought to eliminate excessive speculation and market manipulation while protecting the efficiency of the markets. Consequently, as Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, I encouraged the CFTC to differentiate between "trading activity that is unleveraged or fully collateralized, solely exchange-traded, fully transparent, clearinghouse guaranteed, and poses no systemic risk" and highly leveraged swaps trading in its implementation of position limits.

I repeat my request again today. As it contemplates position limits, I encourage the CFTC to carefully consider how such limits may impact particular types of investment vehicles and classes of investors. I hope that the CFTC will implement position limits in a manner that protects ordinary investors and ensures that the commodity markets continue to benefit from the liquidity and price stability provided by unleveraged broad-based index investments.

Sincerely,

Blanche L. Lincoln

Senator Blanche L. Lincoln
Chairman
Committee on Agriculture, Nutrition, and Forestry

17 October 2012

Hon. Gary Gensler
Chairman
US Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street
NW Washington
DC 20581

Dear Chairman Gensler

US cross border swaps rules

We, the undersigned, would like to share our concerns with you about the implementation of the current phase of post-crisis regulatory reform, as you reflect on the final shape of the CFTC cross border rules for swaps.

Faithfully implementing the reforms adopted by the G20 in 2009 in Pittsburgh on the clearing and electronic trading of standardised OTC derivatives in a non-discriminatory way remains of the utmost importance. As you know, Europe has adopted legislation on clearing and is in the final stages of negotiation on the trading aspect of the G20 Pittsburgh reforms. In Japan, clearing requirements will be effective in November and legislation on trading platforms was recently approved by the Diet. While there may be differences in some areas of detail, we believe the US, the Member States of the EU and Japan are now set to implement these historic reforms in a broadly consistent way in our respective jurisdictions.

This is a significant achievement, capturing the large majority of the global swaps market. But as has been continuously stressed by G20 leaders since 2009, domestic legislation alone does not fulfil the political aim that was agreed in Pittsburgh and reaffirmed in Toronto in 2010. Regulation across the G20 needs to be carefully implemented in a harmonised way that does not risk fragmenting vital global financial markets.

For all its past faults, the derivatives market has allowed financial counterparties across the globe to come together to conduct more effective risk management and, as a result, support economic development. Done properly this should be of benefit to all. At a time of highly fragile economic growth, we believe that it is critical to avoid taking steps that risk a withdrawal from global financial markets into inevitably less efficient regional or national markets.

We of course recognise and understand the need for US and other regulators to satisfy themselves on the adequacy of regulation in other jurisdictions. But we would urge you before finalising any rules, or enforcing any deadlines, to take the time to ensure that US rulemaking works not just domestically but also globally. We should collectively adopt cross border rules consistent with the principle that equivalence or substituted compliance with respect to partner jurisdictions, and consequential reliance on the regulation and supervision within those jurisdictions, should be used as far as possible to avoid fragmentation of global markets. Specifically, this principle needs to be enshrined in CFTC cross border rules, so that all US persons wherever they are located can transact with non-US entities using a proportionate substituted compliance regime.

We assure you our regulatory authorities stand ready to work closely with you to ensure an effective cross border regime is implemented at the earliest possible opportunity and provide you with the necessary information and reassurance regarding our respective regulatory frameworks.

Yours sincerely,

GEORGE OSBORNE
Chancellor of the Exchequer
UK Government

MICHEL BARNIER
Commissioner for Internal Market and Services
European Commission

中塚 一宏

IKKO NAKATSUKA
Minister of State for Financial Services
Government of Japan

PIERRE MOSCOVICI
Minister of Finance
Government of France

"Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act"
December 12, 2012
Question from Chairman Spencer Bachus

Question for Mr. Bopp:

At the December 12, 2012 hearing titled "Challenges Facing the U.S. Capital Markets to Effectively Implement Title VII of the Dodd-Frank Act", Dr. John Parsons suggested that end-users "misunderstood the relationship between the practice of margining and the cost of trading derivatives." Would you please provide the Committee with your assessment of Dr. Parsons' position on margin?

Response:

Dr. Parsons and I agree on an important principle; namely, that there is no free lunch in the transaction of derivatives. Both sides bear credit risk when a derivatives trade is entered into, and that credit risk can be reflected in margin payments or embedded in the transaction costs associated with the derivative.

That said, for a number of reasons, I disagree completely with the conclusion that Dr. Parsons attempts to draw from the principle, that end-user trades should be subject to margin requirements.

First, Dr. Parsons' positions are internally inconsistent. In his testimony before the Committee, Dr. Parsons states, "legislation that directs bank regulators to turn a blind eye to the credit risk embedded in non-margined derivatives is dangerous." *Parsons Testimony* at 2. But this position cannot be squared with the principle Parsons and I agree upon. Because if margin is not collected on an end-user trade, then the credit risk, according to Parsons' testimony, will be "embedded in the derivative." *Id.* Either way, the credit risk is accounted for – and paid for, as Dr. Parsons acknowledges.

Second, Dr. Parsons would unnecessarily deny end-users the ability to negotiate the terms of trades with their counterparties. What Parsons fails to acknowledge is that legislation creating a margin exception for non-financial end-users then allows end-users and their swap dealer counterparties to negotiate the terms of the swaps, and those terms could include the posting of margin. Hence, the end-user margin bill (H.R. 634 in the 113th Congress) that Parsons denigrates does not preclude the posting of margin on uncleared swaps, it just leaves that decision up to the swap counterparties. I simply do not believe that a regulator should sit in the room and second guess the negotiations undertaken between end-users and their swap dealers and the business judgment they exercise; Parsons does.

Third, I disagree with the notion that end-users "misunderst[and] the relationship between the practice of margining and the cost of trading derivatives." *Id.* at 3. I believe that the treasurers of our Nation's most successful businesses do understand the costs associated with entering into swaps to manage risks, and that they want the ability to negotiate terms with their counterparties.

Fourth, that choice is an important one for end-users. Corporate treasurers are uniquely positioned to weigh the costs and benefits associated with margined and unmargined trades, taking into account the particular circumstances of the corporation. The trade-off between cost and liquidity may well determine whether it makes sense to margin a swap, or not. *See, e.g.*, Chatham Financial, Evaluating Criticisms of Derivatives End-User Exemption (November 28, 2011). The bottom line is, corporate treasurers should retain the ability to evaluate costs and benefits and to act accordingly, and not to be forced by regulators to post margin in all cases.

In sum, Dr. Parsons appears determined to take away the choices end-users now have with respect to executing swaps. Though cloaked in the guise of reducing risk to the system, this position would accrue no real benefit and would serve only to discourage end-users from managing risk effectively. This result should be resisted, as should Dr. Parsons' position on margin.