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DERIVATIVES REFORM: THE VIEW FROM MAIN STREET

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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DERIVATIVES REFORM: THE VIEW FROM MAIN STREET

THURSDAY, JULY 21, 2011

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 2:03 p.m., in room 1300, Longworth House Office Building, Hon. Frank D. Lucas [Chairman of the Committee] presiding.

Members present: Representatives Lucas, Goodlatte, Johnson, King, Neugebauer, Conaway, Schmidt, Thompson, Stutzman, Gibbs, Tipton, Crawford, Roby, Huelskamp, DesJarlais, Ellmers, Gibson, Hultgren, Hartzler, Schilling, Ribble, Noem, Peterson, Holden, McIntyre, Boswell, Baca, Walz, Kissell, Owens, Courtney, Welch, Fudge, Sewell, and McGovern.

Staff present: Tamara Hinton, Kevin Kramp, Ryan McKee, Matt Schertz, Debbie Smith, Lauren Sturgeon, Heather Vaughan, Suzanne Watson, John Konya, Liz Friedlander, Lisa Shelton, and Jamie Mitchell.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

The CHAIRMAN. This hearing of the Committee on Agriculture entitled, *Derivatives Reform: The View from Main Street,* will come to order. I want to thank all of you for being here today and I would especially like to thank Chairman Gensler for joining us today on our first panel. I am grateful for all the witnesses on the second panel for taking time away from their businesses to be here also.

This is our sixth hearing on the Dodd-Frank implementation process. And we have heard from over 30 witnesses, including Chairman Gensler, on three different occasions. We have explored about every issue under our jurisdiction, and Members of the Committee from both sides of the aisle have raised concerns regarding the direction of many of the rules. We have listened carefully to the concerns from small banks and small businesses. We have learned how businesses on Main Street, the end-users of derivatives, could be affected by proposed regulations. We have heard how organizations that played no role in the financial crisis could be subject to significant new regulations designed for the largest financial institutions.

And Chairman Gensler, we have used these hearings to put issues in front of you that are very important to our constituents and constituencies. So as you prepare the rules in final form, I

hope you have been listening. I hope you will listen today to the issues that will be raised, and I urge you to respond honestly and directly, as I know you will. Congress has given you an extraordinary amount of authority and ability to write rules to govern these markets. But with that authority comes the responsibility and the expectation that you will keep at the forefront the prevailing issue facing the country—economic growth and job creation.

We can achieve a robust regulatory regime without imposing undue or ill-fitting regulations on businesses across the country. The Commodity Futures Trading Commission, CFTC, has acted on some issues that this Committee has raised. In light of the unrealistic timeline established by Dodd-Frank, the Commission has finalized an order to extend the effective dates, providing much-needed certainty to market participants, and additional time for rulemaking.

Unfortunately, we have not seen similar responses on most of the concerns that have been raised in this hearing room. The Commission has given us little reason to believe that the clarity and scope of the regulations will improve. Nor is there any indication that proposed regulations, which are overly burdensome or counterproductive in their current form, will change substantially or that they will not bring economic harm.

And, frankly, I don't believe anyone in this Administration can provide an honest assessment of what the cumulative impact of these regulations will be for the end-users, for liquidity in our financial system or for our competitive position globally.

With unemployment stagnating at more than nine percent, we need greater accountability from you, Chairman Gensler, and from the Administration that you at least have a handle on what impact these regulations will have on our economy and the functioning of our financial markets. If you don't think the statute gives you the flexibility to address the concerns raised today, I urge you to indicate that clearly. And I urge you to balance the need for modern regulations with common sense policy that differentiates between farmer cooperatives and Wall Street firms. And as many of you know, the CFTC has turned the corner in the implementation of Title VII. They have moved from proposing rules to implementing the Dodd-Frank Act to finalizing regulations.

So it stands to reason that the moving parts of these regulations are starting to settle into place. Parties that will likely be regulated should know where they stand. Yet, our Committee continues to hear from stakeholders that say they have received little or no guidance on what the final rules will look like, or how they will be affected by them.

We are hearing that despite the fact that these stakeholders are regularly meeting with you and your staff and instead of the confusion clearing, that as rules become final, stakeholders seem even less sure of where they stand now than they were 3 months ago.

The title of today's hearing is, *The View from Main Street.* Our witnesses bring a valuable perspective on how financial regulation will stretch well beyond Wall Street to the Main Streets of towns across America and from water departments in California to rural electric cooperatives in our Congressional districts.

I would like to thank our witnesses once again for being here and bringing and sharing their testimony. I look forward to learning more about how your organizations will be affected by Dodd-Frank and I hope that this hearing guides Mr. Gensler and his colleagues towards a balanced approach to the regulation.

[The prepared statement of Mr. Lucas follows:]

PREPARED STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

Thank you all for being here today. I'd especially like to thank Chairman Gensler for joining us on our first panel, and I'm grateful to all the witnesses on our second panel for taking time away from your businesses to be here.

This is our sixth hearing on the Dodd-Frank implementation process. We've heard from over 30 witnesses, including Chairman Gensler on three different occasions.

We've explored just about every issue under our jurisdiction. And Members of the Committee, from both sides of the aisle, have raised concerns regarding the direction of many of the rules.

We have listened carefully to concerns from small banks and small businesses. We've learned how businesses on Main Street—the end-users of derivatives—could be affected by proposed regulations.

We've heard how organizations that played no role in the financial crisis could be subject to significant new regulations designed for the largest financial institutions.

And Chairman Gensler, we've used these hearings to put issues in front of you that are very important to our constituencies. So, as you prepare the rules in final form, I hope you've been listening. And I hope you will listen today to the issues that will be raised.

I urge you to respond honestly and directly.

Congress has given you an extraordinary amount of authority and responsibility to write rules to govern these markets.

But with that authority comes the responsibility and expectation that you will keep at the forefront the prevailing issue facing the country—economic growth and job creation.

We can achieve a robust regulatory regime without imposing undue or ill-fitting regulations on businesses across the country.

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Nor is there any indication that proposed regulations which are overly burdensome or counterproductive in their current form will change substantially or that they will not bring economic harm.

And frankly, I don't believe anyone in this Administration can provide an honest assessment of what the cumulative impact of these regulations will be—for end-users, for liquidity in our financial system, for our competitive position globally.

With unemployment stagnating at more than 9%, we need greater accountability from you, Chairman Gensler, and from the Administration, that you at least have a handle on the impact these regulations will have on our economy and the functioning of our financial markets.

If you don't think the statute gives you the flexibility to address the concerns that are raised today, I urge you to indicate that clearly.

And, I urge you to balance the need for modern regulations with common sense policy that differentiates between farmer cooperatives and Wall Street firms.

As many of you know, the CFTC has turned the corner in its implementation of Title VII. They have moved from proposing rules to implement the Dodd-Frank Act to finalizing regulations.

So it stands to reason that the moving parts of these regulations are starting to settle into place. Parties that will likely be regulated should know where they stand.

But our Committee continues to hear from stakeholders that say they have received little to no guidance on what the final rules will look like, or how they will be affected by them.

We're hearing this despite the fact that these stakeholders are regularly meeting with you or your staff. And instead of the confusion clearing as rules become final, stakeholders seem even less sure of where they stand now than they were 3 months ago.

The title of today's hearing is "The View from Main Street." Our witnesses bring a valuable perspective on how financial regulations will stretch well beyond Wall Street to the Main Streets of towns across America—from water departments in California to rural electric cooperatives in our Congressional districts.

I'd like to thank our witnesses once again for being here and sharing your testimony.

I look forward to learning more about how your organizations will be affected by Dodd-Frank, and I hope that this hearing guides Mr. Gensler and his colleagues towards a balanced approach to regulation.

The CHAIRMAN. I will now turn to the Ranking Member for his opening comments.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you Mr. Chairman. And you said today is the sixth oversight hearing we have held on Dodd-Frank, and I welcome again Chairman Gensler to the Committee. I think this is his third appearance before the Committee this year.

As we begin today's oversight hearing, I want to express my concern that the Committee is ignoring some of its important oversight responsibilities. Two-and-a-half months ago, the General Farm Commodities and Risk Management Subcommittee Ranking Member, Mr. Boswell, along with several other Members requested a hearing on rising energy prices, stressing the importance of making sure that prices are based on market forces and not excess speculation.

And I know that a lot of people dismiss this idea that speculation affects prices. But I would remind Members that Goldman Sachs said publicly that they thought speculators at one time were boosting crude oil prices by as much as $27 a barrel. So I don't see how anybody can dismiss this out of hand if one of the major traders is making those kind of statements.

The Committee should, I believe, act on Mr. Boswell's request and hold a hearing on this issue and see if we can shed some light on it.

Additionally, the Committee has not brought any of the prudential regulators to testify so Members can address their concerns directly with them. People forget that the CFTC is not the only responsible party in implementing the derivatives title of this legislation. Last April, the prudential regulators put forth their proposed rule on margin requirements for swaps with dealers they regulate. As we will hear today, this proposal has caused some consternation among end-users who see in that proposal the threat of possible margin requirements on end-users.

When are we going to bring the prudential regulators in to answer questions about this proposed rule?

Additionally, we have not had the Federal Reserve appear to update the Committee on the implementation of Title VIII of the Dodd-Frank law which gave the Federal Reserve authority over clearinghouses, and which I remind the Chairman remains within our jurisdiction. I also remind people it was something I did not

support, along with a lot of other things in the Dodd-Frank law that I had to compromise on.

We have also heard concerns regarding the consistency of rules between regulators, particularly the CFTC and the SEC. I believe we should hear from all of the regulators charged with implementing the derivative titles, not just the CFTC.

Many of the definitions that today's witnesses are concerned about must be developed jointly between the SEC and the CFTC. I believe the joint rulemaking requirements, which were added in conference, I remind you, right at the end, and I also opposed, are one of the reasons why the proposed rules regarding important definitions have come later in the process. Unfortunately, the Committee has not brought in the SEC so Members can ask about this. I do hope that we can hear directly from these other regulatory agencies in the near future so we can help clarify some of the issues that folks are bringing up.

And I also believe that there is a rush to judgment by Members and by market participants with regard to the CFTC. The Commission has put forth about 50 proposed rules. At this point, most of them are only proposals, I think they have adopted eight rules in final form, they have been unanimous, so they are working through the process the way they should and taking their time. They have extended the legal certainty and extended the deadline and I think that all should be taken in good faith. Some people apparently still believe, based solely on these proposals, that we need to rewrite the Dodd-Frank law or to repeal it.

As I have said before, I think this is premature. At this point these rules are proposals. I think the Commission has been listening. My opinion may be sometimes too much to some of these folks that are whining or complaining about these rules. And so far, the Commission has finalized a handful of rules, as I said, and they are doing a pretty good job considering everything.

As I have said at every Dodd-Frank oversight hearing we have had, if regulators don't implement the law as we intended, if they screw things up, I stand ready to help with the legislative fixes. However, we need to give the regulators the opportunity to get things right. Dodd-Frank is not a perfect law, particularly if you look at some of the provisions outside of the derivatives title, people seem to forget that I opposed Title VIII. I thought the Consumer Protection Bureau was ideology run amok and I ultimately voted for the bill because we needed to respond to the economic crisis of 2008 and I along, with others, had to accept compromises.

So if Congress is going to act on legislation to change Dodd-Frank, it should meet some tests. First regarding the CFTC, it should address something they have actually done, not something they might do. And I don't want to waste time working on a solution to a problem that could disappear in the coming months when the regulators hopefully get these rules right.

And the other thing, I don't think anything is going to happen in the Senate, even if we move something over here.

Second, it shouldn't be done in a piecemeal approach. If we truly need to fix Dodd-Frank because of however the regulators are implementing it, then we should take a comprehensive approach that

addresses all of our problems, not just those in one title or one small provision.

And finally, it should be developed in a bipartisan cooperative fashion, not handed down in a "take it or leave it" approach.

When I was Chairman and drafting the derivatives title, I worked with Mr. Lucas and others and the staff to develop a package that won bipartisan support. There were things, as I said, that I thought should have been included that weren't, but I sacrificed those to keep bipartisan support for our primary objective, which was bringing greater transparency and accountability to these opaque markets.

Ultimately, I believe that CFTC is taking their time to get this right, and perhaps that is what some people are afraid of, that the regulator can actually listen to the public and respond appropriately. And maybe that is what many on the other side that still seem dedicated to repealing Dodd-Frank are afraid of. But I guess time will ultimately tell, and I am holding out hope that we are going to get the right outcome.

So I welcome Chairman Gensler back to the Committee. I look forward to his testimony and I know that we will have a thorough and candid update as we have in the past. So, Mr. Chairman, I yield back.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you Mr. Chairman. Today is the sixth oversight hearing this Committee has held to review the Dodd-Frank Act. I want to welcome CFTC Chairman Gensler back for his third appearance before Members of the Committee this year.

As we begin today's oversight hearing, I want to express my concern that the Committee is ignoring some of its important oversight responsibilities. Two and a half months ago, the General Farm Commodities and Risk Management Subcommittee Ranking Member, Mr. Boswell, along with several other Members, requested a hearing on rising energy prices, stressing the importance of making sure that prices are based on market forces and not excessive speculation.

While some dismiss the idea of speculation affecting prices, Goldman Sachs has said that speculators are boosting crude oil prices by as much as $27 a barrel. I don't see how anyone can dismiss that statement out of hand. The Committee should act on Mr. Boswell's request and hold a hearing on energy prices.

Additionally, the Committee has not brought in any of the prudential regulators to testify so Members can address their concerns directly with them. People forget that the CFTC is not the only responsible party in implementing the derivatives title. Last April, the prudential regulators put forth their proposed rule on margin requirements for swaps with dealers they regulate.

As we will hear today, this proposal has caused some consternation among end-users who see in that proposal the threat of possible margin requirements on end-users. When are we bringing the prudential regulators in to answer questions about this proposed rule?

Additionally, we have not had the Federal Reserve appear to update the Committee on implementation of Title VIII of Dodd-Frank, which gave the Federal Reserve authority over clearinghouses and which, I remind the Chairman, remains within our Committee's jurisdiction.

We have also heard concerns regarding the consistency of rules between regulators, particularly the CFTC and SEC. I believe we should hear from all of the regulators charged with implementing the derivatives title, not just the CFTC. Many of the definitions that today's witnesses are concerned about must be developed jointly between the SEC and the CFTC.

I believe the joint rulemaking requirements, which were added to the conference report at the end, are one of the reasons why proposed rules regarding important definitions came later in the process. Unfortunately, the Committee has not brought

in the SEC so Members can ask about this. I do hope that we can hear directly from these other regulatory agencies in the near future.

I believe there is a rush to judgment by Members and by market participants with regard to the CFTC. The Commission has put forth about 50 proposed rules—only proposals. Some people believe that based solely on these proposals, we need to rewrite Dodd-Frank or repeal it. I think that is premature. So far, the Commission has finalized a handful of rules and all of them were approved unanimously by the Commission.

As I have said at every Dodd-Frank oversight hearing we have had, if regulators don't implement the law as we intended, if they screw things up, I stand ready to help with legislative fixes. However, we need to give the regulators the opportunity to get things right.

Dodd-Frank is not a perfect law, particularly if you look at some of the provisions outside of the derivatives title. People seem to forget that I opposed Title VIII. I thought the Consumer Protection Bureau was ideology run amuck. I ultimately voted for the bill because we needed to respond to the economic crisis of 2008 and I had to accept compromises.

If Congress is going to act on legislation to change Dodd-Frank, it should meet some tests.

First, regarding the CFTC, it should address something they actually have done, not something they might do. I don't want to waste time working on a solution to a problem that could disappear in the coming months when the regulators get the rule right.

Second, it shouldn't be done in a piece-meal approach. If we truly need to fix Dodd-Frank because of how all the regulators are implementing it, then we should take a comprehensive approach that addresses all our problems, not just those in one title or one small provision.

And finally, it should be developed in a bipartisan, cooperative fashion, not handed down in a take it or leave it approach. When I was Chairman and drafting the derivatives title, I worked with Mr. Lucas and his staff to develop a package that won bipartisan support. There were things I thought should have been included, but sacrificed to preserve bipartisan support for our primary objective—bringing greater transparency and accountability to these opaque markets.

Ultimately, I believe the CFTC is taking their time to get this right. And perhaps that is what some people are afraid of, that a regulator can listen to the public and respond appropriately. Maybe that is why many in the Republican Congressional leadership still seem dedicated to a total repeal of Dodd-Frank. They are afraid it could succeed. Time will ultimately tell, but I'm holding out hope.

Chairman Gensler, again welcome back to the Committee. I know you will provide a thorough and candid update as you have in the past. With that Mr. Chairman, I yield back.

The CHAIRMAN. I thank the Ranking Member for his opening statement. And the chair would request that other Members submit their opening statements for the record so the witness may begin testimony and ensure there is ample time for questions.

With that, I would like to welcome our first witness to the table, the Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission, Washington, D.C.

You may proceed, Mr. Chairman, whenever you are ready.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. GENSLER. Good afternoon Chairman Lucas, Ranking Member Peterson, and Members of the Committee. It is good to be back before you today. I had the honor to testify in front of the Senate Banking Committee this morning but it is good to be with our authorizing Committee here in the House. And I am pleased to testify on behalf of the Commission, the CFTC itself.

On this anniversary of the Dodd-Frank Act, it is important to remember why the law's derivatives reforms were necessary. When AIG and Lehman Brothers failed, we all paid the price, your con-

stituents and everybody in this room. And what is more, the effects of that crisis continue to be very real, very significant, uncertainty is still in the economy and millions of Americans are still out of work.

The CFTC is working along with other regulators, particularly the SEC, to efficiently and transparently write rules to implement the provisions of the Dodd-Frank Act. And among the rules we have proposed are specific exceptions for commercial end-users consistent with Congressional intent. For instance, we have published proposed rules that do not require dealers to collect margin from end-users.

This spring we substantially completed the proposal phase of our rulemaking and provided an additional 30 day period of comment to look at the whole mosaic, that period closed June 3. Now the staff and Commissioners have turned to final rules and approved eight of them so far.

In August, we hope to consider a final rule on swap data repositories, something that many market participants asked us to take a look at first. In early fall we are likely to take up rules—I say "likely" because schedules can sometimes change—but likely to take up rules relating to clearinghouse core principles, position limits, business conduct, and the *entity* definition related to this *swap dealer* definition that I know many Members are interested in here.

Later in the fall, we hope to consider rules relating to trading, real-time reporting, data reporting, and the end-user exception.

There are some rules that we proposed a little later and they only closed comment periods in the last month. And so by necessity, we will probably take them up later. But one of them I would like to mention is a comment period closing tomorrow on the product definition and we look to work with the SEC to take that up as soon as practicable, but we don't know how many comments there will be as of yet.

We are taking great care to provide the public with meaningful notice and opportunity to comment on those proposed rules before it becomes final. And sometimes we may even take, or determine it is appropriate to re-propose a rule as we did earlier this week, we re-proposed one rule on something called straight-through processing at the clearinghouses.

We have also reached out broadly to market participants including three roundtables, a 60 day public comment period, and so forth, to consider how best to phase the compliance with the rules themselves. Phased implementation, I believe, of the compliance will help lower costs and lower risks across the board.

And we are planning to request additional public comment on a critical aspect of this phasing. We have a lot of public comment already that has been very helpful, but there is one piece that is really important: the requirements related to the transactions themselves that might affect the broader market. These requirements, like the clearing mandate, the trading mandate, even some of the documentation and margin requirements, we have to get more input from the public about how to best phase that and phase it by market participant and category of participant.

Before I close, I would like to just note that the CFTC is taking on a significantly expanded scope and mission, a market seven

times that which we already are regulating, and to do so the Commission must adequately be resourced to effectively police the markets and protect the public.

