Written Testimony of Kenneth E. Bentsen, Jr.

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Committee on Financial Services

Subcommittee on Capital Markets, Securities, and Investment

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Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee, my name is Ken Bentsen and I am President and CEO of the Securities Industry and Financial Markets Association (SIFMA).[1] SIFMA welcomes this opportunity to testify regarding this Subcommittee's review of the post-crisis regulatory regime for derivatives and consideration of targeted legislative improvements.

As you know, Title VII of the Dodd-Frank Act created, and U.S. regulators have now mostly implemented, a new regulatory regime for derivative products commonly referred to as swaps. SIFMA believes that many of the key pillars of this regime – enhanced transparency requirements, central clearing for standardized swaps, and capital and margin requirements designed to address the risks of non-cleared swaps – should remain in place.

We are concerned, however, that some of the regulations adopted as part of these reforms go beyond what is necessary to achieve core risk mitigation and transparency objectives and may even be in conflict with or redundant to other regulations on the books. These new regulations impose undue costs on beneficial risk management activities by financial institutions and their end-user customers, including manufacturers and the agricultural industry. They also foster unnecessary regulatory complexity and uncertainty. Targeted fixes to these regulations can help promote U.S. competitiveness, job creation and economic growth, without undermining the increased safety and stability brought about by the reforms.

SIFMA and its members are pleased to see that policymakers across the globe are now evaluating these issues as they take stock of recent derivatives reforms. Specifically, we are supportive of recent efforts by the President and the Department of the Treasury to review the full scope of financial regulations covering capital markets participants, products, and activities and make recommendations for changes[2] – many of which SIFMA agrees with. The Commodity Futures Trading Commission (CFTC), for its part, has undertaken a similar initiative, known as "Project KISS,"[3] with the goal of reducing unnecessary regulatory burdens on the markets and participants the CFTC oversees to make them simpler, less burdensome and less of a drag on the American economy. SIFMA provided many detailed recommendations in response to this initiative, and we look forward to working with CFTC Chairman Giancarlo and the rest of the CFTC moving forward on this initiative. And as the Securities and Exchange Commission (SEC) nears

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] See: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[3] 82 FR 23765 (May 24, 2017) (Project KISS), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-10622a.pdf.

completion of its Title VII regime, SIFMA is hopeful that the agency will be informed by the recommendations and output stemming from these review efforts, and will seek to engage in a beneficial dialogue as they work to finalize their rules.

SIFMA believes that Congress also has an important role to play in evaluating how to improve derivatives regulation. Indeed, there are areas of reform that would require statutory modification as the regulators lack the proper authority. In the remainder of my testimony, I will focus on a few specific areas where the Subcommittee's important work in this area, including the legislative proposals under consideration today, can make significant contributions by making our regulations more risk-sensitive, less complex, and clearer.

Treatment of Transactions Between Affiliates

A key goal of the Dodd-Frank Act was to reduce the risk of financial contagion by reducing interconnectedness in the swaps markets. One of the primary ways that multinational companies, both financial institutions and commercial companies, can help accomplish this goal is through centralized, group-wide risk management strategies. By using swaps between commonly owned and managed affiliates to efficiently allocate and net risks within the corporate group, these strategies reduce interconnectedness by reducing the need to trade with third parties.

Rather than encouraging these beneficial, risk-reducing transactions, certain regulations impose significant, additional costs on firms executing them. In particular, U.S. bank regulators require the firms they regulate to collect an additional amount of collateral (called "initial margin") from their affiliates above and beyond the current credit exposure posed by those affiliates, which is already covered by mark-to-market or "variation" margin. The covered banks must then segregate this initial margin instead of using it to fund their lending activities or as a liquidity cushion they can use for other aspects of their businesses.

Some of the SIFMA members subject to these inter-affiliate initial margin requirements report that they are locking up as much, and sometimes more, collateral for these risk-reducing inter-affiliate transactions than they are collecting from third parties. Such risk-insensitive margin requirements discourage prudent risk management strategies and make it more challenging for the affected firms to provide cost-effective hedging solutions for end-user customers. They also reduce the resources these firms otherwise could loan out or invest in the broader economy.

Additionally, because only the U.S. bank regulators have imposed initial margin requirements on inter-affiliate swaps – not the CFTC or foreign regulators – the requirements create an un-level playing field and unnecessary regulatory complexity. The requirements also undermine decisions by the CFTC to extend relief to inter-affiliate swaps from the Dodd-Frank Act's mandatory clearing and mandatory trading requirements. The CFTC extended this relief because it recognized the risk management benefits of inter-affiliate swaps, although it adopted certain conditions to the relief that have proved problematic in some cross-border contexts.

We believe that an appropriate and targeted solution to these issues would be to exempt inter-affiliate swaps from initial margin, mandatory clearing, and mandatory trading requirements, so long as they are part of a centralized risk management program and remain subject to variation margin and trade reporting requirements. This approach would bring the banking regulators' margin rules in line with the CFTC's and help streamline existing CFTC exemptions. The banking regulators would retain a full suite of traditional bank regulatory tools to address any unique considerations raised when a federally-insured bank enters into inter-affiliate swaps.