And without sufficient funds, there will be fewer cops on the beat, but possibly even more interesting to many here, it is also we need enough staff to actually answer the basic questions of market participants. And there are many market participants that have uncertainty about the law, the rules as they finalize, and will want interpretation and guidance.

In conclusion, we are working thoroughly at the Commission to get these rules right, based on significant public comment. We have already received more than 20,000 public comments.

It is more important to get it right than to work against the clock, and we have extended the time frame to do that. But until the CFTC completes its rule-writing process and implements and actually gets funding to be able to oversee the markets, the public remains unprotected.

I thank you, and I look forward to the questions.

[The prepared statement of Mr. Gensler follows:]

PREPARED STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good afternoon, Chairman Lucas, Ranking Member Peterson, and Members of the Committee. I thank you for inviting me to today's hearing on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC). I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

Financial Crisis

One year ago, the President signed the Dodd-Frank Act into law. And on this anniversary, it is important to remember why the law's derivatives reforms are necessary.

The 2008 financial crisis occurred because the financial system failed the American public. The financial regulatory system failed as well. When AIG and Lehman Brothers faltered, we all paid the price. The effects of the crisis remain, and there continues to be significant uncertainty in the economy.

Though the crisis had many causes, it is clear that the derivatives or swaps market played a central role. Swaps added leverage to the financial system with more risk being backed by less capital. They contributed, particularly through credit default swaps, to the bubble in the housing market and helped to accelerate the financial crisis. They contributed to a system where large financial institutions were thought to be not only too big to fail, but too interconnected to fail. Swaps—developed to help manage and lower risk for end-users—also concentrated and heightened risk in the financial system and to the public.

Derivatives Markets

Each part of our nation's economy relies on a well-functioning derivatives marketplace. The derivatives market—including both the historically regulated futures market and the heretofore unregulated swaps market—is essential so that producers, merchants and end-users can manage their risks and lock in prices for the future. Derivatives help these entities focus on what they know best—innovation, investment and producing goods and selling and services—while finding others in a marketplace willing to bear the uncertain risks of changes in prices or rates.

With notional values of more than $300 trillion in the United States—that's more than $20 of swaps for every dollar of goods and services produced in the U.S. economy—derivatives markets must work for the benefit of the American public. Members of the public keep their savings with banks and pension funds that use swaps to manage interest rate risks. The public buys gasoline and groceries from companies that rely upon futures and swaps to hedge swings in commodity prices.

That's why oversight must ensure that these markets function with integrity, transparency, openness and competition, free from fraud, manipulation and other

abuses. Though the CFTC is not a price-setting agency, recent volatility in prices for basic commodities—agricultural and energy—are very real reminders of the need for common sense rules in all of the derivatives markets.

The Dodd-Frank Act

To address the real weaknesses in swaps market oversight exposed by the financial crisis, the CFTC is working to implement the Dodd-Frank Act's swaps oversight reforms.

Broadening the Scope

Foremost, the Dodd-Frank Act broadened the scope of oversight. The CFTC and the Securities and Exchange Commission (SEC) will, for the first time, have oversight of the swaps and security-based swaps markets.

Promoting Transparency

Importantly, the Dodd-Frank Act brings transparency to the swaps marketplace. Economists and policymakers for decades have recognized that market transparency benefits the public.

The more transparent a marketplace is, the more liquid it is, the more competitive it is and the lower the costs for hedgers, which ultimately leads to lower costs for borrowers and the public.

The Dodd-Frank Act brings transparency to the three phases of a transaction.

First, it brings pre-trade transparency by requiring standardized swaps—those that are cleared, made available for trading and not blocks—to be traded on exchanges or swap execution facilities.

Second, it brings real-time post-trade transparency to the swaps markets. This provides all market participants with important pricing information as they consider their investments and whether to lower their risk through similar transactions.

Third, it brings transparency to swaps over the lifetime of the contracts. If the contract is cleared, the clearinghouse will be required to publicly disclose the pricing of the swap. If the contract is bilateral, swap dealers will be required to share mid-market pricing with their counterparties.

The Dodd-Frank Act also includes robust record-keeping and reporting requirements for all swaps transactions so that regulators can have a window into the risks posed to the system and can police the markets for fraud, manipulation and other abuses.

On July 7, the Commission voted for a significant final rule establishing that clearinghouses and swaps dealers must report to the CFTC information about the swaps activities of large traders in the commodity swaps markets. For decades, the American public has benefited from the Commission's gathering of large trader data in the futures market, and now will benefit from this additional information to police the commodity swaps markets.

Lowering Risk

Other key reforms of the Dodd-Frank Act will lower the risk of the swaps marketplace to the overall economy by directly regulating dealers for their swaps activities and by moving standardized swaps into central clearing.

Oversight of swap dealers, including capital and margin requirements, business conduct standards and record-keeping and reporting requirements will reduce the risk these dealers pose to the economy.

The Dodd-Frank Act's clearing requirement directly lowers interconnectedness in the swaps markets by requiring standardized swaps between financial institutions to be brought to central clearing.

This week, the Commission voted for a final rule establishing a process for the review by the Commission of swaps for mandatory clearing. The process provides an opportunity for public input before the Commission issues a determination that a swap is subject to mandatory clearing. The Commission will start with those swaps currently being cleared and submitted to us for review by a derivatives clearing organization.

Enforcement

Effective regulation requires an effective enforcement program. The Dodd-Frank Act enhances the Commission's enforcement authorities in the futures markets and expands them to the swaps markets. The Act also provides the Commission with important new anti-fraud and anti-manipulation authority.

This month, the Commission voted for a final rule giving the CFTC authority to police against fraud and fraud-based manipulative schemes, based upon similar authority that the Securities and Exchange Commission, Federal Energy Regulatory

Commission and Federal Trade Commission have for securities and certain energy commodities. Under the new rule, the Commission's anti-manipulation reach is extended to prohibit the reckless use of fraud-based manipulative schemes. It closes a significant gap as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers.

Dodd-Frank expands the CFTC's arsenal of enforcement tools. We will use these tools to be a more effective cop on the beat, to promote market integrity and to protect market participants.

Position Limits

Another critical reform of the Dodd-Frank Act relates to position limits. Position limits have been in place since the Commodity Exchange Act passed in 1936 to curb or prevent excessive speculation that may burden interstate commerce.

In the Dodd-Frank Act, Congress mandated that the CFTC set aggregate position limits for certain physical commodity derivatives. The law broadened the CFTC's position limits authority to include aggregate position limits on certain swaps and certain linked contracts traded on foreign boards of trade, in addition to U.S. futures and options on futures. Congress also narrowed the exemptions for position limits by modifying the definition of a *bona fide* hedge transaction.

When the CFTC set position limits in the past, the purpose was to ensure that the markets were made up of a broad group of market participants with a diversity of views. Market integrity is enhanced when participation is broad and the market is not overly concentrated.

Commercial End-User Exceptions

The Dodd-Frank Act included specific exceptions for commercial end-users, and the CFTC is writing rules that are consistent with this Congressional intent.

First, the Act does not require non-financial end-users that are using swaps to hedge or mitigate commercial risk to bring their swaps into central clearing. The Act leaves that decision up to the individual end-users.

Second, there was a related question about whether corporate end-users would be required to post margin for their uncleared swaps. The CFTC has published proposed rules that do not require such margin.

And third, the Dodd-Frank Act maintains the ability of non-financial end-users to enter into bilateral swap contracts with swap dealers. Companies can still hedge their particularized risk through customized transactions.

Rule-Writing Process

The CFTC is working deliberatively, efficiently and transparently to write rules to implement the Dodd-Frank Act. Our goal has been to provide the public with opportunities to inform the Commission on rulemakings, even before official public comment periods.

We began soliciting views from the public immediately after the Act was signed into law and during the development of proposed rulemakings. We sought and received input before the pens hit the paper. We have hosted 13 public roundtables to hear ideas from the public prior to considering rulemakings. On August 1, we will host another public roundtable to gather input on international issues related to the implementation of the law. Staff and commissioners have held more than 900 meetings with the public, and information on these meetings is available at *cftc.gov*.

We have engaged in significant outreach with other regulators—both foreign and domestic—to seek input on each rulemaking, including sharing many of our memos, term sheets and draft work product. CFTC staff has had about 600 meetings with other regulators on Dodd-Frank implementation.

The Commission holds public meetings, which are also webcast live and open to the press, to consider rulemakings. For the vast majority of proposed rulemakings, we have solicited public comments for 60 days. In April, we approved extending the comment periods for most of our proposed rules for an additional 30 days, giving the public more opportunity to review the whole mosaic of rules at once.

We also set up a rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Dodd-Frank Act. This is consistent with a requirement included in the President's January Executive Order. In addition, we will be examining the remainder of our rule book consistent with the Executive Order's principles to review existing regulations. The public has been invited to comment by August 29 on the CFTC's plan to evaluate our existing rules.

This spring, we substantially completed the proposal phase of rule-writing. Now, the staff and commissioners have turned toward finalizing these rules. To date, we held two public Commission meetings this month and approved eight final rules. In the coming months, we will hold additional public meetings to continue to consider

finalizing rules, a number of which I will highlight. In August, we hope to consider a final rule on swap data repository registration. In the early fall, we are likely to take up rules relating to clearinghouse core principles, position limits, business conduct and entity definition. Later in the fall, we hope to consider rules relating to trading, real-time reporting, data reporting and the end-user exemption. We will consider most of the rules with comment periods that have yet to close, including capital and margin requirements for swap dealers and segregation for cleared swaps, sometime in subsequent Commission meetings. The comment period for product definitions closes tomorrow, and working with the SEC, we will take them up as soon as it is practical.

As the Commission continues with its rulemaking process, the Commission is taking great care to adhere to the requirement that the public be provided meaningful notice and opportunity to comment on a proposed rule before it becomes final. Therefore, depending on the circumstance—such as when the Commission may be considering whether to adopt a particular aspect of a final rule that might not be considered to be the logical outgrowth of the proposed rule—the Commission may determine that it would be appropriate to seek further notice and comment with respect to certain aspects of proposed rules. For example, in response to comments received on a proposed rule regarding the processing of cleared swaps, the Commission this week re-proposed aspects of this rule regarding the prompt, efficient and accurate processing of trades.

The Dodd-Frank Act set a deadline of 360 days for the CFTC to complete the bulk of our rulemakings, which was July 16, 2011.

Last week, the Commission granted temporary relief from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This order provides time for the Commission to continue its progress in finalizing rules.

Phasing of Implementation

The Dodd-Frank Act gives the CFTC flexibility to set effective dates and a schedule for compliance with rules implementing Title VII of the Act, consistent with the overall deadlines in the Act. The order in which the Commission finalizes the rules does not determine the order of the rules' effective dates or applicable compliance dates. Phasing the effective dates of the Act's provisions will give market participants time to develop policies, procedures, systems and the infrastructure needed to comply with the new regulatory requirements.

In May, CFTC and SEC staff held a roundtable to hear directly from the public about the timing of implementation dates of Dodd-Frank rulemakings. Prior to the roundtable, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. We also offered a 60 day public comment file to hear specifically on this issue. The roundtable and resulting public comment letters will help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time. This public input has been very helpful to staff as we move forward in considering final rules.

We are planning to request additional public comment on a critical aspect of phasing implementation—requirements related to swap transactions that affect the broad array of market participants. Market participants that are not swap dealers or major swap participants may require more time for the new regulatory requirements that apply to their transactions. There may be different characteristics amongst market participants that would suggest phasing transaction compliance by type of market participant. In particular, such phasing compliance may relate to: the clearing mandate; the trading requirement; and compliance with documentation standards, confirmation and margining of swaps.

Our international counterparts also are working to implement needed reform. We are actively consulting and coordinating with international regulators to promote robust and consistent standards and to attempt to avoid conflicting requirements in swaps oversight. Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the U.S. unless those activities have "a direct and significant connection with activities in, or effect on, commerce" of the U.S. We are developing a plan for application of 722(d) and will seek public input on that plan in the fall.

Conclusion

Only with reform can the public get the benefit of transparent, open and competitive swaps markets. Only with reform can we reduce risk in the swaps market—risk that contributed to the 2008 financial crisis. Only with reform can users of derivatives and the broader public be confident in the integrity of futures and swaps markets.

The CFTC is taking on a significantly expanded scope and mission. By way of analogy, it is as if the agency previously had the role to oversee the markets in the state of Louisiana and was just mandated by Congress to extend oversight to Alabama, Kentucky, Mississippi, Missouri, Oklahoma, South Carolina, and Tennessee—we now have seven times the population to police.

Without sufficient funds, there will be fewer cops on the beat. The agency must be adequately resourced to assure our nation that new rules in the swaps market will be strictly enforced—rules that promote transparency, lower risk and protect against another crisis.

Until the CFTC completes its rule-writing process and implements and enforces those new rules, the public remains unprotected.

Thank you, and I'd be happy to take questions.

The CHAIRMAN. Thank you, Chairman, for your testimony.

The chair would like to remind Members they will be recognized for questioning in the order of seniority for the Members who were here at the start of the hearing. And after that, Members will be recognized in order of arrival, and I appreciate the Members understanding.

And with that I recognize myself for 5 minutes.

Mr. Chairman, this afternoon we are going to hear from the Los Angeles Department of Water and Power as well as Ford Motor Company. And, it is safe to say that neither of these entities caused the financial crisis. Yet the L.A. Department of Water and Power will testify that in addition to concerns regarding margin and capital costs under your rules, they may be deemed swap dealers. They may be unable to find counterparties due to the business conduct standards, and the new reporting requirements may impose significant new costs and infrastructure challenges.

As for Ford, not only are they concerned about margin and capital costs, they are concerned about the ability of their pension fund to continue hedging, the treatment of their captive financial unit, and the continued viability and efficiency of their centralized hedging affiliate.

Mr. Chairman, are you able to describe the cumulative impact of all of these regulations for individual entities like Ford or the L.A. Water Department, let alone the whole economy?

Mr. GENSLER. Well, the cumulative effect, Mr. Chairman, is a net positive. I think that transparency and the openness and the competitiveness that this Committee worked so hard to get into Title VII is a key to lowering costs of the derivatives market and lowering risks to the public.

On the specific issues, issue by issue, we take up the cost-benefit analysis in each of the rules. And I will be glad to address each one of the issues you raised in that question.

The CHAIRMAN. But it is fair to say they have legitimate points there in the way the rules are coming together, isn't it Chairman?

Mr. GENSLER. I think that if I can, taking the pension point, we think it is a clear intent that pension funds, and all, really, participants in this market, be able to use these products to hedge a risk so they can focus on that which they do best and then lock in a price array. That is the core of this market, just as a farmer locks in the price of corn or wheat at harvest time. And so pension funds need to do to do that.

We are working very closely with the Department of Labor because the specific issue there is just how some rules they have and these rules come together so that a counterparty is not necessarily

a fiduciary under the Department of Labor rules. I think that we have a path forward with the Department of Labor on that issue.

The CHAIRMAN. But at the present moment it is a legitimate concern.

Mr. GENSLER. Of the 20,000+ comments most are legitimate concerns, and we are taking them in, and I think that when the business conduct rules with regard to pension funds, we will take up those in the final rule.

The CHAIRMAN. Let's for a moment focus on the issue of being defined as swap dealers, these entities.

Mr. GENSLER. Swap dealer in the statute had—it was four different definitions. And then Congress asked us to, "further define it beyond these four definitions," which we are doing. It also gave us some ability to define *de minimis*. So some entities like agriculture cooperatives we have been working with and meeting with actively, I think we will be able to find a path forward that agricultural cooperatives, if they are offering swaps, agricultural swaps and related swaps to their members, and they are under Capper-Volstead, an agricultural cooperative for instance will find a path forward that they are not a dealer.

We have some similar dialogues going with municipal cooperatives like I know you have later today, I saw earlier from the L.A. Municipal Cooperative.

The CHAIRMAN. But, Mr. Chairman, is it fair to say that in the way the rules are evolving right now, the Water Department and Ford Motor Company's concerns about their being defined as swaps dealers, that is a legitimate concern at this point.

Mr. GENSLER. I actually think they know more about their business than we do. If they are dealing in swaps, then it is possible. But, most of them, the Ford Motor Company to my knowledge, or the Municipal Cooperative in L.A., may not actually even be dealing in swaps. So we have had very good dialogues with them and we are trying to clarify the rules to lessen any uncertainty.

The CHAIRMAN. The next panel will be fascinating.

In speeches and statements, your focus remains on the need to reduce risks to the financial system, increase transparency, and every Member of this Committee agrees with those efforts. But we are here to tell you, Mr. Gensler, looking at our industry panel, the folks who will come next, this is much bigger than Wall Street. It seems as though you are unwilling to acknowledge the breadth of your own proposals. And there are simple and direct steps that you could take to improve your process and the outcome of your rules. And those steps will not undermine the creation of an effective or modern regulatory regime for derivatives.

For example, why did you choose to extend the exemptive order only until December, the exemptive order, whereas the SEC chose a route so that they basically extend the exemption until the rules are in place?

Mr. GENSLER. Well, there are actually a number of other differences with the SEC.

The CHAIRMAN. But just on that one, just for curiosity's sake.

Mr. GENSLER. If a rule is mandated by Dodd-Frank, it is extended until that rule is in place. And that is even beyond the 6 months, Mr. Chairman. There are some things that were not de-

pendent upon a rule and we are just dependent upon the definition of *swap,* and *swap dealer,* and so forth. So we chose to extend it for 6 months with an anticipation that we would, before that time, get to the definitions of *swap dealer* and *swap*. If for some reason we have not, we will take up in November and we will tailor relief at that point to give additional relief.

The CHAIRMAN. But you do see why this would cause angst, as an example this particular case, why it would cause angst and concern out there?

With that, my time has expired I now turn to the Ranking Member, and recognize Mr. Peterson for 5 minutes.

Mr. PETERSON. Thank you, Mr. Chairman.

Chairman Gensler, the Commission and the prudential regulators have both put forth their proposed rules regarding the margin requirements for the uncleared swaps traded by swap dealers and major swap participants under their jurisdiction.

Can you explain the differences between these proposals with regard to margin requirements that could be required of non-financial end-users, low-risk financial entities and high-risk financial entities?

Mr. GENSLER. We worked very closely, as Dodd-Frank asked us to, with the prudential regulators and we proposed a rule that these non-financial end-users would not be subject to margin. I believe that is what the prudential regulators did as well. They did add something because we cover banks. It is not our rule but they said that banks had to extend credit consistent with their credit policies. But, we each have proposals out there where the non-financial end-users would not be subject to any margin requirement from the CFTC's rules.

Mr. PETERSON. It was suggested at a previous hearing that the CFTC should delegate some of its Dodd-Frank responsibilities to the National Futures Association which is funded entirely by its participants.

Given that the CFTC is not funded directly by participants in the market it oversees, but by Congress, wouldn't more NFA responsibility place a greater cost on the industry than direct CFTC oversight?

Mr. GENSLER. They would raise their fees and they are going to take up some rules later this fall so that they would—all the dealers would register with the NFA. We are working with the NFA that they would be the examination front and go into these entities on some regular basis and then they would, of course, as you say, charge fees.

Mr. PETERSON. Do you have any idea——

Mr. GENSLER. I would like to try to get back to you and work with the NFA to see, but I haven't seen a cost estimate of what they are doing yet. But they are planning to propose some rules and then have an examination staff starting, with about 50 people, January, but then growing after that.

Mr. PETERSON. A few days ago, Representative Garrett introduced legislation to limit the CFTC in its ability to set rules for operation of swap execution facilities. And it appears to be particularly targeted, appears to target you, the Commission's proposed

rules regarding these SEFs. Do you believe—are you familiar with this legislation?

Mr. GENSLER. Not the details of it. I must apologize. With two Congressional hearings, I didn't read the legislation.

Mr. PETERSON. So maybe you can't just, it limits your authority to set these up. But the question I had was whether you believe these limitations are warranted. I assume you don't but——

Mr. GENSLER. I can't speak to the specific legislation, but these facilities will help end-users because they will get transparency. If they are commercial end-users, they have no requirement to use them. Congress is clear and we will follow that intent. But it does require the dealers and the financial insurance companies and hedge funds to use them, and so there will be a great deal more transparency. And economists for decades have said when you bring things into the open, when you shine a light on it, you narrow the costs. You do tip some of the information advantage from Wall Street to Main Street, and some of the opposition is from that.

Mr. PETERSON. The next panel, Mr. Peterson with Chatham Financial states that Chatham supports the CFTC's position that it is not required to impose margin requirements on non-financial end-users. However, Mr. Schloss with Ford states that your proposed rules require swaps dealers to collect margin from non-financial end-users if the thresholds were to be exceeded. Can you tell us who is right?

Mr. GENSLER. Our rule as proposed does not require a dealer to collect margin from any non-financial end-user but we will take his testimony into our comment file and consider it as a comment so that we can take——

Mr. PETERSON. Under the proposed rule, the only time the CFTC-regulated swap dealer would require a non-commercial end-user to post margin is if it wanted to do that on its own accord.

Mr. GENSLER. It would be a matter of a private contract.

Mr. PETERSON. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The chair now recognizes the gentleman from Illinois for 5 minutes.

Mr. JOHNSON. Thank you Mr. Chairman. I would echo the comments earlier in the week that the chair made. Mr. Gensler, I don't think Members of this Committee are trying to dismantle Dodd-Frank. We are trying to make it work better. And with that premise and with also the understanding that I only have 4 minutes and 43 seconds on the time clock, I am going to make a couple statements and ask a couple questions and hope you take them in the respectful light that they are given.

I have found in the time that you have come here before, that you are very skillful in not answering questions. So I am not going to pose some questions to you, although I may have a couple, and just make a couple of statements that I think are applicable. And I say that with all due respect, and that is the experience I have had and that is what I am going to act on.

I guess the first comment I would have is it seems as though your proposals and the various others in the regulatory scheme, specifically the SEC, have obvious conflicts, and I think that the definitions that you have given us with respect to swaps and swap dealers are somewhat less than clear.

Do you have any response to what you are doing *vis-à-vis* the SEC and how much more specific you can or are willing to be with respect to some of these definitions?

Mr. GENSLER. The SEC and CFTC have worked jointly on those definition rules. So in that case we are actually aligned.

Mr. JOHNSON. But you will concede there are inconsistencies, there are clearly inconsistencies. I don't think you can deny that, can you?

Mr. GENSLER. In other rules. In other rules. Because the joint rule is a joint rule, but in the——

Mr. JOHNSON. I am talking about your entity and SEC as it applies to two different regulatory schemes dealing with economically comparable products and having schizophrenia, so to speak, in terms of which set of rules are going to apply. I think it is clear, and I wonder what you are going to do to try to get us out of that dilemma.

Mr. GENSLER. I do. I am trying my hardest to answer the question. With some rules, whether it is about swap execution facilities or some of the clearinghouse rules, there are some differences, as we are a regulator that also regulates futures, and we are trying not to have too much regulatory gap or differences between futures and this.

On the definitions, we are aligned because it is a joint rule and it has to have the same words.

Mr. JOHNSON. Let me, since we have limited time, and respectful not only to the chair and Ranking Member but to other Members of the Committee, just make a couple of comments that are apparent from your testimony and from the history of what we have dealt with so far. I think other Members of the Committee and certainly I have heard from various pension plans which we are all vitally concerned about in these economic times and various states and their "attack" on pension plans, a lot of the pension plans believe that the rules that you are in the process of implementing and the underlying legislation are harming them. They harm their ability to operate and act on behalf of the people who have paid into them. I am concerned about that and simply want to posit that.

I am also concerned—really concerned—representing an area as a lot of us do where rural electric cooperatives, agricultural cooperatives and all that are an essential part of our being, critical positive entities that really do a whole lot for the infrastructure of this country. For people living in big cities you probably know it too, but we know it in a very specific way. And I am very concerned that we are treating in many ways, and you are, those cooperatives in a way almost identical to Goldman Sachs, and I think that is, frankly—that falls of its own weight.

I am also concerned about the definition of *swap dealers.* I consider that in the agriculture sector and in the energy sector, which are two really critical sectors, that those definitions are overly broad and really don't serve well the interests of either the agriculture sector or the energy sector. And I hope in the course of your further rule implementation you will be aware of that.

Let me just finish by asking you one question and then we can go from there. I do appreciate your receiving these questions, and

they are given really in the most respectful light, but I also want to be candid with you.

Do you believe that you are on track, both substantively and time wise, to do what the underlying legislation, this Committee and other oversight committees expect you to do, or have you had an unexpected amount of delays and snafus in the process that have resulted in what is, at least appears to be, a very perplexing final product?

Mr. GENSLER. I think we are on track to do what Congress intended us to do, but we are delayed. We are delayed because we didn't do it in 360 days as Congress had mandated us to do it, but that is because we are going to get it right. We are going to take all these comments in, the pension fund, the agricultural cooperative, the definitions as you say, and the final rules will be different than the proposals. If they are a logical outgrowth we will finalize. If we need to repropose——

Mr. JOHNSON. I am out of time. You are out of time, Mr. Chairman. I appreciate this very much. I think this is an ongoing dialogue that really needs to continue. And I am hopeful that you will be able to get back to us and see some improvement in what I think has been a failed process so far.

The CHAIRMAN. The gentleman's time has expired. The chair now turns to the gentleman from Pennsylvania to be recognized for 5 minutes.

Mr. HOLDEN. Chairman Gensler, you mentioned you had the ongoing conversation the with the co-ops. I am wondering if you are having the same conversation with the Farm Credit System, and where are we with their concerns about mandatory clearing?

Mr. GENSLER. We have—we have had them with them and with the Farm Credit Administration. And we are looking at, for, as Congress had mandated for institutions, small, financial institutions, banks, farm co-ops and credit unions and the statute says less than $10 billion. We are working with all the regulators as to how to address that, that we shall consider exempting those groups. We have not yet published something just because of the breadth of all the things that we are focused on.

Mr. HOLDEN. Are you looking just, does the statute only allow you to look at the assets or do you look at the percentage, like with the system it is 1/10 of 1 percent of the system's total loan volume. That doesn't seem to be systemic risk. Does the statute allow you to look at that?

Mr. GENSLER. We are looking at a number of alternatives with regard to, the group that Congress said to look at, these small institutions and how to exempt them. And one of the things is within that, as you say, percentage of capital, percentage of other ratios.

Mr. HOLDEN. And one final question on the system. I guess in looking at a bank to determine if it is a swap dealer, Dodd-Frank gives insured depository institutions a broad exemption from the *swap dealer* definition so long as the swaps they provide customers are related to providing that customer alone. Would the Farm Credit System be eligible for the same exemption?

Mr. GENSLER. I am familiar with the issue, as Members might recall and as the Congressman said, a bank or what is called an insured depository institution, can originate—do a swap in connec-

tion with originating a loan, and it doesn't become a swap dealer and so forth.

The statutory language uses those words, and so the lawyers are looking at whether that insured depository institution, words I am led to believe may not cover the Farm Credit System—and that may be a limitation that was in those words, but we are looking at that closely. I know the lawyers and others have looked at that.

Mr. HOLDEN. You said it may not cover, I thought you said, right?

Mr. GENSLER. That is what the comment letters are concerned with. That is right.

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

The CHAIRMAN. Would the gentleman yield for just a moment before he yields back?

Chairman, we were talking a moment ago about the swap dealers and margin requirements. If you are a captive enterprise, for instance say Ford, you would be exempt it would appear. But what about Ford Credit and all of the other enterprises underneath that? Would they also be exempt from the *swap dealer* definition or the margin requirements, those issues?

Mr. GENSLER. Two questions: From our understanding—and, again, it may be we don't have enough of the facts, it is case by case—they are not making markets and they are not accommodating other parties. They are not helping others with risk management, doing what dealers normally do.

So I haven't heard from whether it is Ford Credit or other credit companies about the dealer.

On the second question about margin, that comes to a question of how Congress defined what is a financial entity, and captive finance companies are meant to be out, but there is a statistical test that is in the statute for that. So there are probably out as long as they meet the Dodd-Frank provisions of a captive finance company.

The CHAIRMAN. So they may or may not be in this example, and the test is clearly defined in law or will be defined in rule?

Mr. GENSLER. The test for clearing is clearly defined in law. It has two 90 percent tests that I am glad to meet with you and chat with you about. But it is clearly defined in the statute. Our rule didn't define it. The statute did.

The CHAIRMAN. I thank the gentleman for yielding.

And I recognize the gentleman from Texas, Mr. Conaway, for 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being here.

Transparency has been a recurrent theme throughout your testimony and I didn't count today's testimony but you have used the word *transparent* or and/or *transparency* a lot. Under that heading, would you consider on future final rules a 3 to 7 day advanced posting of the rule that your Commission is going to vote on? We do that here with respect to laws that we are going to vote on the floor. Would you consider that for your team?

Mr. GENSLER. Congressman, this has been raised even by one of our Commissioners. And as thoughtful as the suggestion is, it runs right smack into the Administrative Procedures Act which Con-

gress doesn't have to comply with but we do. And so our General Counsel has reviewed other regulatory agents, too. To post a final rule that is different than a proposal would run into serious concerns with the Administrative Procedures Act.

Would that be a re-proposal? Would 7 days or 3 days be sufficient when we are putting things out for 60 days and the Administrative Procedures Act says there is a minimum of 30 days to comment?

Mr. CONAWAY. So the idea is that the Administrative Procedures Act works against transparency, or at least the interpretation by your team is that——

Mr. GENSLER. And we are not aware of other regulators that do here in the U.S.

Mr. CONAWAY. I looked at the rules that you went final on last week, they are all 5–0. A particular concern to this Committee has been the cost-benefit analysis. And earlier testimony from a couple of the folks from the Commission had said that you would redo cost-benefit analysis on final rules.

I was particularly troubled by how cavalier that your decisions are with respect to the costs. Is it going to be your interpretation that there is no rule that is so unimportant that there aren't—that the costs exceed the benefits and therefore you wouldn't do the rule? Is every single rule that you proposed of such vital impact on the regulatory scheme that it really doesn't matter what the costs are to the industry to comply?

Mr. GENSLER. The costs are very important. I would say there is almost not a meeting that goes on in my office that we are not weighing costs and the benefits, because there are a lot of choices within those rules. And so when the commenters come in, if we can find a lower-cost approach, or just one that—we will accept the comment and change the final rule to try to lower these things.

Mr. CONAWAY. That is helpful to hear, because if you just read through the one that I was looking at it just seemed to be, well, we know there are going to be a lot of costs and we will keep dividing them by some bigger number so they get down to a smaller number per entity or whatever, and that is fine. That is in effect a tax that you are levying on the system, or equivalent to a tax on the system when you, through your rulemaking, raise their costs.

Swap dealers under the business standard of conduct, business conduct standards, you are a swap dealer, you have to look at your counterparties and decide whether or not they have the sophistication, I guess, to deal with you. But if they have an independent adviser—Mr. Hultgren will pick sides when you are Chairman, Mr. Hultgren, I am trying to swap back and forth.

Mr. GENSLER. He is swapping.

Mr. CONAWAY. The swap dealer then gets a veto on the independent adviser, which seems a bit of a conflict of interest in this system. Are you going to change that in the final rule?

Mr. GENSLER. Just so Members—this has been dealing with pension funds and municipalities. It goes back to one of the earlier questions about pension funds. Yes, it has been raised by a number of comments. I think it is a very thoughtful—I can't tell you how we are going to come out on it but there is an easy fix to make

sure that the pension fund can pick their adviser and it is not a check, as you say, on them picking that adviser.

Mr. CONAWAY. And flipping to commodity pool operators and commodity trading advisers, not really required under Dodd-Frank, as I understand it, but we have new rules with respect to those folks. Obvious question, why add to your burden of rulemaking with something that appears to be elective *versus* all the stuff that you have to do under Dodd-Frank, and are you sure, based on the cost-benefit analysis that you have done on these proposed rules that the reach of these registration rules or whatever you want to do with respect to these folks is warranted in these circumstances?

Mr. GENSLER. We addressed ourselves to commodity pool operators—some in the public we call money managers or hedge funds—because we are mandated jointly with the SEC to do rules on information and providing information particularly for those who have over $150 million in assets. And so it was in that context that the staff looked and said there are some exemptions from 2002 or 2003, that we didn't even know the whole inventory, and these proposals came out of that.

We had a public roundtable since then. I don't know where we will come out. It is not on our agenda to take up in August. It would probably be later in the fall or even later than that because, as you know, it is not one of the swap rules. So it may be quite later in the agenda.

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

The CHAIRMAN. The gentleman's time has expired. The chair recognizes the gentleman from Connecticut for 5 minutes.

Mr. COURTNEY. Thank you, Mr. Chairman. Thank you for holding this hearing. When you look at the title of this hearing, *The View from Main Street,* Mr. Chairman, I want to thank you first of all on page three of your testimony that you are reminding the Committee that when we talk about Main Street, that the public buys gasoline and groceries from companies that rely on futures and swaps to hedge swings in commodity prices. On my Main Street, that is what people are thinking about when they think about this issue.

And there was a hearing in the Senate in May where the CEO of ExxonMobil, Mr. Tillerson, testified about what the traditional real price of oil should be. At that point it was about $115 a barrel. He said under oath in front of the Senate Committee that it should be $60–$70 a barrel. And he went on to say that it was speculation that is engineered by the high-frequency trading of quantitative hedge funds that explained this increase, which again Mr. Peterson mentioned in his opening comments about the impact of speculation.

That is what my public from Main Street is looking for from Washington, is trying to get some sanity in these prices which, again, is causing great damage in the economy. Those unemployment numbers that came out earlier this month for June, every single analyst, public sector, private sector, indicated that it was energy prices that was sapping consumer confidence and it was really suppressing businesses in terms of feeling confident to expand. And that is really what is at stake here in terms of getting these rules out from Main Street's perspective, in my opinion.

And this Committee produced a bill which basically pushed back your authority into 2012. We tried to amend it, at least to carve-out one in Title VII for the position limits rules, which failed in a close vote. But, again, from Main Street right now, that is what people are waking up in the morning and thinking about, which is what it is going to cost to fill up their car.

Connecticut now has the distinction of being number one in the country in terms of gasoline prices so maybe it is a little more acute there. But maybe you can help us in terms of updating us with regard to where we are with the position limits rule in terms of your deliberations.

Mr. GENSLER. Thank you. I think a critical piece of the Act and a critical piece of the hearing record of this Committee was related to aggregate position limits. And it is part of promoting integrity in the markets that no one player is, no one speculator is so large in the market that they have some dominance, and you have diversity in the marketplace.

So we proposed a rule in January of this year, we received 12,000 comments. It does suggest the public—this was the most comments—over ½ of our comments are on one rule, and it is about energy prices and agricultural limits and silver and gold.

We have now successfully summarized those comments. It is our hope to put a staff recommendation in front of the five Commissioners shortly and try to take it up after Labor Day. I don't know if that will be September or October. The Commissioners, five Commissioners, have to weigh in on the staff recommendation. But, it is critical.

We are not an agency that sets prices. But our markets right now are 85 to 90 percent electronically traded, and probably somewhere between 80 and 95 percent of different markets are day trading and spread trading with only—it depends on which market, but the oil market right now is about five percent of the position changes on a day or traders that are trying to change a position overnight.

Most of the rest of it is sort of day trading. It doesn't relate to position limits, but it gives you a sense. The markets have changed over the last 30 years.

Mr. COURTNEY. Well, again, that effort in my opinion is critical for this recovery. And that is really, again, where Main Street is most focused right now.

And last, I would just say in terms of your budget which you referred to earlier, again the unfortunate reductions in terms of resourcing your staff, I have said this before in the Committee and I say it again, every $10 a barrel increase in oil prices costs the Navy hundreds of millions of dollars. And from the taxpayer standpoint, getting a market which is at least somewhat aligned to real supply-and-demand forces is going to be helpful in terms of reducing what we are spending in D.C.

Mr. GENSLER. I couldn't agree with you more.

I think this agency is a good investment. We are only about 700 people; less, and they would call it a battalion in the military. And we think that taking on a market this large, we should grow to about 1,000 people. I know that is hard because we have a terrible

budget deficit problem. But, it is a good investment to police the markets.

The CHAIRMAN. The gentleman's time has expired, and I would note that the Commission is definitely swinging above its weight so far. With that, the chair would announce we are in the process of two recorded votes on the House floor. The chair would ask the indulgence of the Chairman to remain with us while we stand at the call of the chair and announce to other panelists that we will continue as soon as the series is over with. Members, please return promptly.

With that we stand at ease.

[Recess.]

The CHAIRMAN. The hearing will reconvene. And the chair wishes to thank the Chairman of CFTC for his indulgence on time.

And, with that, I would now recognize the gentleman from Pennsylvania for 5 minutes.

Mr. THOMPSON. Thank you, Mr. Chairman.

Chairman, thanks again for being here.

I want to take a look in relation to impact on farm credit. You know, farm credit banks engage in swaps in connection with loans, just as commercial banks do. Do you have the authority to extend that exemption to farm credit institutions?

Mr. GENSLER. I am familiar with the issue. The question is because Congress in the statute says it is—two parts to your question maybe.

I think that we do have the ability to exempt the small ones from clearing, similar to credit unions and other banks. And we are trying to bring together some statistics and try to do that in a thoughtful way.

There is a separate question that you may be asking about this, whether some of their activity would be caught up in *swap dealer* definition. And there, there may be some limitations just because of how the statute is written about insured depository institutions, and we are taking a close look at that.

But I don't know which part of the question, but in the second one, there is a little bit of a limitation in the statute.

Mr. THOMPSON. So it sounds like from both parts of those, neither of those is something you have determined at this point, but you are looking at——

Mr. GENSLER. Oh, absolutely.

Mr. THOMPSON.—the impact on farm credit?

Mr. GENSLER. Absolutely.

Mr. THOMPSON. Any idea at what point there would be some certainty in determination?

Mr. GENSLER. It is our hope to finalize the *entity* definition rule, which includes the definition of *swap dealer* in this fall. It is joint with the Securities and Exchange Commission, so there is a lot of movement together. And Chairman Schapiro and I had a pretty constructive conversation about 3 hours ago on this. But it seems that we will be looking at that period of time.

On the earlier point about the small bank and small financial institution exemption, we still would have to propose something before finalizing it, so that would take a little bit longer. But hopefully we could propose something again in this fall.

Mr. THOMPSON. Okay. In terms of the *swap dealer* definition, I have some concerns with that. It seems that the two sectors that are most impacted by the overly broad definition are agriculture and energy. And those are two sectors where we should do everything we can, obviously, to promote the use of responsible mitigation tools, risk-mitigation tools, so that consumers, in turn, benefit from more stable prices for food and for power.

How do you respond to the disproportionate impact a broad *swap dealer* definition will have for agriculture and energy end-users and, subsequently, the customers, where all costs always get passed along to?

Mr. GENSLER. Well, I think that agriculture and energy users will benefit from this rule. I think they will get greater transparency. I think they will get lower costs from that transparency. And all of these energy and agricultural interests, if their end-users would have a choice to not be in the clearinghouse, not have margin, and yet get a benefit of transparency.

On a very small number of them, they are interested in the *swap dealer* definition. And as I mentioned earlier, we have had very constructive dialogue and discussions with agricultural cooperatives. If they are a Capper-Volstead cooperative and they are offering agricultural swaps to their members, we are working toward how to, in essence, fit them out through the *de minimis* rule. Because they are really targeted in what they are doing with their members in the agricultural world.

Mr. THOMPSON. Okay. Thank you, Chairman.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman yields back the balance of his time.