SIFMA accordingly supports legislative measures to fix the current application of Title VII requirements to inter-affiliate transactions. We believe that any such measure should apply across the CFTC, SEC and U.S. banking regulators, who should be required to amend existing rules, as necessary, to be consistent with the new legislative framework and prevented from adopting any future rule, regulation or interpretation that is inconsistent with that framework.

Agency Review and Harmonization of Rules Relating to the Regulation of Over-the-Counter Swaps Markets

The regulatory distinction between "swaps" and "security-based swaps" as defined by Title VII did not accurately reflect market practice, and the resulting jurisdictional split between the CFTC and SEC has posed challenges for market participants. Despite some efforts by the agencies to coordinate and harmonize their Title VII requirements, important differences in these requirements remain.

SIFMA has long encouraged the CFTC and SEC to identify additional opportunities to simplify, harmonize and streamline their respective Title VII requirements, where appropriate. We are especially focused on areas where both agencies have an opportunity to build on lessons learned from experience with the CFTC's Title VII rules during the five years since they took effect at the end of 2012. These include:

- Reducing conflicts with other legal regimes, especially where different U.S. regulators' rules overlap, or U.S. rules apply extraterritorially. For example, the SEC has adopted ambiguous certification and legal opinion requirements relating to the SEC's access to a non-U.S. dealer's books and records, which create conflicts with foreign laws that the CFTC has sought to avoid. These conflicts would put U.S. investors at a disadvantage when they seek to access foreign markets because they would prevent non-U.S. dealers from trading with U.S. investors, lest those dealers become subject to conflicting requirements. The SEC should follow the CFTC's approach to avoiding or mitigating these conflicts.
- Following consistent international standards in areas such as margin and reporting requirements, which help promote a level playing field and efficient coordination among regulators. In contrast, the SEC's proposed margin rules include

idiosyncratic approaches to calculation and segregation of initial margin, which if adopted would make it difficult for SEC registrants to trade with other firms effectively. Also, the SEC's reporting rules take different approaches than rules adopted by the CFTC and foreign regulators to what data is required, who must report it, and when it must be reported, which will inhibit use of existing reporting systems and prevent regulators from effectively aggregating each other's data. To the extent characteristics of the SEC's markets or regulatory mandates justify differences in these areas, those differences should be more narrowly tailored.

- Recognizing instances where satisfying another domestic or foreign regulator's requirements would achieve a comparable regulatory outcome while avoiding the complexity and uncertainty associated with overlapping regulations. In particular, the SEC and CFTC should look for more opportunities to leverage each other's rules, especially for dual registrants.

We are supportive of recent efforts of the agencies to coordinate and consider where harmonization is appropriate, as indicated in recent speeches by the Chairmen, and look forward to contributing to this important dialogue. We hope that these efforts consider the principles that I have summarized above. We also would encourage additional coordination between the markets regulators and the U.S. banking regulators, especially in relation to capital and margin requirements.

Regulatory Capital Requirements

Regulatory capital requirements should be based on the principle that taking greater risk requires greater capital. Completely risk-insensitive leverage capital measures, such as the supplemental leverage ratio (SLR), are becoming the binding capital measures for many banking organizations, and the standardized risk-based capital requirements do not permit sufficient use of more risk-sensitive methodologies. As a result, the amount of required capital is increasingly unrelated to the level of risk taken. This defeats the principle of correlation between risk and capital and could lead to insufficient or excess capital levels, depending on prevailing economic conditions. These trends are exacerbated by excessively conservative and unrealistic assumptions built into the requirements, which creates a one-way ratchet toward higher amounts of capital and liquidity without adequate consideration of the effects on lending, market liquidity and the ability of end-users to hedge their risks.

One particularly problematic area is the SLR's treatment of centrally cleared derivatives. When a firm acts as an intermediary between a derivatives clearinghouse and a client, the firm guarantees the client's obligations to the clearinghouse, collects initial margin from the client to secure the client's obligations, and segregates that margin from its own assets (often by posting the margin to the clearinghouse). Although this initial margin largely offsets the clearing firm's exposure to the client and the clearing firm cannot use the margin to fund its business, the SLR requires the clearing firm to treat the full client exposure as a source of leverage without recognizing an offset for the initial margin.

Because the SLR's approach to client clearing requires clearing firms to hold capital against these exposures far in excess of the risks they face, it discourage client clearing activity. This incentive runs directly counter to the Dodd-Frank Act's mandates to promote central clearing. SIFMA accordingly supports H.R. 4659, as it would deduct any client-provided initial margin on centrally cleared derivatives from the amount of leverage exposure for the firm clearing the swap, and requires the banking regulators to amend their leverage-based capital rules to reflect this change.