The chair now recognizes the gentlelady from Ohio for 5 minutes.

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

And thank you, Chairman Gensler.

Market participants really need some clarity on how inter-affiliate transactions will be regulated, as well as on how the Commission plans to define what they are. So could you explain to me how the CFTC is planning to identify and define inter-affiliate transactions so that as many truly inter-affiliate transactions are captured in the definition and American companies are not burdened with an unnecessary regulation for their internal risk allocating transactions?

Mr. GENSLER. It is something that we have not yet taken up publicly. And we have had a lot of meetings with market participants, and we would be glad to meet with you and your staff to get further input.

The issue that comes about is whether a transaction between two wholly owned affiliates comes under this clearing requirement. It does not come under the clearing requirement if one of them is non-financial. This is really just a question between affiliates of two financial companies. We think it is pretty clear: If it is non-financial, it is out.

And we have been meeting with market participants and really trying to see what statutory authorities and where they are and how to address it. Europe also is addressing this, and we try to

stay aligned with how Europe is looking at the inter-affiliate situation as well.

Ms. FUDGE. So we don't really—we are not there yet?

Mr. GENSLER. We are not there yet. That is correct. Partly because we are looking a lot about how Europe is doing it. This is one where they have actually been a little bit ahead of us.

The Dodd-Frank Act itself did not explicitly address this wholly owned affiliate to wholly owned affiliate. It did address, and I think constructively, the credit, if there is an affiliate that is doing finance credit, like the Ford Credit situation the Chairman raised earlier.

Ms. FUDGE. Okay. Thank you.

Speaking of the Dodd-Frank, the law would require quite a bit from the Commission, obviously, in terms of responsibilities. If your agency does not receive sufficient funding, businesses could see delays in reviewing applications and requests.

Can you talk just a bit about how inadequate funding of your agency could slow down your review process, which could adversely affect American businesses?

Mr. GENSLER. I think, Congresswoman, you are right. We have rededicated some of our staff. We are just a little bit larger than we were in the 1990s. And a lot of them are working on rules right now. We don't actually know how many people will try to file as dealers and swap execution facilities, but as they file their paperwork, as they file for review, we do not have adequate staff right now to put those papers through, and up to the five-member Commission to review them, vote on them, and so forth.

We are going to use the NFA as much as we can for the registration. I think that is a helpful—is very helpful. But, we will be slower than we should be. I think we should be a responsive agency, and I fear we will be slower than we should be on many of those applications.

Ms. FUDGE. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentlelady's time—she yields back her time.

One of the few advantages left anymore to being a Chairman of a standing committee is the ability to control the time. So if you would indulge me, Mr. Chairman, I am going to yield myself time for one last question.

On Tuesday, the Commission finalized the rule, the process review of swaps for mandatory clearing. And in the rule, the Commission states that it does not—does not foresee that it would take actions to impose margin or capital requirements on end-users.

The wording of that, does that imply that you believe you have the authority to impose margin requirements on end-users in the future sometime?

Mr. GENSLER. The word *foresee* might have even been the Chairman's choice, so I will describe it. It said that we had not finalized the rule, so I didn't want to, in essence, front run the Administrative Procedures Act that we hadn't finalized. But we have proposed that we would not require swap dealers to collect margin from these end-users. It would be—certainly, where my thinking is, is that is where the final rule will certainly be, as well.

The CHAIRMAN. But do you believe the statute gives authority to the Commission to impose such requirements if the Commission chooses to in the future?

Mr. GENSLER. As I have been informed by General Counsel, it does not deny us that authority. I think it is consistent with Congress that we do not pursue that. I think Congress has been very clear, and it is consistent with the intent of Congress that it is not going to apply to clearing and not to margin.

The CHAIRMAN. I am going to assume that that means the answer is, yes, you believe the Commission could in the future under the rule. But I appreciate the way you answered the question, Chairman.

Mr. GENSLER. I am trying to be careful.

The CHAIRMAN. You and I both, sir.

With that, the Committee thanks Chairman Gensler for his testimony today before the panel and would like to welcome our second panel to the dais.

Mr. GENSLER. Thank you very much.

The CHAIRMAN. Thank you, Chairman.

As our witnesses are moving to the table, I would like to welcome the second panel: The Honorable Glenn English, Chief Executive Officer, National Rural Electric Cooperative Association, Arlington, Virginia; Mr. Randy Howard, Director of Power System Planning and Development, Power System Executive Office, Department of Water and Power, Los Angeles, California; Mr. Neil Schloss, Vice President—Treasurer, Ford Motor Company, Dearborn, Michigan; Ms. Denise Hall, Senior Vice President, Treasury Sales Manager, Webster Bank, Hartford, Connecticut; Mr. Sam Peterson, Senior Advisor, Derivatives Regulatory Advisory Group; Mr. David Fraley, President, Fraley and Company of Cortez, Colorado.

Being no stranger to this room, Mr. English, and having observed how necessary it is to display patience in working through the vote and hearing schedule, I now call upon you to begin whenever you are ready, sir.

STATEMENT OF HON. GLENN ENGLISH, CHIEF EXECUTIVE OFFICER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, ARLINGTON, VA

Mr. ENGLISH. Well, thank you very much, Mr. Chairman, and I appreciate that.

First of all, I want to express to you and the Members of the Committee and to the world here today how proud those of us from western Oklahoma are to see you as Chairman. I believe you are the first Chairman from western Oklahoma in the history of the House of Representatives, and so we take great pride in that and appreciate it very much.

The CHAIRMAN. I appreciate that, Mr. English. When you consider the fact that I am Chairman at a time when there is not only no new money to work with but no old money, it is a challenging time. Thank you very much for those kind words.

Mr. ENGLISH. All right. Thank you, Mr. Chairman.

As you know, I spent about 20 years in this room, and throughout that time I was a champion of the CFTC. It was born shortly before I took office. Throughout the entire period I was on the sub-

committee that dealt with the CFTC, I chaired that subcommittee and certainly championed day-in and day-out the need for more resources, as the Chairman was here today recognizing the fact. And I was trying to recall how many members of the staff that they had during most of that time, and I am not sure it ever got above a hundred members of the staff. It was anemic.

And this was during a period, if you will recall, in which we were enthusiasts of deregulation, and, certainly, we were following that. And we got to the point that, my last tenure in chairing that subcommittee, we had a Chairman of the CFTC who made the decision that a derivative was not a future—even though the only difference between the two, I believe, is the word, a "derivative," and by any other name it is a futures—and, at that point, declared that it was not subject to regulation under the CFTC and under the legislation, therefore. And that went on to free up and create Enron, and we all know what happened to Enron. And then we went on now to 2008, the problems and challenges we have there.

As so often happens, Mr. Chairman, it seems like we have this tendency for the pendulum to swing from one extreme to the other. And we are very concerned about the reaction as people respond, though we are way past Enron, to what happened in 2008 and swing to the other extreme. I think, without question, the CFTC certainly needs to recognize and understand their responsibilities under Dodd-Frank. And we are delighted to see the transparency, the openness that it brings about. And it feels like that is a good, strong piece of legislation. However, that legislation can be discredited, and certainly this Committee can find that they have a very violent response from the public if it begins to cause damage because of the fact that it reaches beyond what the intent of the law was.

And, Mr. Chairman, I would suggest that it was not the intention of this Committee or the Congress, whenever they passed this legislation, that Norfolk Electric Cooperative be declared a swaps dealer. But under some of the discussion that we have been hearing down at the CFTC and given the broad scope in which they don't seem to be distinguishing between those people who, in fact, are focused on trying to hedge risk and to protect the members of those electric cooperatives, including the Chairman, we are in danger of the fact that this overreach could, in fact, be something that goes far beyond what the Congress had in mind and certainly would bring about the kind of negative reaction that I am sure we don't want to see.

At the heart of the issue that we are facing, Mr. Chairman—and I forgot to say I hope that my entire written testimony would be made a part of the record, Mr. Chairman.

The CHAIRMAN. So ordered.

Mr. ENGLISH.—is this definition of *swap* and *swap dealer*. That is really at the heart of the issue. That is what we are talking about. And how the CFTC recognizes that and deals with that and where they draw the line is going to be the critical point as to how successful this legislation is in moving forward. And, for that reason, I want to commend you and commend the Committee for doing this oversight work to bring this to the attention.

I would also point out, Mr. Chairman, as you know, there are provisions for exemptions but no one has applied for them. The reason is because everyone is waiting for this definition.

So with this in mind, I would hope, Mr. Chairman, that this Committee would continue to have a rigorous and vigorous focus on oversight in this law. I hope that we do get the transparency, the standardization of trading products, and the continued cost-effective access to over-the-counter commodity transactions for those people who legitimately want to hedge.

And I hope very sincerely, Mr. Chairman, that we recognize and understand that those non-financial-products people who are not looking to trade but to take care of their risk are exempt from these very burdensome costs that traders on Wall Street may be subject to. Let's look after electric cooperatives not only in Norfolk but all the electric cooperatives here on this Committee.

[The prepared statement of Mr. English follows:]

PREPARED STATEMENT OF HON. GLENN ENGLISH, CHIEF EXECUTIVE OFFICER, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, ARLINGTON, VA

Mr. Chairman, Mr. Peterson, and Members of the Committee, thank you for holding this hearing on Derivatives Reform: The View from Main Street. We appreciate the opportunity to discuss how the implementation of the Dodd Frank Act could negatively impact the rural electric cooperatives' ability to keep electric bills affordable for our consumer-members on Main Street, and on the farm. Any costs for the rural electric cooperatives resulting from regulatory overreach by the Commodity Futures Trading Commission (CFTC) will come out of the pockets of our consumer-members who live in some of the poorest areas in the country.

The National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing over 900 not-for-profit, member-owned, rural electric utilities, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering ¾ of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools (and other establishments) in 2,500 of the nation's 3,141 counties.

Our member cooperatives serve over seven million member owners in Congressional Districts represented on this Committee.

Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including constituents of many Members of the Committee. That challenge is critical when you consider that the average household income in the service territories of our member co-ops lags the national average income by over 14%.

Mr. Chairman, the issue of commodity derivatives and how they should be regulated is something with which I have a bit of personal history going back twenty years when I served on this Committee. Accordingly, I am grateful for your leadership in pursuing the reforms necessary to increase transparency and prevent manipulation in this complex global marketplace.

NRECA's electric cooperative members, primarily generation and transmission cooperatives, need predictability in the price for power, fuel, transmission, financing, and other supply inputs if they are to provide stable, affordable rates to their members, including farmers in your Districts. As not-for-profit entities, we are not in the business of making money or trading financial instruments. Rural electric cooperatives use a range of energy and capacity contracts to keep costs down by reducing the commercial risks associated with electricity, capacity, and necessary electricity production inputs. These contracts include both traditional commercial transactions and commodity derivatives. Some number of those contracts may be considered "swaps" under Dodd-Frank, but we don't know yet which ones because—a full year later—the CFTC has not yet defined the most basic term in the statute. How those contracts are ultimately labeled could have dramatic impacts for cooperative consumers.

Regardless of labels, it is important to understand that electric co-ops are engaged in activities that are pure hedging, or commercial risk management. We DO NOT use commercial transactions, commodity derivatives or swaps for speculation or other non-hedging purposes.[1] We are in difficult economic times, making it more important than ever for cooperatives to be able to use whatever tools may be available for managing commercial risk on behalf of our members.

Most of our hedges are bilateral commercial transactions in the OTC market. Many of these transactions are entered into by cooperatives using as their agent a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing. ACES was founded a decade ago by many of the electric co-ops that still own this business today. Through diligent credit risk-management practices, ACES and our members make sure that the counterparty taking the other side of a hedge transaction is financially strong and secure—whether that counterparty is a financial institution, a natural gas producer or an investor-owned electric utility.

Even though the financial stakes are serious for us, rural electric co-ops are not big participants in the global derivatives market, which is estimated at $600 trillion. Our members participate in only a fraction of that market, and are simply looking for an affordable way to manage commercial risk and price volatility for our consumers. Because many of our co-op members are so small, and because energy markets are so volatile, legislative or regulatory changes that would dramatically increase the cost of hedging or prevent us from hedging all-together would impose a real burden. If commodity derivatives are unaffordable, then these price risks will be left unhedged and resulting cost increases will be passed on dollar-for-dollar to the consumer, where these risks would be unmanageable.

Electric cooperatives are owned by their consumers. Those consumers expect us, on their behalf, to protect them against volatility in the energy markets that can jeopardize their small businesses and adversely impact their family budgets. The families and small businesses we serve do not have a professional energy manager. Electric co-ops perform that role for them and should be able to do so in a cost effective way.

Our Concerns With Implementation of the Dodd-Frank Act Are As Follows

The July 16, 2011 Order

As this Committee is aware, the effective date of the Dodd-Frank Act came and went on July 16, 2011, without final rules being in place for a definitive new market structure for "swaps." Congress made some of the provisions of the Dodd-Frank Act automatically effective on the unrealistic assumption that the new market structure for the diverse global swaps markets would take shape within a 1 year time frame. Several of those automatically effective provisions deleted the exclusions and exemptions upon which commercial entities rely to transact in the OTC markets for non-financial commodities like power, natural gas, electric transmission and other common commercial risk transactions. In an attempt to prevent a possible disruption of commodity and derivatives markets, including power supply and fuel supply contracting, on July 14, 2011, the CFTC issued the "Effective Date Order". Although the rural electric cooperatives, as part of the Not-for-Profit Electric Trade Associations Coalition, made a request for certain "grandfather relief" to the CFTC in September 2010 and again in May 2011, the CFTC has not addressed those requests.

The CFTC has extended until December 31, 2011 the timeline during which it intends to propose and finalize rules to establish the new regulatory market structure for "swaps." The CFTC has also granted "temporary exemptions" from the current Commodity Exchange Act provisions to allow parties to transact in commodities and related derivatives during this interim period. This temporary relief automatically expires as of the earlier of December 31, 2011 or the date on which the final CFTC rule is effective in respect of any Dodd-Frank Act provision. This means a busy fall for CFTC rulemakings and the potential for further uncertainty as to whether (and when) the CFTC will again address these expiring temporary exemptions.

It is our hope that Chairman Gensler has addressed these issues before the Committee today to provide more guidance for energy end-users who need legal certainty and the ability to continue to use OTC derivatives to provide affordable and reliable power for American consumers while the regulators finalize their new markets. Our

[1] For convenience, the remainder of the testimony will refer to commodity derivatives, but it is important to remember that those cooperative hedges that could ultimately be regulated as "swaps" include both commercial derivatives and traditional commercial contracts that were never before treated as derivative products, such as capacity contracts, reserve sharing agreements, and the all-requirements contracts that have traditionally provided financial backing to loans from the Rural Utilities Service.

members enter into long term contracts to hedge our public service commitments and our infrastructure project costs. We remain concerned that temporary 6 month exemptions may not give our counterparties and financing sources much comfort in these long-term commercial hedging transactions.

The Definition of "Swap"

The most important term in the Dodd-Frank Act—because it defines the scope of the CFTC's regulatory authority—is "swap." NRECA is concerned that if the CFTC defines that term too broadly, it could bring under the CFTC's jurisdiction commercial transactions that cooperatives and others in the energy industry have long used to manage electric grid reliability and to provide long-term price certainty for electric consumers. It is our belief that the CFTC must draw clear lines between "swaps," which are subject to the CFTC's jurisdiction and non-financial commodity forward contracts. The CFTC should make it clear in its rules that "swap" does not include commercial trade options that settle physically, or commercial commodity contracts that contain option-like provisions, including the full requirement contracts that even the smallest cooperatives use to hedge their needs for physical power and natural gas generation. Further, CFTC should draw clear lines in its rules between "swaps" and those long-term power supply and generation capacity contracts, reserve sharing agreements, transmission contracts, emissions contracts and other transactions that are subject to FERC, EPA, or state energy or environmental regulation.

These non-financial transactions between non-financial entities have never been considered "products" or "instruments" or been traded with or between financial institutions for speculative purposes. They were not created to "trade", they were developed to protect the reliability of the grid by ensuring that adequate generation resources will be available to meet the needs of consumers. These transactions do not pose any systemic risk to the financial system, nor should they cause concern to a regulator that is focused on fair, liquid and secure trading markets for standardized products. These are commercial contracts.

The CFTC must show restraint and interpret the term "swap" narrowly, as intended by Congress. If these commercial contracts were to be regulated by the CFTC as "swaps," such regulation could impose enormous new costs on electric consumers and could undermine reliability of electric service.

The CFTC must also write clear rules that plainly explain which transactions will and will not be subject to regulation as "swaps." Cooperatives and other non-financial commercial end-users cannot be left in the dark, uncertain which transactions will subject them to increased regulatory burdens. That uncertainty can be as damaging as rules that clearly overreach.

In the Dodd-Frank Act, Congress excluded from the definition of "swap," the "sale of a non-financial commodity . . . so long as the transaction is intended to be physically settled." NRECA asks Congress to insist that the CFTC read this language as it was intended—to exclude from regulation these kinds of commercial transactions that utilities use in the normal course of business to hedge commercial risks and meet the needs of electric consumers reliably and affordably.

Margin and Clearing Requirements

In general, co-ops are capital constrained. We and our members would prefer that cash remain in our members' pockets rather than sitting idle in large reserve accounts to pay margin or capital costs of our counterparties. At the same time, we have significant capital investment demands, such as building new generation and transmission infrastructure to meet load growth, installing equipment to comply with clean air standards, and maintaining fuel supply inventories. Maintaining 42% of the nation's electrical distribution lines requires considerable and continuous investment.

Congress respected those constraints in Dodd-Frank by establishing an "end-user exemption" that exempted those entities—like cooperatives—that use swaps solely to hedge commercial risk obligations. End-users may choose to forgo the requirements to trade their swaps on regulated exchanges, which would require paying "margin" (posting collateral) to a dealer or clearing entity for those swaps. If properly implemented by regulation, that exemption would leave millions of dollars in electric consumers' pockets that might otherwise sit in margin accounts or be paid in capital fees to financial institutions.

I want to remind you that we are NOT looking to hedge in an unregulated market for standardized swaps. NRECA DOES want swaps markets to be transparent and free of manipulation.

The problem is that requiring cooperatives' hedges to be centrally cleared or, if they are not cleared, still subjected to margin requirements would be unaffordable

for most co-ops and would provide no value to the markets or to the nation. Our hedging transactions do not impose any of the systemic risk Dodd-Frank was intended to address. Yet any "initial margin" or "variance" margin requirements on our transactions under broad CFTC rules could force our members to post hundreds-of-millions of dollars in idle collateral that our consumers cannot afford to provide.

If the CFTC implements Dodd-Frank's end-user exemption too narrowly, the resulting clearing and margining requirements could force cooperatives to postpone or cancel needed investment in our infrastructure, borrow to fund margin postings, abandon hedging, or dramatically raise rates to consumers to raise the required cash to post as margin. Of course, whatever choice co-ops made would lead to the same result: increased electric bills for 42 million cooperative members.

Reporting Requirements

Mr. Chairman, the Dodd-Frank Act quite properly allows the CFTC to require reporting of those swaps traded on regulated exchanges, and those swaps involving swap dealers or other financial entities. That information is critical to providing transparency to those markets. Unfortunately, the CFTC is proposing to move far beyond the reporting requirements in the Act to also require utilities to report a significant volume of information for those end-user transactions that Congress exempted from Dodd-Frank's central clearing requirements. And, if no dealer is involved (as is the case in a lot of our transactions with other energy companies), the CFTC's rules will require one of the non-financial counterparties to report—perhaps "in real time." In our energy markets, many utility-to-utility transactions are entered into between two end-users, and there are no swap dealers or major swap participants to bear the reporting burdens that these types of dealer entities are accustomed to.

I encourage the Committee to urge the CFTC to reduce this reporting process burden, as permitted by the law. We are requesting that the CFTC adopt a "CFTC-lite" form of regulation for non-financial entities like the cooperatives. The CFTC should let us register, keep records and report in a less burdensome and less frequent way—not as if we were swap dealers or hedge funds. For example, it should be sufficient to require end-users to make a single representation that they will rely on the end-user exemption (and are *bona fide* hedgers) using swaps exclusively to hedge commercial risk. Once they have made that representation, they should not have to report those transactions any more frequently than is now required by the Federal Energy Regulatory Commission.

As explained above, these transactions represent a minuscule fraction of the global swap market and pose no systemic risk to the financial markets, making more frequent reporting unnecessarily expensive.

Exemptions for FERC-Regulated and 201(f) transactions

Congress recognized in the Dodd-Frank Act that elimination of the Commodity Exchange Act's exemption for energy transactions could lead to duplicative and potentially conflicting regulation of transactions now subject to FERC regulation, and could lead to unnecessary and expensive regulation of transactions between cooperative and government-owned utilities. Accordingly, it directed the CFTC to grant those transactions a "public interest waiver" from its regulation if it found such a waiver to be in the public interest.

No entity has yet sought such an exemption because the rules from which they would be seeking exemption have not yet been written. The CFTC can initiate the public interest waiver process, but it has not done so. Because the industry does not yet know what the CFTC will consider to be a "swap" or whether utility hedging efforts will be exempted from central clearing and margining requirements as end-user transactions, it does not yet know how critical it will be to pursue these additional avenues for relief. We certainly hope that the CFTC will choose to write its rules in a manner that minimizes potential conflicts with FERC regulation and that minimizes potential costs for transactions between cooperatives or government owned utilities. We further urge the CFTC not to impose a regulatory regime on individuals for commercial transactions involving non-financial energy commodities.

Nevertheless, should it become necessary to pursue additional exemptions or public interest waivers, NRECA hopes that the CFTC will recognize that Congress intended in Dodd-Frank to address systemic risk in financial markets without disrupting existing markets for electricity, and that the CFTC will entertain the industry's applications for further exemptions and public interest waivers if and or when they are submitted.

The Definition of "Swap Dealer"

The definition of "swap dealer" has just recently become a concern for the rural electric cooperatives. The regulators have suggested they might interpret this defini-

tion broadly enough to sweep in our not-for-profit members. If so, such an interpretation has the potential to be one of the more damaging unintended consequences of the Dodd-Frank Act. If our members were considered "swap dealers," those cooperatives would be subject to a slew of new capital-draining requirements, business practices, and financial markets regulations that Congress intended to impose on Wall Street derivatives dealers. To put it bluntly—it would be an incredible regulatory overreach for the CFTC to apply the definition of "swap dealer" to rural electric cooperatives—who are obviously not in the business of derivatives dealing, but instead are not-for-profit end-users of non-financial energy derivatives to hedge commercial risk and protect consumers from price volatility in wholesale power markets. The rural electric cooperatives' core mission is keeping the lights on for farmers, families and small businesses in rural America, not dealing in the global swaps markets. There are no "Wall Street derivatives dealers" in our membership. We believe it should be obvious to the CFTC that Congress did not intend for end-users, particularly not-for-profit end-users, to be regulated as "swaps dealers." We are happy to continue to explain our business to the regulatory staff, but we urge the CFTC to keep a clear focus on legislative intent.

Treatment of Cooperative Lenders

Rural electric cooperatives banded together 4 decades ago to form their own financing cooperative to provide private financing to supplement the loan programs of the U.S. Department of Agriculture's Rural Utilities Service (RUS). Today, this nonprofit cooperative association, the National Rural Utilities Cooperative Finance Corporation (CFC), provides electric cooperatives with private financing for generating stations and other facilities to deliver electricity to residents of rural America, and to keep rates affordable. In this context, CFC, which is owned and controlled by electric cooperatives, uses OTC derivatives to mitigate interest rate risks, and to tailor loans to meet electric cooperative needs. CFC does not enter into derivative transactions for speculative purposes, nor is it a broker or a dealer. CFC only enters into derivatives necessary to hedge the risks associated with lending to electric cooperatives. If CFC is unnecessarily swept up in onerous new margining and clearing requirements, electric cooperatives will likely have to pay higher rates and fees on their loans, and those costs will be passed on to rural consumers.

We ask that CFC's unique nature as a nonprofit cooperative association owned and controlled by America's consumer-owned electric cooperatives be appropriately recognized. Electric cooperatives should not be burdened with additional costs that would result by subjecting their financing cooperative, CFC, to margining and clearing requirements.

Conclusion

Mr. Chairman, at the end of the day, we are looking for a transparent market for standardized trading products, and continued cost-effective access to the OTC commodity transactions which allow cooperatives to hedge commercial risk and price volatility for our members. If we are to do that, the CFTC must define "swap" in clear terms to exclude those pure hedging transactions in non-financial commodities that the industry uses to preserve reliability and manage long-term power supply costs; must give real meaning to Dodd-Frank's end-user exemption; must limit unnecessary record-keeping and reporting costs for end-users; and must limit duplicative and unnecessary regulation of cooperatives and other electric utilities.

Rural electric cooperatives are not financial entities, and therefore should not be burdened by new regulation or associated costs as if we were financial entities. We believe the CFTC should preserve cost-effective access to swap markets for non-financial entities like the co-ops who simply want to hedge commercial risks inherent in our non-financial business—our mission is to provide reliable and affordable power to American consumers and businesses.

I thank you for your leadership on this important issue. I know that you and your Committee are working hard to ensure these markets function effectively. The rural electric co-ops hope that at the end of the day, there is an affordable way for the little guy to effectively manage risk.

Thank you.

The CHAIRMAN. Thank you, Mr. English.

The chair would like to recognize Mr. Howard.

STATEMENT OF RANDY S. HOWARD, DIRECTOR OF POWER SYSTEM PLANNING AND DEVELOPMENT AND CHIEF COMPLIANCE OFFICER, POWER SYSTEM EXECUTIVE OFFICE, LOS ANGELES DEPARTMENT OF WATER AND POWER, LOS ANGELES, CA; ON BEHALF OF LARGE PUBLIC POWER COUNCIL

Mr. HOWARD. Good afternoon, Chairman Lucas and Members of the Committee. Thank you for the opportunity to discuss the operational and economic impacts to the Los Angeles Department of Water and Power specifically, and to the electric utilities in general, related to the proposed rules implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act.

I am Randy Howard, Director of Power System Planning and Development and Chief Compliance Officer for LADWP. LADWP is a department of the City of Los Angeles and the largest municipal utility in the nation, serving approximately four million people.

I am also testifying on behalf of the Large Public Power Council. Large Public Power Council consists of roughly two dozen large public power systems that own and operate over 75,000 megawatts of generation capacity and over 35,000 miles of transmission lines. Our members are located in 11 states, including Texas, Georgia, Colorado, Florida, North Carolina, New York, Washington, and California.

As a group of not-for-profits, we have been actively participating in the Commodity Futures Trading Commission rulemaking process, submitting written comments, participating in the roundtables, and meeting with CFTC staff. Similar to my friends serving the rural parts of America at the National Rural Electric Cooperative Association and the American Public Power Association, our mission and our business is plain and simple. It is to keep the lights on 24 hours a day, 365 days a year, and, as you know today, the air conditioners running for all of our customers.

For days like today, where the temperatures across the nation exceed 100°, many electric utility staffs are struggling just to keep enough power flowing to meet the demand. But for many utilities, the planning and the preparation for this extreme heat event started months ago, with hedges and options just in case we would have a day like today. This is one of the important reasons we hedge. In addition to keeping our rates low and stable for customers, it is not just about our costs, but about the health and the safety concerns of our ratepayers and to keep the power systems operating.

It is important that derivative regulators consider some of the business issues impacting non-financial businesses like electric utilities. We need to avoid putting current risk-management practices in jeopardy.

I would like my written testimony to also be part of the record. I have tried to highlight in there some specific concerns and recommendations.

So, at the core, we do not believe we contribute to the systemic risk. Several LPPC utilities have estimated the cost impacts into the hundreds of millions of dollars when looking at the added collateral and operating costs that could be imposed. As public, not-for-profit utilities, we don't have shareholders. We can only turn to

our ratepayers to absorb the risk if we are unable to hedge, going forward, or we must pay additional costs.

Once again, thank you for your work on these issues and for the opportunity to testify before you today. I look forward to responding to any questions you might have.

[The prepared statement of Mr. Howard follows:]

PREPARED STATEMENT OF RANDY S. HOWARD, DIRECTOR OF POWER SYSTEM PLANNING AND DEVELOPMENT AND CHIEF COMPLIANCE OFFICER, POWER SYSTEM EXECUTIVE OFFICE, LOS ANGELES DEPARTMENT OF WATER AND POWER, LOS ANGELES, CA; ON BEHALF OF LARGE PUBLIC POWER COUNCIL

Chairman Lucas, and Members of the Committee, thank you for this opportunity to discuss the operational and economic impacts to the Los Angeles Department of Water and Power (LADWP) specifically and to electric utilities in general related to the proposed rules implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

I am Randy S. Howard, Director of Power System Planning and Development and Chief Compliance Officer for LADWP. LADWP is a Department of the City of Los Angeles and the largest municipal utility in the country serving approximately 4.0 million people.

I also am testifying on behalf of the Large Public Power Council (LPPC). LPPC consists of roughly two dozen large public power systems that have actively participated in the Commodity Futures Trading Commission (CFTC) rulemaking process, submitting written comments, participating in roundtables, and meeting with CFTC staff.

Electric Utilities Use Hedges To Keep the Lights on at Reasonable Rates

Our business is to keep the lights on for customers. To accomplish this, we manage a range of operational and commodity market risks every day to provide power to the residents and businesses we serve.

LADWP, like many utilities, controls operational risks by producing power from a mix of natural gas, coal, nuclear, hydro-electric, biofuels, and renewable energy resources. In addition to diversifying our power generation resources, LADWP strategically diversifies the locations of our generating facilities. LADWP owns, operates, and/or contracts generation in seven different western states to provide Los Angeles with reliable electricity service 24 hours a day, 365 days a year. For example, LADWP has wind farm resources in the Southern California Tehachapi mountains, in Utah and Wyoming, and in Oregon and Washington State, that have different wind profiles and at any one time, at least one location should be producing energy.

These physical diversification activities are not enough alone to provide our customers with reliable service at affordable and stable prices. Therefore, it is essential to manage the price volatility inherent in commodity markets such as natural gas and electric power through the use of bilateral contracts, hedges, and options. LADWP, as well as other utilities purchase fuel to generate electricity and buy and sell wholesale power at multiple delivery points. We enter into hedging contracts to control the costs our customers ultimately pay for energy commodities. Many of these transactions are between LADWP and another commodity end-user and not part of an organized trading market. These transactions have proven to be an extremely effective tool in keeping the lights on and insulating our customers from the energy market risks of price volatility.

As electric utilities, such as LADWP, transition into a higher resource level of renewable energy and proceed with significant reductions in fossil fuel emissions output, the operation and economic risks will increase.

As you know, the inability to predict the weather many months ahead impacts many decisions in the agricultural community, including the desire to hedge price swings. The electric industry is similar in this respect. It is not just the inability to predict weather, but the extreme weather events and the risks of the wind not blowing, the multi-year drought scenarios, the cloudy days when the sun is not shining for the solar systems, or wildfires burning under the transmission lines creating outages that make hedging and options critical to our businesses. These types of hedges and options physically or financially settle. But, all still to hedge commercial risks.

Specific Concerns With Frank-Dodd Implementation

There are four main areas of concern with the ongoing implementation of the Frank-Dodd Act: definitions and sequencing, margining and capital requirements, reporting requirements and business conduct rules for special entities.

Definitions and Sequencing

Several important definitions are still being drafted by CFTC and will impact LADWP and other utilities. In particular, we are concerned that individual LPPC members could be considered a "swap dealer" due to certain transactions we use to hedge our costs. LADWP and the members of LPPC do not belong within this definition, as we hedge strictly to minimize commercial risk and do not contribute to systemic risk of the market. If our utility systems were regulated as swap dealers, our ratepayers—the residents and businesses which we are obligated to serve—would be swept into the same regulatory regime meant to target financial speculation.

Notwithstanding the recent CFTC Effective Date Order, as a result of continuing uncertainty about how long the "temporary relief" will continue, and about what happens to outstanding longer-term transactions that may fall within the definition of "swap" once the CFTC's Dodd-Frank Act rulemakings are finalized (under the new regulatory regime for "swaps"), some expect that there will be fewer counterparties willing to enter into transactions with delivery dates or maturities that would extend past that temporary exemptive relief expiration date of December 31, 2011 in the Effective Date Order. In order to execute such longer-term transactions, there may also be additional credit support or collateralization requirements, new qualifications in legal opinions, and new representations and warranties.

Margining and Capital Requirements

Generally, our hedges are not standardized transactions suitable for clearing through financial intermediaries. Instead, our hedges are negotiated directly with counterparties with whom we have longstanding relationships. In particular, this enables us to customize the terms of our hedges, reducing or eliminating the need for collateral posting except where one of the party's credit deteriorates. All over-the-counter transactions do not share the same risk profile. End-users like electric and gas utilities, rural electric cooperatives, and municipalities often rely on their strong credit quality to structure transactions. A one-size-fits-all approach for determining credit risk would punish more prudent risk managers and holders of strong balance sheets. Accordingly, we think the CFTC should reconsider its counterparty exposure charge in its proposed capital requirements rulemaking. An effective and meaningful end-user exemption is called for in the law and should be reflected in the regulations.

Congress has repeatedly indicated that it did not intend to reduce hedging options for end-users or to impose additional costs on end-users hedging traditional commercial risks. We are concerned that our customers will experience rate instability and cost increases if Congress' intent is not effectuated through proper implementation of the Dodd-Frank Act. While the Dodd-Frank Act contains provisions exempting end-users from margin and clearing requirements, the CFTC, in issuing its regulations, threatens to render meaningless this statutory protection for end-users.

Record-keeping and Reporting

We are also concerned that the extent of the reporting requirements proposed by the CFTC, if coupled with onerous penalties for noncompliance, will unnecessarily add significant costs to our hedging transactions and are excessive in light of our relatively modest share of the derivatives market. We have encouraged the CFTC to carefully consider the cost impacts of proposed transaction documentation and reporting mandates on end-users like electric and gas utilities, rural electric cooperatives, and municipalities. These kinds of entities do not generally have large back-office operations dedicated to dealing with swap transactions, and many of the proposed rules will impose completely new requirements on some of these energy end-users. A better analysis of the costs and benefits of these proposed documentation and reporting requirements should be undertaken, in consideration of the low systemic risk associated with end-users like electric and gas utilities, rural electric cooperatives, and municipalities. Further, an adequate amount of time should be provided to these kinds of entities to adjust and transition to a new regime of reporting and documentation.

Business Conduct of Special Entities

Although LADWP and LPPC support the establishment of business conduct standards for counterparties to special entities, we are concerned that the CFTC's regulatory approach imposes excessive burdens on swap counterparties in deter-

mining whether special entities have "independent advisors" and uses an overly broad definition of "advisor." We believe that this approach will unnecessarily increase the costs of hedging and cause counterparties to be less willing to enter into swaps with special entities. The CFTC's regulations should minimize the burdens and potential liabilities for counterparties trading with "special entities." Rules that make it more difficult or risky to do business with "special entities" discourage counterparties from conducting trades with end-users that are special entities, undermining Congress' intent to protect legitimate hedging of risks by end-users such as electric utilities. Simple, practical regulations are needed.

Although we are still digesting them, the proposed rules issued by the SEC seem to be more in line with what is needed: dealers can disclaim "advisor" status and dealers can rely on representations to determine that an entity has an independent swap advisor.

Recommendations

CFTC should not impose collateral posting requirements on either party to hedges in which an end-user is a counterparty. LPPC members and their counterparties have historically relied on individually-negotiated credit support and collateral arrangements. Our transactions do not create systemic risk to the U.S. financial system, which is what Dodd-Frank Act seeks to mitigate. While the CFTC has made recent positive statements on this issue, we would hope to see regulations that protect the continued use of hedges that involve end-users such as our utilities.

The Commodity Exchange Act has recognized such an exemption from margin requirements since the 1970's.

Regulations should minimize the burdens and liabilities for counterparties trading with "special entities". Rules that make it more difficult or risky to do business with "special entities" discourage counterparties from conducting trades with end-users such as LPPC members, undermining Congress' intent to protect legitimate hedging of risks by end-users such as electric utilities.

Record-keeping and reporting rules should be crafted to provide transparency in the derivatives markets without interfering with the daily operations of businesses. Rules that allow businesses to report data on reasonable timeframes, including a "CFTC-lite" method of registration, will foster Dodd-Frank's market transparency goals without imposing unnecessary, and costly instantaneous information reporting mandates.

a. Energy end-users and public power doesn't contribute to systemic risk and it is critical that we do not fall under margining rules.

b. Transparency is not a concern, as public power entities, most entities have very open policies. Quarterly Reporting would accomplish this goal without being overly burdensome—CFTC-lite.

c. Business Conduct—allow counter parties to rely on representation of utility that they have internal expertise sufficient to enter into trades.

The CHAIRMAN. Thank you.

And the written testimony of all the witnesses will be incorporated in the record.

Mr. Schloss, you may begin whenever you are ready.

STATEMENT OF NEIL M. SCHLOSS, VICE PRESIDENT—TREASURER, FORD MOTOR COMPANY, DEARBORN, MI

Mr. SCHLOSS. Great. Thanks very much. And good afternoon, everyone.

Chairman Lucas and Members of the Committee, Ford Motor Company appreciates the opportunity to share Ford's view on derivative regulation under the Dodd-Frank Act.

Ford Motor Company is a global vehicle manufacturer with a captive finance company. Derivatives allow us to manage market risks in our business and our pension plans around the world relating to foreign exchange, commodities, and interest rates. We are not market makers, and we do not use derivatives to speculate.

We support Congress' intention in the Dodd-Frank Act to strengthen over-the-counter derivatives regulation, promoting

transparency and facilitating Federal oversight of these critical markets. However, it is important that, as regulations are being developed and implemented, that Congressional intent is clearly reflected in the regulation.

Congressional intent is evident not only in the Dodd-Frank Act but also in the many other forms of communication, including, Mr. Chairman, your most recent letter, along with Chairman Stabenow, to the prudential regulators at CFTC which supported our concerns. We strongly support your efforts. There are two unintended consequences I would like to cover today, and both of these were included in the notices of proposed rules and are inconsistent with Congress' intent.

Our first concern is a potential mandatory margin requirement on derivatives for commercial end-users' captive finance companies. A margin requirement not only negates Dodd-Frank exemption and Congressional intent but would result in a contradiction with the regulations themselves, whereby Ford Credit would be exempt from clearing but subject to the most onerous margin requirements.

The consequence of such margin requirements is an increase in the cost of our risk management. Unlike swap dealers and major swap participants, most end-users' captive finance companies do not have ready access to low-cost liquidity such as the Fed discount window or FDIC-insured deposits. Such costs also potentially put end-users and the broader U.S. market at a competitive disadvantage to our foreign competition.

A key concern specific to Ford Credit is the potential disruption in the access to the asset-backed securitization market. Mandating margin requirements for securitization derivatives will force major structural changes to our programs and result in substantial additional cost and complexity. Ultimately, this could impact our ability to efficiently access the securitization market or our backstop bank capacity.

Another disruption in the auto securitization market is something neither the U.S. economy nor our industry can withstand while trying to grow and add jobs. During the recent credit crisis, when many financial institutions were curtailing credit availability, Ford Credit, supported by its securitization funding, consistently supported our dealers and retail customers with their financing needs. We support continued dialogue between regulators and legislators throughout the implementation process to ensure the final regulations clearly reflect the legislative intent to exempt commercial end-users' captive finance arms from margin requirements.