There are also several other areas where leverage-based capital rules require firms to hold capital far in excess of their risks and discourage beneficial activity. For example, several post-crisis rules now require banks to hold significant amounts of high-quality, liquid assets as a cushion against future liquidity strains. But the leverage ratio treats these assets as though they were just as risky as any other asset held by a bank. To address this issue, we also recommend excluding from total leverage exposure all cash and cash equivalents, such as cash on deposit with central banks, U.S. Treasuries and government agency securities, and foreign sovereign debt that qualifies for a 0% risk weight under the risk-based capital rules.

Establishment of *De Minimis* Exception Annual Thresholds for Swap Dealers and Security-Based Swap Dealers

The Dodd-Frank Act exempts a person from being deemed a swap dealer or security-based swap dealer if the person engages in only a *de minimis* quantity of swaps or security-based swaps connected to its dealing activity. When the CFTC and SEC initially adopted rules implementing these provisions, they did not yet have much data they could use to quantity participation in the swap and security-based swap markets. They therefore set their *de minimis* thresholds relatively conservatively, with automatic reductions after a period of time absent a rulemaking to change the threshold or its methodology. For example, the CFTC's threshold is currently set at $8 billion, with an automatic reduction to $3 billion to occur absent CFTC action.

Over time, a potential decrease in the *de minimis* threshold has been a source of significant uncertainty for smaller firms, especially regional banks and dealers that facilitate access of smaller commercial end users to swaps. SIFMA has previously raised concerns[4] that decreasing the *de minimis* threshold would lead to a reduction in the number of swap market participants willing to engage in swap dealing activity with commercial end users for fear of going above the threshold and triggering the swap dealer registration requirement. Such an outcome would lead to reduced liquidity and a greater concentration of swaps transactions with larger financial institutions. In fact,

[4] See comments from SIFMA and the International Swaps and Derivatives Association, Inc. in response to CFTC staff's "Swap Dealer De Minimis Exception Preliminary Report" (submitted Jan. 19, 2016), available at: https://www.sifma.org/resources/submissions/sifma-and-isda-submit-comments-to-the-cftc-on-the-swap-dealer-de-minimis-exception-preliminary-report/.

a 2016 CFTC staff report on this issue stated that lowering the swap dealer registration threshold to $3 billion would provide "insignificant additional regulatory coverage" for dealing activity in interest rate swaps and index credit default swaps as compared to the $8 billion level.[5] The Department of the Treasury recently recommend that the CFTC should maintain the swap dealer *de minimis* registration threshold at $8 billion, and establish that any future changes be subject to formal rulemaking and a public comment process.[6]

We believe that any determination to modify the *de minimis* threshold must be supported by reliable, complete and robust data to avoid uncertainty and disruption in the swap markets. We support the CFTC's recent order[7] providing for additional time to consider data and make informed decisions moving forward regarding the appropriate level for the *de minimis* threshold.

In addition to setting their *de minimis* thresholds at an appropriate level, it is also critical for the CFTC and SEC to tailor what types of transactions count toward those thresholds. In particular, we are concerned about the extent to which the agencies currently require firms to count non-U.S. transactions, even transactions entered into by affiliates subject to comparable foreign regulation. We believe it is imperative that the agencies appropriately tailor the scope of transactions that lead to swap dealer or security-based swap dealer registration in the cross-border context.[8]

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Thank you for giving me this opportunity to explain our views related to several important measures to be considered by the Subcommittee.

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[5] Swap Dealer De Minimis Exception Final Staff Report (Aug. 15, 2016) at 21, available at: http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis081516.pdf.

[6] Department of the Treasury Report, "A Financial System that Creates Economic Opportunities: Capital Markets" (Oct. 2017) at 139, available at: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[7] 82 FR 50309 (Oct. 31, 2017) (Order Establishing a New De Minimis Threshold Phase-in Termination Date).

[8] See comments from SIFMA in response to the CFTC's Project KISS initiative regarding swap dealer registration requirements (submitted Sep. 29, 2017), available at: https://www.sifma.org/resources/submissions/response-to-cftc-project-kiss-initiative-in-regards-to-swap-dealer-registration/. "*Title VII should not apply extraterritorially to U.S. firms' foreign branches or affiliates where existing regulation already protects against significant risk flowing back to the United States. As such, [swap dealer ("SD")] registration should not apply to a U.S. firm's non-U.S. affiliate on the basis of trading with non-U.S. counterparties if the U.S. firm's non-U.S. affiliate is regulated in a G20 jurisdiction or otherwise subject to Basel-compliant capital standards, regardless of whether the affiliate is guaranteed by its U.S. parent. Further, non-U.S. swap counterparties should not be required to register as SDs as a result of doing business with a U.S. firm's foreign branch or affiliate (guaranteed or not), and rather allow for existing prudential regulation to address any risks faced by U.S. firms trading abroad. By appropriately excluding such transactions from registration calculations, the Commission would promote U.S. competitiveness abroad and facilitate continued access of U.S. firms to foreign liquidity providers, trading platforms and centralized counterparties ("CCPs").*"