Our second concern involves limitation of our pension plan's ability to use derivatives to protect Ford's balance sheet and, just as importantly, pensions of our employees and our retirees. We are very concerned that the inadvertent conflict between Department of Labor proposed regulation and CFTC's business conduct standards may result in counterparties refusing to trade with pension plans because they would be treated as fiduciaries or plan advisors.

Pension plans use derivatives to manage interest-rate risks and other risks to reduce volatility with respect to funding obligations. If derivatives were not available in pension plans, plan costs and funding volatility would significantly increase. This would undermine retirement security and create large uncertainties regarding

company cash contributions. Such an outcome would put American end-user manufacturers with their defined benefit plans at further competitive disadvantage to our foreign competitors.

Ford strongly recommends that Congress continue to urge DOL and CFTC to coordinate their efforts in areas where regulations are conflicting, to ensure pension plans are not inadvertently limited from using derivatives to manage risk on behalf of pension plan beneficiaries.

I appreciate you listening to our concerns. In my written testimony, I provide more detailed recommendations to address these concerns and would be pleased to discuss these further at your convenience.

In closing, we thank this Committee and your recent letter to the CFTC and prudential regulators and for giving derivative market reform the serious attention and the dialogue it deserves. We also greatly appreciate the Chairman and Ranking Member and the Committee Members for your help today in clarifying several of these issues with Chairman Gensler. And we look forward to having the regulation express the same clarity that was expressed today in the prior panel.

Thank you very much.

[The prepared statement of Mr. Schloss follows:]

PREPARED STATEMENT OF NEIL M. SCHLOSS, VICE PRESIDENT—TREASURER, FORD MOTOR COMPANY, DEARBORN, MI

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, Ford Motor Company appreciates the opportunity to share our views on the important role of financial derivatives and their regulation under the Dodd-Frank Act. As you are aware, Ford Motor Company is a global automotive industry leader with about 166,000 employees and about 70 plants worldwide. In the U.S., about 320,000 present and past employees depend on Ford for their pension and retirement. Through our captive finance arm, Ford Motor Credit Company ("Ford Credit"), we also provide financial services to about 3,000 dealers and about three million retail consumers in the U.S. alone.

Derivatives are integral to allowing us to manage market risk and help ensure that we can continue to focus on the things that really matter—manufacturing, selling, and financing vehicles globally. We do not use derivatives to speculate or take a view on the market.

We support Congress' intention in the Dodd-Frank Act to strengthen over-the-counter derivatives regulations, promote transparency and facilitate Federal oversight of these critical markets. However, we want to urge that as regulations are being developed, proposed, and implemented, that Congress' clear intent to allow end-users to continue to use derivatives to reduce risk be reflected. We are especially concerned about two potential unintended consequences that could negate Congress' intent and have significant adverse implications for our business—(1) mandatory margin requirement on derivatives that we use solely to hedge legitimate business risks; and (2) limitations on our pension plans' ability to use derivatives to protect our pension obligations to our employees and retirees.

While the recent financial crisis certainly impacted our company, our employees, customers, and dealers, we managed through these difficult economic conditions and our underlying business continues to improve. Despite continued weakness in the economy, we have been able to not only fund our business, but also hedge our risks with derivatives at a cost that is both acceptable and sustainable. Derivatives are a key tool for risk mitigation as Ford continues to work toward improving its balance sheet and financing its plan. In the first quarter of 2011, Ford Motor Company earned a pre-tax operating profit of $2.8 billion and generated $2.2 billion of Automotive operating cash flow. This is after a very good 2010 with $8.3 billion of pre-tax operating profits and $4.4 billion of positive Automotive operating cash flow. Our One Ford plan is working and remains unchanged, focusing on delivering great products, a strong business, and a better world.

Background

Ford uses derivatives to manage market risks (*i.e.,* foreign exchange, commodity and interest rate risks) resulting from the design, manufacture, sales and financing of our vehicles. Derivatives are also a key risk mitigation tool for our pension plans as we seek to match the duration of plan assets with the duration of plan liabilities (which at year-end 2010 were $70 billion globally).

As of March 31, 2011, our total automotive manufacturing and financial services derivative notional outstanding was about $75 billion: $62 billion hedging interest rate risk; $11.5 billion hedging foreign exchange risk; and $1.5 billion hedging commodity price risk. The market value of our derivatives was over $800 million and was a receivable to Ford and its subsidiaries—this is the amount the banks would owe us if we needed to terminate the derivatives. A substantial portion of our derivatives (about $68 billion) are hedging exposures from our financial services business.

All of these derivatives are over-the-counter ("OTC") customized derivatives. Only a small fraction of our foreign exchange and commodity derivative trading relationships at Ford require us to post margin. We have no such posting requirements at Ford Credit. Instead, we pay an upfront credit charge commensurate with the risk of the underlying transaction, which is a common industry practice. The credit charges we pay have reduced significantly since the late 2008 financial crisis as market conditions and Ford's credit profile have improved.

The derivative notional within Ford's pension funds is also significant. Our pension funds use both exchange-traded and OTC derivatives. On OTC derivatives, our pension funds post and receive variation margin but do not post or receive initial margin.

Automotive Manufacturing Operations

In our manufacturing operations, Ford uses derivatives to hedge currencies and commodities to lock in some near-term certainty for both revenues and costs from global vehicle production. Without hedging we expose ourselves, our customers and our investors to significant volatility risk. That translates into higher costs, lost sales, and fewer jobs.

We are a capital intensive business with facilities that manufacture vehicles that we sell globally. For example, the Ford Explorer SUVs manufactured in Chicago, Illinois, are not only shipped to various states within the U.S., but are also exported to Canada, Mexico, and many other countries. Currency exposure that arises from Explorer's production costs being in U.S. Dollars and revenues in Canadian Dollars and Mexican Pesos is hedged using foreign currency swaps, forwards, and option contracts. This assures we have more certainty around our vehicle profits.

Similar exposures exist throughout Ford's worldwide operations related to finished vehicles, components, and raw material. We also use over-the-counter derivatives to hedge commodities such as aluminum and copper, while opting for long-term supply arrangements for some commodities that do not have a deep and liquid financial market. Many product and sourcing decisions are made years in advance of delivery.

We execute the majority of our global foreign exchange and all of our commodity swap transactions through a wholly owned hedging subsidiary in the U.S. This centralized entity acts as the primary external-facing counterparty for these transactions. It executes transactions with banks after having compiled a net position representing the sum total of a given day's affiliate transactions. A centralized hedging model not only serves to concentrate expertise, controls, and execution, but it also provides the benefit of being able to net positions across an entire company, which results in more efficient execution thereby lowering the overall cost and counterparty exposure to Ford, and reducing the corporate credit risk we pose to the market.

Financial Services Operations (Ford Credit)

Ford Credit uses derivatives to manage its interest rate and currency exposure resulting from financing sales and leases of vehicles manufactured by Ford. A large majority of Ford Credit's derivatives (about $62 billion of our total $68 billion in derivatives notional) are used to manage its interest rate exposure.

Interest rate risk at Ford Credit results from differences in terms of interest rates on the loans we extend to dealers and consumers *versus* the rates on the funding we raise in the capital markets. For example in the U.S., we offer our retail customers fixed payments at fixed interest rates. However, much of our funding is driven by investor preferences, which could be floating rate notes and bonds. As a result, we must rely on derivatives to manage this mismatch.

Apart from managing the overall interest rate risk, Ford Credit also uses interest rate derivatives to hedge its asset-backed securitization transactions. Today, over 60% of Ford Credit's interest rate derivatives are being utilized to hedge securitization transactions. Securitization transactions use derivatives to protect investors from market risks and are required to support the triple-A ratings demanded in these markets. As of March 31, 2011, Ford Credit's securitization transactions funded more than 50% of our managed receivables. The securitization and other funding Ford Credit attains from the market enables it to provide financing to the vast majority of Ford's dealers and customers, providing financing to about 3,000 Ford dealers with about three million active consumer accounts in the U.S. To the extent our structures are compromised it would likely impact the cost of credit to the small businesses (*i.e.,* Ford dealers) and consumers.

Ford Credit also uses derivatives to hedge currency exposure resulting from accessing the debt and capital markets globally. Cross-border transactions are an essential part of Ford Credit's funding toolkit—providing access to a more diverse group of investors, which reduces our overall borrowing costs.

Pension Plans

Ford Motor Company has about 65,000 active participants and 257,000 retired and deferred participants in the U.S. who depend on Ford's U.S. pension fund for their retirement. Ford's U.S. pension fund uses derivatives to manage risk and mitigate funded status volatility that would be harmful to participants in the pension plans and to the company. For example, one of the biggest risks faced by pension funds is interest-rate risk. In Ford's case, a one percentage point drop in interest rates causes U.S. pension liabilities to increase by $5.6 billion, offset partially by an increase in pension assets. The net impact would be a substantial funding shortfall. For our pension participants, this means their pensions would be less well-funded and potentially less secure. For the company, making up the funding shortfall would mean eliminating new car programs, and the thousands of jobs they would support.

However, this interest-rate risk can be managed by using interest-rate swaps which reduce the volatility of our funding obligations. Ford's pension fund used swaps from 2007 to 2009 to hedge interest-rate risk. As a result, we were able to mitigate the deterioration in our plans' funded status during this critical economic period, saving over seven percentage points of funded status and over $3 billion in contributions.

Ford's Position

As an end-user of derivatives, Ford Motor Company recognizes that well-functioning derivatives markets are important. We fully support legislation to strengthen the OTC derivatives regulations that would promote transparency to facilitate oversight of markets and activities of participants.

We are pleased with Congress' intent to grant exemptions in the Dodd-Frank Act to commercial end-users and their captive finance arms. These end-user exemptions ensure companies like Ford can continue to hedge their manufacturing and financing risks as they do today. As policymakers continue to look for job growth and investment in the U.S. economy, it should be very clear that diverting capital, jobs, and investment away from businesses focused on Main Street is not the kind of unintended consequence the U.S. economy can afford. It is our expectation that the implementation of the Dodd-Frank Act will reflect Congressional intent to clearly distinguish between areas that do and do not present risk to the stability of the U.S. financial markets. It is critical that we avoid any potential unintended consequences that would introduce risk or potentially hinder the economic recovery.

We believe Congressional intent is reflected in U.S. Treasury's proposed rule that foreign exchange swaps and forwards should be excluded from the definition of "swap" in the Dodd-Frank Act and, therefore, be exempt from central clearing and exchange trading requirements. Unlike other derivatives, foreign exchange swaps and forwards are short-term instruments and have been trading in a liquid, efficient, and highly transparent market for many years. We support this proposed rule.

However, we also believe there are couple of areas where Congressional intent is in jeopardy. These most notably include mandatory margin requirements and fiduciary standards imposed on swap dealers that trade with pension plans.

Margin Requirements for Commercial End-Users and Their Captive Finance Arms

Our first concern is on the Notices of Proposed Rulemaking ("NPRs") from the prudential regulators and Commodity Futures Trading Commission ("CFTC") related to margin requirements on derivatives that are not cleared through a clearing-

house. As presently written, they would require commercial end-users (Ford) and their captive finance arms (Ford Credit) to post both initial and variation margin.

A margin requirement would not only negate the exemption from the Major Swap Participant definition provided by the Dodd-Frank Act, but it is also contrary to Congressional intent to exempt commercial end-users and their captive finance arms from both clearing and margin requirements. It would also result in a contradiction within the regulations themselves, whereby Ford and Ford Credit are exempt from clearing but then subject to the most onerous margin requirements. Similar to other end-user corporations and manufacturers, we are concerned that imposing margin requirements would significantly increase our cash requirements and costs, and provide a disincentive to hedge legitimate business risks, which would seemingly increase systemic risk.

The unintended consequence of margin requirements on commercial end-users is the increased cost of risk management for U.S. companies. This higher cost potentially puts participants and the broader U.S. market at a competitive disadvantage to its foreign competition. In an already competitive automobile industry, any added required costs are a material issue. We therefore urge the prudential regulators and the CFTC to exempt commercial end-users and their captive finance arms from margin requirements to avoid putting the U.S. market, and the U.S. companies that are dependent on them, at a competitive disadvantage.

Commercial End-Users

Although the regulators note their intent to be consistent with current market practices, the proposed rules require swap dealers to collect initial and variation margin from commercial end-user counterparties.

> Section __.1(2) of the prudential regulators' NPR requires banks to collect margin above an exposure threshold adopted by the banks. Similarly, sections 23.151 and 23.154 of the CFTC NPR require swap dealers to execute credit support arrangements specifying exposure thresholds and margin requirements and require swap dealers to collect margin from non-financial end-users if thresholds were to be exceeded.

We agree that trading derivatives is a credit decision for dealers and that their credit exposure should be appropriately managed. However, posting margin or having a credit support agreement is not a universal practice followed by all market participants today. Swap dealers execute master netting agreements with their end-user counterparties and manage net credit exposure on a portfolio basis rather than managing credit exposure on a transaction-by-transaction basis. In many cases, as an alternative to requiring margin, the dealers buy credit protection to reduce their credit exposure and transfer the cost to the end-user counterparty as credit charges on the transaction.

Mandatory margin requirements would necessitate new and costly incremental funding requirements on end-users. Unlike swap dealers and major swap participants, most end-users do not have expedient and low-cost access to liquidity sources such as the Federal Reserve discount window and FDIC-insured consumer deposits. In our case, raising additional capital requires lead time, is normally done for a longer tenor, and is relatively more expensive. Additionally, given that the nature of our derivative requirements is generally driven by one-sided exposures, we are disadvantaged in being able to manage margin compared to swap dealers, who generally see more trading flow with offsets and have a broader base of counterparties to allow for lower margin requirements. Again, while unintended, the impact would be disproportionately high to manufacturing end-users.

Captive Finance Companies

Another important issue is that the margin rules need to be consistent with the Dodd-Frank Act and Congressional intent to exclude certain captive finance companies from the definition of financial entity, thereby exempting them from clearing and margin requirements.

As evidenced by the following references, both NPRs acknowledge that captive finance companies should be excluded from margin and clearing requirements:

> Footnote 41 in section __.2(1)(b) of the prudential regulators' NPR states that "This definition of 'financial end-user' is based upon, and substantially similar to, the definition of a 'financial entity' that is ineligible to use the end-user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act."
>
> The CFTC, in its NPR, states that its definition of financial entity "tracks the definition in section 2(h)(7)(C) of the Act that is used in connection with an exception from any applicable clearing mandate."

Although the goal to be consistent with the Dodd-Frank Act is evident in the NPRs, neither the financial end-user definition in section __.2(1)(b) of the prudential regulators' NPR, nor the financial entity definition in section 23.150 of the CFTC NPR explicitly exclude captive finance companies. Moreover, the definitions of financial end-user and financial entity in the NPRs could be interpreted as categorizing captive finance companies of commercial end-users as a "high risk financial end-user" because they are not subject to capital requirements established by a prudential regulator or state insurance regulator. This subjects them to the strictest margin requirements. Clearly, this would be very problematic for us.

Our key concern related to margin requirements for Ford's captive finance arm, Ford Credit, is the potential disruption in accessing the asset-backed securitization markets. Mandating a margin requirement for securitization derivatives will force major structural changes to many of our programs and result in substantial additional cost as well as legal and administrative complexity. Consistent with present market practice, Ford Credit's securitization transactions are not structured to post margin. An initial margin could theoretically be posted by diverting some of the proceeds from the issuance of the transaction, which would reduce the funding received from the issuance, lowering transaction efficiency and increasing cost. Variation margin is even more problematic as our bankruptcy remote structures do not presently have a mechanism allowing them to post cash collateral on an ongoing basis, and we are unaware of any structure in the market that has such a feature. Alternate hedging solutions that do not require margin would be very expensive and, as a result, would reduce liquidity for Ford Credit.

Going forward, these provisions could prevent Ford Credit and many other end-users that use securitization from efficiently accessing these markets or from having the backstop liquidity that is so important for an economic downturn. (Ford Credit has over $30 billion of committed funding credit lines from banks and their conduits.) Limiting investor demand or bank support for Ford Credit would directly impact the amount of financing that could be made available to our dealers and customers.

During the recent credit crisis, when many financial institutions were curtailing credit availability, Ford Credit continued to consistently support Ford's dealers and customers, now providing financing to about 3,000 dealers with a portfolio of about three million retail customers. Unlike other asset classes in the securitization markets, auto ABS is back to pre-crisis market liquidity levels with borrowing spreads that are nearly back to pre-crisis levels. Another disruption to the auto securitization markets is something neither the U.S. economy nor our industry can withstand while trying to recover and add jobs.

Throughout the process of drafting, passing, and implementing the Dodd-Frank Act, Congress has repeatedly expressed its intent to exempt commercial end-users, including certain captive finance companies from margin requirements. This is evident not only in the Dodd-Frank Act but also in records of Congressional proceedings, colloquies, and letters. The most recent of these is a particularly helpful letter dated June 20, 2011, submitted by Chairman Lucas and Chairman Stabenow to the prudential regulators and CFTC in response to the proposed margin rules.

This letter not only asks for clarification that certain captive finance affiliates of manufacturing companies ("*whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company*") be classified as non-financial (or commercial) end-users, but also expresses concern that the proposed margin rules undermine the exemption granted by the Dodd-Frank Act to the commercial end-users.

Recommendation

Since Ford's last testimony on derivatives before the Senate Agriculture Committee in late 2009, we certainly appreciate that the Dodd-Frank Act specifically recognized the low-risk nature of how derivatives are used by commercial end-users and their captive finance arms. Ford strongly commends this Committee and Congress for this. We also ask that you continue to urge regulators to match their rulemaking to Congress' clear intent expressed in the Dodd-Frank Act and numerous other ways. Specifically, we would recommend the following related to margin requirements on derivatives that are not cleared through a clearinghouse to implement section 4s(e) of the Commodity Exchange Act ("CEA"), as amended by section 731 of the Dodd-Frank Act:

- Captive finance companies and their securitization entities as described in the CEA section 2(h)(7)(C)(iii) as amended by section 723 of the Dodd-Frank Act

that are excluded from financial entity definition in the CEA section 2(h)(7)(C) and therefore exempt from clearing requirements per CEA section 2(h)(7)(A) should also be excluded from prudential regulators' and CFTC's definition of financial end-user and financial entity, respectively, and therefore be exempt from margin requirements.

- Commercial (or non-financial) end-users who are exempt from clearing requirements per CEA section 2(h)(7)(A) as amended by section 723 of the Dodd-Frank Act should not be required to post margin on their un-cleared derivative transactions with swap dealers.
- End-user affiliates of commercial end-users including centralized hedging entities wholly owned by commercial end-users who are exempt from clearing requirements per CEA section 2(h)(7)(A) as amended by section 723 of the Dodd-Frank Act should also be exempt from clearing and margin requirements.
- Consistent with Treasury's proposed determination, all foreign exchange swaps and forwards should be excluded from the definition of "Swaps" in section 721 of the Dodd-Frank Act and therefore be exempt from clearing and margin requirements.

Business Conduct Requirements for Swap Dealers Trading Derivatives With Pension Plans

Our second major issue is regarding derivatives used by pension plans, specifically the business conduct standards for swap dealers and major swap participants ("MSPs"). As part of the Dodd-Frank Act, Congress adopted the business conduct standards to ensure that swap dealers and MSPs deal fairly with pension plans. However, the proposed regulations issued by the CFTC could actually have serious adverse effects on pension plans.

Pension plans use swaps to manage interest-rate risk and other risks, in order to reduce volatility with respect to funding obligations. If swaps were to become materially less available to pension plans, plan costs and funding volatility would rise sharply. We are very concerned that an inadvertent disconnect in proposed regulations between the Department of Labor ("DOL") and the CFTC business conduct standards, as well as other issues in the business conduct standards, may have several unintended consequences resulting in counterparties being unwilling to trade with pension plans.

The proposed CFTC business conduct standards require swap dealers and MSPs that enter into swaps with pension plans to provide certain services (for example, provide information regarding the risks of entering into a swap, provide valuation services, and review whether the plan's advisor is qualified to advise the plan with respect to the swap). These required services could make the swap dealer a plan fiduciary under DOL regulations. If a swap dealer or MSP is a plan fiduciary, it would be a prohibited transaction under ERISA for the swap dealer or MSP to enter into a swap with the plan; swaps dealers would thus be precluded from entering into swap transactions with pension plans.

In addition, the proposed business conduct standards define so broadly the terms under which a swap dealer is an "advisor" that swap dealers would effectively function as advisors to plans, triggering a duty to act in the best interests of the plan. This creates a conflict of interest that would also, pending further clarification, prevent dealers from entering into swaps with a plan.

Finally, the business conduct standards require the swap dealer to review the qualifications of the plan's advisor, which would give the dealers the right to veto plan advisors. Congressional intent underlying the business conduct standards was to protect entities such as pension plans. However, if swap dealers or MSPs can veto plan advisors, concerns about being vetoed by dealers could make plan advisors more reluctant to negotiate in a zealous manner with dealers, and less inclined to vigorously defend the plan's best interests by challenging dealers.

If Ford's U.S. pension fund is unable to use swaps to manage its interest-rate risk, its pension fund participants would be affected, and the company's own balance sheet risk profile and potential cash contributions could increase significantly because of increased volatility. Concern about the uncertainties regarding cash contributions in any given year would cause Ford to hold large contingency reserves of cash. This is money that would not be available for investment in research and development, new car programs, and jobs.

Such an outcome would also put us and other American end-user manufacturers with defined benefit plans at an enormous competitive disadvantage to foreign competitors who do not have large defined benefit pension plans. This increased volatility and its enormous potential cost would be solely focused on those American

end-users who are seeking to offer company sponsored and funded retirement security to their retirees and workers.

Recommendation

Ford strongly recommends that Congress continue to urge regulators to coordinate efforts in areas where their regulations overlap and to address other issues in their regulations; so that pension plans are not inadvertently precluded from using derivatives that help them manage risk on behalf of the pension plans' beneficiaries.

We and other large defined benefit plan sponsors have been working with industry groups, including the Committee on Investment of Employee Benefit Assets ("CIEBA") and American Benefits Council ("ABC") on the issues affecting pension plans. CIEBA and ABC have provided a number of comment letters and proposed solutions addressing these issues. Among their proposals to the DOL and CFTC are:

1. Preferred solution—that the CFTC Business Conduct Standards NOT be applied to swaps transacted with pension plans, or as an,
2. Alternate Solution—(i) clarification by the DOL and CFTC that no action of a swap dealer that is required solely by reason of the CFTC Business Standards will result in the swap dealer becoming a fiduciary, (ii) statement by the CFTC that a swap dealer will not be considered as an advisor if it explicitly states that it is acting only as a counterparty, and (iii) removal or limitation of the CFTC dealer requirement to approve the plan's advisor.

We support these proposals, and urge the regulators to take these recommendations into consideration as they finalize their regulations.

Closing

We appreciate Congress' and this Committee's recognition that margin requirements should not apply to end-users such as Ford and Ford Credit that only use derivatives to manage legitimate business risks. Our concern focuses on two areas of proposed regulations, which, if not addressed, could have major unintended adverse ramifications for our business. We thank you for the opportunity to share our concerns. In summary, we are focused on primarily two issues as derivative regulations become finalized:

Commercial end-users and their captive finance arms including their securitization entities should be exempt from margin requirements on their uncleared derivatives—Congressional intent is evident in the Dodd-Frank Act, records of Congressional proceedings, colloquies, and letters.

Coordinated efforts by the CFTC and DOL to ensure that pension plans are not inadvertently precluded from using derivatives that help companies protect pension plan beneficiaries and manage their own balance sheet risk.

We thank the Committee for maintaining this dialogue—through the Chairman's recent letter and your invitation to appear here today—and for giving derivatives market reforms the serious attention they deserves. We are happy to continue to provide our support in whatever way possible and answer any questions the Committee may have.

The CHAIRMAN. Thank you.

Ms. Hall, you may begin whenever you are ready, please.

STATEMENT OF DENISE B. HALL, SENIOR VICE PRESIDENT, TREASURY SALES MANAGER, WEBSTER BANK, HARTFORD, CT

Ms. HALL. Chairman Lucas and Members of the Committee, I appreciate the opportunity to testify today on the implementation of Title VII of the Dodd-Frank Act.

My name is Denise Hall, and I am a Senior Vice President at Webster Bank and manage the department that executes all interest-rate derivatives. Webster Bank is an $18 billion full-service commercial bank headquartered in Waterbury, Connecticut, with 176 branches stretching from Boston to New York. In our 76 years, we have only had two CEOs: our founder, Harold Webster Smith, and his son Jim, our current CEO. Throughout our history and growth, we have never lost sight of whom we serve and why we

exist. I want to share with you how we have conducted ourselves during the residential mortgage crisis.

Since 2008, Webster has modified the payment terms of mortgages with balances totaling more than $187 million and kept more than 1,000 families in their homes. In that time, Webster has not had a single adversarial mortgage foreclosure where we were able to contact the borrower. What distinguishes Webster is that we have addressed head-on the issue of affordability for borrowers who have encountered difficulties through no fault of their own; we have not just postponed the day of reckoning. Our mortgage modification program was profiled in the *Hartford Courant,* and I am leaving the Committee with a copy of that article.

Although the topic of the hearing today is derivatives, not mortgages, Webster believes Members of Congress need to know that there are community-minded banks that are trying to do the right thing by customers every day, whether it is a business that wants to hedge floating-rate risk or a homeowner who has lost their job. Webster does not use credit default swaps or use derivatives for speculation. We use them to reduce risks that naturally arise from making loans and taking in deposits and to meet customer needs.

In 1999, Webster Bank loan officers approached me to request that we develop the ability to offer swaps in conjunction with loans that we underwrite. We were losing deals to larger banks that were able to offer borrowers the risk-mitigation benefits associated with a swap. Swaps would allow us to compete.

We have offered these products responsibly to our customers for over 10 years, and I am concerned that the unintended consequence of the legislation would be that it becomes cost-prohibitive to continue to do so. Borrowers would have fewer choices, and the lack of competition drives their cost of credit higher.

I would like to address three concerns about the impact of certain rules the CFTC has proposed: the potential exemption from central clearing for small banks, the *small dealer* definition, and the *eligible contract participant* definition.

Congress recognized the low risk posed to the system by small banks when it granted regulators authority to exempt them from clearing. Subjecting us to such requirements will be costly and will offer little or no risk-reducing benefits to the financial system. The fixed costs inherent in establishing these systems will make it uneconomical for us to continue to offer these products.

The Commission should also consider the parameters for identifying which banks are eligible to qualify for the small-bank exemption. We recommend the Commission focus on the risk of its derivatives portfolio, which could be defined by a bank's net uncollateralized derivatives exposure.

The *swap dealer* definition in the proposed rule could inadvertently encompass banks like us that offer swaps to commercial customers. Executing more than 20 trades with customers in 1 year would require a bank to register as a dealer. The volume of our swaps would not justify the substantial compliance burden.

Title VII included an exemption from the *swap dealer* definition for a swap offered in conjunction with originating loan. The exemption is too narrowly defined as it is restricted to the loans contem-

poraneous with a swap. It is very common for a borrower to enter into a swap before or after the origination of the loan.

Finally, Title VII prohibits a firm that is not an eligible contract participant from entering into OTC derivatives. This creates uncertainty for small businesses that have been able to utilize uncleared OTC derivatives for the past 20 years to manage their interest-rate risk in accordance with the criteria previously established by the CFTC.

Regulatory approaches that fail to properly distinguish banks like Webster from major derivatives players like AIG could jeopardize the ability of small banks to efficiently mitigate risk, to compete, and to provide customers with competitively priced alternatives.

Thank you for the opportunity to testify today, and I am happy to answer any questions you may have.

[The prepared statement of Ms. Hall follows:]

PREPARED STATEMENT OF DENISE B. HALL, SENIOR VICE PRESIDENT, TREASURY SALES MANAGER, WEBSTER BANK, HARTFORD, CT

Chairman Lucas, Ranking Member Peterson and Members of the Committee, I appreciate the opportunity to testify today on the implementation of Title VII of the Dodd-Frank Act. My name is Denise Hall and I am a Senior Vice President at Webster Bank ("Webster"). I have been employed by Webster for 15 years and manage the department that executes all interest rate and foreign exchange derivative products.

Webster Bank is an $18 billion full-service commercial bank headquartered in Waterbury, Conn., with 176 branches stretching from Boston to Westchester County, NY. We are a major provider of banking products and services to middle market companies, small businesses and families in our region. For 3 consecutive years, Webster has written more SBA loans than any other bank in our home market of Connecticut. In our 76 years, we have only had two CEOs—our founder, Harold Webster Smith, and his son, Jim Smith, who has held that title since 1987. Throughout our history and growth, we have never lost sight of whom we serve and why we exist, something we call the Webster Way. To give the Committee Members a better idea of what this means, I want to share with you how we have conducted ourselves during the residential mortgage crisis. Since 2008, Webster has modified the payment terms of mortgages with balances totaling more than $187 million. These modifications have saved homeowners an average of more than $300 a month and kept more than 1,000 families in their homes. In that time, Webster has not had a single adversarial mortgage foreclosure where we were able to contact the borrower. What distinguishes Webster is that we have addressed head-on the issue of affordability for borrowers who have encountered difficulties through no fault of their own; we have not just postponed the day of reckoning. The proof of this is that our re-default rate on modified mortgages is about 13 percent, less than a third of the industry average. Our mortgage modification program was profiled in the *Hartford Courant,* and I'm leaving the Committee with a copy of that article. Although the topic of the hearing today is derivatives, not mortgages, Webster believes Members of Congress need to know that there are community-minded banks that are trying to do the right thing by customers every day, whether it's an exporter that wants to hedge currency risk or a homeowner who has lost a job.

Webster, like many other community and regional banks, depends on interest rate derivatives to prudently manage risks inherent to the business of commercial banking. We do not use credit default swaps or use derivatives for speculative purposes. Rather, Webster uses derivatives to increase certainty with respect to its net interest margin and to reduce risks that naturally arise from making loans and taking in deposits.

Additionally, Webster provides a relatively small amount of interest rate and foreign exchange derivatives to our commercial banking customers to assist them in managing their own risks. By way of background, in 1999 Webster Bank loan officers approached me to request that we develop the ability to offer interest rate swaps in conjunction with loans that we would underwrite. In Connecticut, we face competition from many of the large New York banks and they found that we were losing deals to those banks that were able to offer borrowers the risk mitigation ben-

efits associated with an interest rate swap. Interest rate swaps would allow us to offer borrowers competitive long-term financing in a manner that does not require Webster to take on unwanted interest rate exposure. In addition, we offer foreign exchange forwards to assist our customers in managing exposure from fluctuating currency rates that results from selling products or buying raw materials abroad. Again, we are helping our clients to mitigate risk.

We have offered these products responsibly to our customers for the past twelve years, and I am concerned that an unintended consequence of the legislation would be that it becomes cost prohibitive to continue to do so, borrowers would have fewer choices, and the lack of competition from small and mid sized banks drives their cost of credit higher.

Today I would like to address several concerns about the impact of certain rules the Commodity Futures Trading Commission ("CFTC") has proposed that affect smaller banks like Webster.

These proposed rules could unnecessarily jeopardize the ability of smaller banks to manage risk, meet our customers' risk management needs and compete with large dealer banks.

In particular, I will focus today on three issues: the potential exemption from central clearing for small banks, the swap dealer definition, and the eligible contract participant definition.

(1) Potential Exemption for Small Banks

Congress recognized the low risk posed to the system by small banks when it granted regulators authority to exempt them from clearing requirements. It is important that the Commission exercise this authority. Subjecting small banks to such requirements will be costly and will offer little or no risk-reducing benefit to the financial system. The time and expense associated with clearing for small banks could serve to deter some community and regional banks from using swaps to hedge risk.

Small banks use derivatives to a much more limited degree than larger banks. As a result, Webster and its customers' derivatives use pose no risk to financial stability. Rather, such risk is concentrated among a few very large and interconnected financial institutions. In fact, while more than 1,000 banks in the U.S. utilize derivatives, 96% of the notional and 86% of the credit exposure is held at the top five banks in the U.S.[1] Importantly, the limited use of OTC derivatives by small banks means they are unable to meaningfully contribute to risks in the financial system. The derivatives losses that result from a small bank's failure could not cause a large bank to fail. And regulators would have little or no motivation to forestall the resolution of a major swap dealer on account of its swap positions with small banks.

Much of the limited risk posed by small banks is already addressed through bilateral margin arrangements, especially those customarily entered into with large dealer banks. Additionally, capital requirements also serve to ensure banks adequately protect against counterparty credit risks.

Relatively small derivative transaction volume can make clearing uneconomic for many banks. This is because lower transaction volumes make it difficult for small banks to absorb the fixed costs inherent in establishing and maintaining clearing arrangements. By contrast, large dealer banks can amortize the cost of establishing and maintaining clearing arrangements over hundreds of thousands of transactions. In preparation for the clearing requirements I have begun the process of evaluating different proposals, and will be faced with determining how the additional costs will be allocated.

In addition to exercising its authority to exempt small banks from clearing requirements, the Commission should also consider the parameters for identifying which banks are eligible to qualify for the exemption. Rather than focusing on a bank's asset size, the Commission should focus on the risk of a bank's derivatives portfolio. This risk could be defined by a bank's net uncollateralized derivatives exposure. We agree with recommendations that banks whose net uncollateralized exposure is less than $1 billion be exempt from clearing requirements. If the Commission opts to focus solely on a bank's asset size, we believe it would be appropriate to allow banks with less than $50 billion in assets to qualify for the exemption. Even so, we feel that it is conceivable that we could have $55 billion in assets, and still have very little in uncollateralized risk due to our bilateral netting arrangements, and relatively few transactions. Uncollateralized exposure is a far better metric.

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[1] Please refer to page 1 of the report at: *http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq410.pdf*.

(2) Swap Dealer Definition

Webster Bank shares concerns expressed by a wide range of community and regional banks that the swap dealer definition in the CFTC's proposed rule could inadvertently encompass hundreds of community and regional banks that offer risk management products to commercial customers. Such a broad swap dealer definition would result in many small banks ceasing to offer derivatives products to customers. This is because the volume of swaps many small banks offer would not justify the substantial compliance burden imposed on swap dealers. Such an outcome could significantly harm community and regional banks, by making it more difficult for them to compete with larger banks for loans. The diminished competition that would result from smaller banks' withdrawals from the swaps market would ultimately result in customers paying more.

Title VII included an exemption from the swap dealer definition for any swap offered by a bank to a customer in connection with originating a loan with that customer. This exemption reveals that customer hedging activity carried out by small banks does not pose the risks the Act is intended to address. However, the CFTC's proposed rule interpreting this exemption is unnecessarily narrow. While not required by Title VII, the CFTC is considering whether to limit the exemption to swaps offered *contemporaneously* with origination of the loan. As it is very common for a borrower to enter into an interest rate swap before or after origination of the corresponding loan, the exemption should not be limited to any swap entered into contemporaneously with a loan. Indeed, the flexibility to execute a swap after the loan closing is one of the features that borrowers employ to manage their risk. In addition, we urge the CFTC to consider excluding from the swap dealer definition swaps offered by a bank in connection with syndications, participations and bond issuances that are facilitated by the bank.[2]

Additionally, the CFTC's proposed thresholds for the "*de minimis* exception" from the swap dealer definition are *extremely* low and should be increased. If a bank were to offer just 21 foreign exchange options[3] to customers in one year, they would be subject to the full panoply of regulation applicable to swap dealers. As noted, many small banks would simply cease offering certain risk management services to customers, rather than face such a regulatory burden.

In its economic analysis of the proposed margin rule,[4] the Office of the Comptroller of the Currency evaluated the impact of reducing the number of institutions that are classified as "swap entities" (*e.g.,* OCC regulated swap dealers). The analysis considers the impact of increasing the notional test set forth in the *de minimis* exception from $100 million to $10 billion. Such an adjustment would reduce the number of OCC regulated swap entities from 74 to 22.

Importantly, such an adjustment has virtually no impact on the notional amount of swaps covered by the proposed rule.[5]

Regulators have ample authority to address this concern while still faithfully interpreting Title VII.[6] We urge regulators to compare the thresholds for the *de minimis* exception against the volume of dealing done by the large financial institutions. For example, while executing more than 20 trades with customers in one year would require a bank to register as a swap dealer, it is known that Lehman Brothers had 900,000 trades in place at the time of its bankruptcy. It would take Webster a century to generate that volume of transactions!

Expanding this exception will have little or no impact on the mitigation of systemic risk, while significantly reducing the regulatory burden on small banks.

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[2] Please refer to pages 3–4 of the comment letter submitted by Webster Bank and 18 other community and regional banks to the CFTC for examples.

[3] Note that the Secretary of the Department of the Treasury has the authority to make a written determination exempting certain FX derivatives from certain regulatory requirements. Such a determination has not been made as of the writing of this statement.

[4] Office of the Comptroller of the Currency, Economics Department, *Unfunded Mandates Reform Act Impact Analysis for Swaps Margin and Capital Rule* (April 15, 2011).

[5] The notional amount at a swap entity threshold of $100 million covers $1.7949 trillion in notional for 74 banks. The notional amount at a swap entity threshold of $10 billion covers $1.74941 trillion in notional for 22 banks. The OCC notes, "*Because total swap amounts are concentrated in a relatively small number of institutions, varying this threshold has little impact on the dollar amount of swaps affected by the proposed rule.*"

[6] Please refer to pages 5 and 6 of the comment letter submitted by Webster Bank and 18 other community and regional banks to the CFTC for additional comparative data: *http://www.chathamfinancial.com/wp-content/uploads/2011/02/Coalition-Comments-Small-Banks.pdf.*

(3) Eligible Contract Participant Definition

Section 723 of Title VII prohibits a firm that is not an "eligible contract participant" from entering into an OTC derivative.[7] This provision creates uncertainty for certain small businesses that have previously been able to utilize uncleared OTC derivatives. Additionally, absent clarification from the CFTC, even large firms that make investments through smaller subsidiaries may be precluded from hedging the commercial risks associated with those subsidiaries. We urge the CFTC to clarify that such smaller firms can continue to utilize uncleared OTC derivatives, so long as they meet specific criteria already established by the CFTC more than 2 decades ago and relied upon ever since by numerous market participants.[8]

Conclusion

Community and regional banks depend on customized OTC derivatives to mitigate risk and to help small and mid-sized businesses grow and prosper. Regulation intended to protect against systemic failures should not burden those who are incapable of causing such failures in the future. Broad-stroke regulatory approaches that fail to properly distinguish banks like Webster from major derivatives players like AIG could jeopardize the ability of small banks to efficiently mitigate risk, to compete for lending business against large-bank competitors, and to provide customers with competitively priced alternatives.

Thank you for the opportunity to testify today, and I am happy to answer any questions that you may have.

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[7] Firms that are not eligible contract participants will only be permitted to enter into derivatives on regulated exchanges. In addition to other criteria, corporations and partnerships that have at least $10 million in assets or are hedging and have $1 million in net worth qualify as eligible contract participants under the Commodity Exchange Act.

[8] Certain firms have been able to enter into over-the-counter hedges if they meet the criteria set forth in the CFTC's 1989 Policy Statement Concerning Swaps Transactions.

ATTACHMENT

Hartford Courant.

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A BANK GUIDE THROUGH MORTGAGE TROUBLES: WEBSTER SPECIALISTS OFFER CONTINUITY, HOPE OF DEAL FORECLOSURE CRISIS

After years of complaints, state attorneys general are pressuring lenders to overhaul foreclosure practices and stop bouncing delinquent borrowers from department to department - but Natalie Silva is way ahead of the curve.

Silva, a loss mitigation specialist at Webster Bank, has worked under those rules ever since she began dissecting foreclosure cases at the bank two years ago.

Far from lawmakers in Hartford and Washington who are wrestling with the foreclosure mess, Silva's cubicle on the fourth floor of an office building in Cheshire is on the front lines of the crisis. Borrowers in danger of losing their homes jump from tidy statistics to real people in the biggest jam of their lives.

Here, day after day, come the calls: Borrowers - some crying, others screaming - initially make the bank their target. Some are angry about the banking industry in general in the wake of the financial services meltdown and the taxpayer-funded bailout that followed.

"If they are upset or screaming, I let them vent for a little while," Silva said. "I don't want to interrupt. If I try to say something, even if it's good, they get mad about me interrupting."

Silva is one of the point people Waterbury-based Webster began assigning to delinquent borrowers in 2008, to provide a single contact with a road map through the complex and often confusing maze of foreclosure. The specialists may help reach a deal on a mortgage modification, although there is no guarantee that borrowers will keep their homes in the end.

"I talk to them through every step and am pretty much in contact with them every couple of days," Silva said. "I make sure they know how to call me."

The concept sounds deceptively simple. But housing advocates say that, industrywide, delinquent borrowers typically get a different person every time they call, are forced to resubmit paperwork repeatedly and often are left hanging for weeks.

In Connecticut, many borrowers in trouble have described that scenario, saying it adds to the nightmare.

The issue bubbled over last fall in the wake of the "robo-signing" scandal in which foreclosure documents were signed at some of the nation's largest loan servicers without verifying the accuracy of the paperwork.

State attorneys general, including Connecticut's, now are pressing for sweeping changes in the way lenders and mortgage services deal with borrowers in foreclosure as part of a 27-page proposal that was released earlier this month.

But for Silva and her colleagues on the front lines, it comes down to a personal touch. She said she remains calm with borrowers on the phone. And while she must be realistic about whether a borrower can afford a loan modification, even with a lower monthly payment, she can't be totally detached from borrowers, either. "I do feel for them," Silva said. "I completely understand. We are them, they are everyday workers, working their jobs and trying to pay the bills."

TOUGH PREDICAMENT

Joe Raad, a colleague of Silva's, said that once borrowers let off steam, a conversation can begin. Sometimes the person has lost a job or faces runaway credit card debt or mounting medical bills. Other times, borrowers simply have gotten in over their heads.

"The way it is set up here, you get to know the customer on a first-name basis," said Raad,

who has been in the department for two years. "It's not like we're bouncing around these accounts. Every time they call, they get the same person."

The foreclosure crisis has placed banks, including Webster, in a predicament. Modifying loans means banks must take steep losses; Webster has already logged $17.5 million in writeoffs tied to mortgage modifications. And it's unclear whether foreclosures have even peaked in Connecticut and elsewhere in the bank's New England market.

Mounting stockpiles of repossessed homes, on the other hand, can further stymie a still-elusive recovery in the housing market. They pull down values of nearby properties and compete with owner-occupied properties that are on the market.

Webster doesn't offer temporary or trial modifications, which elsewhere in the industry sometimes left distressed borrowers with higher payments than they started with. Either borrowers can afford the permanent, lower payment or they can't, but the payment always has to be lower.

So far, the approach seems to be working.

Since 2008, Webster has worked with 1,881 distressed borrowers - about 56 percent of those, or 1,059, have had their mortgage payments lowered, each saving an average of $333 a month.

Of the borrowers approved for modifications, 11 percent fell behind again, significantly lower than the 35 percent or more at some of the nation's largest servicers.

Of the 822 mortgages that weren't modified, 120 resulted in properties being repossessed by Webster.

Another 441 were put on the market as short sales, in which Webster agreed to accept a sales price that was less than what was owed on the property. Some borrowers were able to get back on track, and some walked away and left the home keys to Webster. Through it all, Silva and Raad and six colleagues had to make tough telephone calls.

"I don't know if there is a way to prepare for that," Silva said. "It's almost like you don't want to deliver the bad news to someone. You have to. It's not the best feeling, but you have to."

Webster has more control over decision-making and has more leeway in modifying loans because 85 percent of the home mortgages Webster deals with are held on its books so the bank, in essence, owns those loans. That isn't the case with large servicers who collect monthly payments on behalf of investors who have bought bundles of loans.

Servicers often must broker modifications with multiple investors, complicating the process. Critics charge that those servicers benefit financially from stretching out the foreclosure process, generating additional fees along the way.

In some cases, Silva and Raad say, they have been caught off guard by the reaction of borrowers, even when a loan modification is offered.

More than once, Silva said, she has been particularly excited about making calls on modifications that have been particular difficult to work out.

"The person said, "That's it?'" Silva said. "Those are the ones that really shock me. Maybe their neighbor got a lower payment. No two people get the same type of modification."

VOLUME RISING

Despite pressure from lawmakers and state attorneys general, housing advocates in Connecticut say little has changed since the foreclosure crisis first hit.

Jeff Gentes, a staff attorney and foreclosure expert at the Connecticut Fair Housing Center in Hartford, said that if change is coming in how lenders and servicers interact with borrowers, it is "very small scale if it is happening."

The majority of calls he receives are still from borrowers who are having trouble communicating with their lenders. And the volume of calls is up this year, he said.

"You still get people where they are in an endless cycle of sending documents and not making progress with their bank," Gentes said. "It's frustrating because there is little legally they can do about the non-responsiveness."

Back at Webster's operations center in Cheshire, Raad says his job carries a big responsibility because it involves a borrower's home. That, he says, obviously carries stress along with it.

His relief valve is going to the gym before arriving at work at about 8 a.m., but his workout schedule has been curtailed because he and his wife have a newborn baby.

Silva simply walks her dog every night.

"We all handle it a little differently," Raad said. "When it comes down to it, we're all individuals living in the same economy. We understand where they are coming from."

Follow Courant staff writer Kenneth R. Gosselin on Twitter at kennethgosselin.

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The CHAIRMAN. Thank you.

Mr. Peterson, you may begin whenever you are prepared.

STATEMENT OF SAM PETERSON, SENIOR ADVISOR, DERIVATIVES REGULATORY ADVISORY GROUP, CHATHAM FINANCIAL, KENNETT SQUARE, PA

Mr. Sam PETERSON. Good afternoon, Chairman Lucas and Members of the Committee. Thank you for opportunity to testify today regarding the impact of derivatives regulation on Main Street businesses.

My name is Sam Peterson, and I am a Senior Advisor at Chatham Financial. Chatham is a global consulting firm based in Pennsylvania that serves more than 1,000 end-users of derivatives, including clients with operations in all 50 states. Our clients range from Fortune 100 companies to small businesses and include firms from virtually every sector of the economy.

What is common to all of our clients is that each uses over-the-counter derivatives to reduce business risk, not to take on risk through speculation. Throughout the debate surrounding derivatives regulation, Chatham supported policy that strikes a balance between reducing systemic risk and preserving efficient access for thousands of firms that rely on over-the-counter derivatives for critical risk management.

On the anniversary of the enactment of the Dodd-Frank Act, it is important to consider rulemaking efforts in light of the primary objective of Title VII. The primary objective of Title VII was to reduce and contain systemic risk in order to ensure that American taxpayers never again would have to step in and subsidize the reckless behavior of major players in the derivatives market.

In pursuing this end, Congress appropriately distinguished between major players with exposures large enough to threaten the financial system and the firms that do not pose systemic risk and who use over-the-counter derivatives prudently to manage ordinary business risks. Now the regulators are tasked with implementing Title VII in a manner that is consistent with Congressional intent.

As the regulators work toward completing this monumental task, I would like to highlight a few key areas of concern for end-users.

First, I will discuss margin. The principal authors of Title VII stated clearly that end-users should be exempt from clearing and margin mandates. However, end-users remain concerned that recently proposed rules could subject them to margin requirements. Imposing margin on end-users is neither consistent with Congressional intent nor a holistic reading of Title VII. However, setting aside the question of statutory authority, there are important differences with respect to the margin rules proposed by the CFTC and the prudential regulators.

The prudential regulators' proposed rule would require all end-users, even non-financial end-users, to have in place new credit support arrangements with margin-posting thresholds. If exposure exceeded the thresholds, end-users would be required to post margin. The CFTC's proposed rule also requires credit support arrangements, but thresholds are not required for non-financial end-users and existing documentation could suffice.

Chatham supports the CFTC's position that it is not required to impose margin on non-financial end-users. The majority of end-user transactions, however, would be subject to the prudential regulators' rule.

The aggregate impact of margin requirements will depend on how the rules are implemented. However, depending on implementation, it is clear that hundreds of billions of dollars in capital could be diverted from productive investment to sit idle as collateral.

In a recent paper, the Progressive Policy Institute warned of unintended consequences associated with imposing margin on end-users, stating the following: "While margin requirements make sense in many contexts to reduce the threat of systemic risk, putting margin requirements on companies that use derivatives to manage risks in the ordinary course of business, *i.e.,* end-users, is both onerous and unnecessary."

Capital: Title VII requires capital requirements for non-cleared derivatives to be set at levels that are appropriate for the risk of the trades. However, end-users are concerned that capital requirements could be set at punitive levels that are disproportionate to risk, appear aimed at reshaping market structure, and that could render the end-user exemption moot.

Just as Title VII reflected Congress' view that end-users do not create systemic risk, it is essential that capital requirements also reflect the lower risk posed to the system by end-user transactions. Taken together, the margin and capital requirements could have the effect of making customized, non-cleared derivatives prohibitively expensive.

Margin and capital requirements appearing tended to create incentives for firms to use exchange-traded and cleared products. Any such incentive should be based on actual risk and not on a regulatory predisposition in favor of a certain type of market structure.

It is unnecessary to force end-users to choose between efficiently managing risks and investing in their businesses. With a sputtering economy, unprecedented uncertainty, and unemployment above nine percent, it is critical that we work to prevent such an outcome.

We look forward to working with the Committee throughout the rulemaking process. I thank you for the opportunity to testify, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Sam Peterson follows:]

PREPARED STATEMENT OF SAM PETERSON, SENIOR ADVISOR, DERIVATIVES REGULATORY ADVISORY GROUP, CHATHAM FINANCIAL, KENNETT SQUARE, PA

Good afternoon, Chairman Lucas, Ranking Member Peterson, and Members of the Committee. Thank you for the opportunity to testify today regarding the impact of derivatives regulation on Main Street businesses. My name is Sam Peterson, and I am a Senior Advisor at Chatham Financial ("Chatham").

Chatham is a global consulting firm based in Pennsylvania that serves as an advisor to more than 1,000 end-users of derivatives, including clients with operations in all 50 states. Our clients range from Fortune 100 companies to small businesses, and include manufacturers, community and regional banks, technology firms, health care companies, real estate companies and businesses from virtually every sector of the economy. What is common to all of our clients is that each uses over-the-counter ("OTC") derivatives to reduce business risk—not to take on risk through speculation.

Throughout the policy debate surrounding effective regulation of the derivatives market, Chatham supported the efforts of Congress to pass legislation that strikes a balance between reducing systemic risk and preserving safe and efficient access for thousands of firms that rely on over-the-counter derivatives for critical risk management. On the anniversary of the enactment of the Dodd-Frank Act, it is important to consider the current rulemaking efforts in light of the primary objective of Title VII.

The primary objective of Title VII was to reduce and contain systemic risk in the over-the-counter derivatives market in order to ensure that American taxpayers never again would have to step in and subsidize the reckless behavior of major players in the derivatives market. In pursuing this end, Congress appropriately distinguished between the major market players with derivatives exposures large enough to threaten the financial system and the firms that do not pose systemic risk and who use over-the-counter derivatives prudently to manage ordinary business risks. Now the regulators are tasked with implementing Title VII in a manner that is consistent with Congressional intent, and must craft the rules that will govern this important market for years to come. As the regulators work toward completing this monumental task, I would like to highlight a few key areas of concern for end-users:

Margin

Despite the considerable efforts taken by the principal authors of Title VII to clarify that end-users should be exempt from clearing and margin mandates, end-users remain concerned that recently proposed rules could subject them to margin requirements for non-cleared trades.

Imposing margin requirements on end-users is neither consistent with Congressional intent nor a holistic reading of Title VII; however, setting aside the question of whether regulators have the authority to impose margin requirements on end-users, there are important differences with respect to the margin rules proposed by the CFTC and the prudential regulators.

The CFTC will finalize rules for trades done with non-bank swap dealers and the prudential regulators will finalize rules for trades done with bank swap dealers. The prudential regulators' proposed rule would require all end-users—even non-financial end-users—to have in place credit support arrangements with specific margin-posting thresholds. If exposure for their trades exceeded the thresholds, end-users would be required to post margin. The CFTC's proposed rule would require all end-users to have credit support arrangements in place, but specific margin-posting thresholds are not required, and we are hopeful that existing documentation would suffice. Chatham supports the CFTC's position that it is not required to impose margin requirements on non-financial end-users. The majority of end-users, however, enter into their hedges with *bank* swap dealers and, as such, would be subject to the prudential regulators' rule.

A precise estimate as to the aggregate impact of the regulators' decision to impose margin requirements on end-users is not possible, since it will depend on how the rules are implemented; however, depending on implementation, it is clear that hundreds of billions of dollars in capital could be diverted from productive economic investment to sit idle as collateral.[1]

In a recent policy brief, the Progressive Policy Institute warned of unintended consequences associated with imposing margin requirements on end-users, stating, "While margin requirements make sense in many contexts to reduce the threat of systemic risk, putting margin requirements on companies that use derivatives to manage risks in the ordinary course of business—*i.e.,* end-users—is both onerous and unnecessary."

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[1] The National Corn Growers Association and the National Gas Supply Association estimated the collateral requirements could run as high as $700 billion. (*http://www.ngsa.org/Assets/docs/2010%20press%20releases/21-ngsa%20urges%20fix%20for%20derivs%20 title%20in%20conference.pdf; (***Editor's note:** the weblink was incomplete in the submitted document) *corn%20growers%20 join%20drumbeat%20against%20mandatory%20clearing.pdf*); The Tabb Group estimated that $2.2 trillion in capital would be required globally to satisfy levels of margin required by clearinghouses (*http://www.tabbgroup.com/PageDetail.aspx?PageID=16&ItemID=972*); a study by ISDA estimated that collateral requirements under Title VII of Dodd-Frank could result in $1 trillion in capital being diverted to satisfy bilateral and clearinghouse margin calls in the U.S. (*http://www.isda.org/media/press/2010/press062910.html*); and, an analysis by Keybridge Research that was based on survey by the Business Roundtable estimated that the non-financial S&P 500 companies alone would have to post approximately $33 billion alone if subject to a fixed initial margin requirement of 3%. [*http://businessroundtable.org/uploads/studiesreports/downloads/An_Analysis_of_the_Business_Roundtables_Survey_on_Over-the-Counter_Derivatives.pdf*].

Capital

Title VII requires regulators to set capital requirements for non-cleared derivatives at levels that are appropriate for the risk of the trades; however, end-users are concerned that capital requirements could be set at punitive levels that are disproportionate to risk and appear aimed at re-shaping market structure. Punitive capital requirements could make non-cleared derivatives prohibitively expensive, potentially rendering the end-user exemption moot. Such an approach is not necessary to achieve the aims of Title VII and could work at cross-purposes to the objectives of the Act. Just as Title VII reflected Congress's view that end-users do not meaningfully contribute to systemic risk, it is essential that capital requirements also reflect the lower risk posed to the system by end-user transactions.

Taken together, the margin and capital requirements could have the effect of making customized, non-cleared derivatives prohibitively expensive, despite the fact that these are exactly the types of trades that end-users require for sound risk management. Margin and capital requirements appear intended to create incentives for firms to use exchange-traded and cleared products. Any such incentives should be based on actual risk, and not on a regulatory predisposition in favor of a certain type of market structure.

It is unnecessary to force end-users to choose between efficiently managing risks and investing in their businesses. With a sputtering economy, unprecedented uncertainty and unemployment above 9%, it is critical that we work to prevent such an outcome.

Implementation

Chatham appreciates the hard work of the CFTC, SEC and prudential regulators in proposing dozens of new rules. We have been impressed by the open and transparent process run by the agencies and by the skill and diligence of regulatory staff. However, as a firm that is working with hundreds of businesses that will be impacted by new rules, we have first-hand knowledge of the frustration felt by executives struggling to decide when to commit scarce resources toward preparing for compliance. Chatham supports the recommendation of Members of this Committee that the CFTC issue for public comment a proposed schedule for completion of final rules and a comprehensive plan for implementation of the rules.

Conclusion

As regulators go about the important work of finalizing rules intended to address problems revealed by the financial crisis, it is critical that well-functioning aspects of these markets not be harmed. It is essential to preserve Main Street businesses' efficient access to these important risk management tools. We appreciate your attention to these concerns and look forward to working with the Committee in order to ensure that derivatives regulations do not unnecessarily burden American businesses, harm job creation or jeopardize economic growth.

I thank you for the opportunity to testify today, and I am happy to answer any questions you may have.

The CHAIRMAN. Thank you.

And, Mr. Fraley, you may begin whenever you are ready.

STATEMENT OF DAVID FRALEY, PRESIDENT, FRALEY AND COMPANY, INC., CORTEZ, CO; ON BEHALF OF PETROLEUM MARKETERS ASSOCIATION OF AMERICA; THE NEW ENGLAND FUEL INSTITUTE; COLORADO PETROLEUM MARKETERS AND CONVENIENCE STORE ASSOCIATION

Mr. FRALEY. Thank you, Chairman Lucas, Members of the Committee, for the invitation to testify today. My name is David Fraley. I am with Fraley and Company, Inc., in Cortez, Colorado. I am also speaking on behalf of the Petroleum Marketers Association of America, The New England Fuel Institute, and the Colorado Petroleum Marketers and Convenience Store Association.

I am the third-generation owner of Fraley and Company, which operates in Colorado, New Mexico, Utah, and Arizona. I employ 30 people and have offices and bulk plants in Cortez, Colorado, and Farmington, New Mexico. I have hedged petroleum products every

year since 1995 and use those hedges to support a marketing program to reduce price risk for my customers, mostly homeowners.

Our industry has been communicating strong concern about excessive speculation and the lack of transparency in the commodity derivatives markets to the Congress for the past 7 years. Last year's Wall Street Reform Act was a vital first step toward correction of the market, and we thank the Committee for its leadership in passing it. The CFTC is clearly dedicated to getting these rules right.

As a businessman, until 2007 I was opposed to derivatives market reform and curbs on speculation. I was on the complete opposite side of the issue, and this was after hedging consistently since 1995. It has only been since then, discovering that our investment banks develop strategies that would enable them to paper themselves over as hedgers while performing ever more egregiously on their own behalf by employing more attorneys, lobbyists, quantitative and other financial engineers, faster computers, and more sophisticated algorithms, taking the opposite side of the trades they recommended to their clients, sinking municipalities with derivative deals, not to mention the housing debacle since 2008, that I have come to understand the broken nature of today's markets and the culpability of our political class over the last decade.

Financial speculation in commodities is necessary. Speculation provides the markets with the liquidity needed to facilitate price discovery and allows for appropriate risk mitigation for hedgers. But these markets were not created primarily to serve speculators alone. They were created to serve businesses like mine and other hedgers and end-users of physical commodities. Opaque rigged markets are not free markets. And they are not hedging platforms; they are casinos.

The reforms included in the Dodd-Frank Act were meant to address these concerns, including new clearing requirements for off-exchange swaps and mandatory position limits for speculative traders. Concerning the latter, the CFTC is 6 months delayed in implementing the final rule. Because reform is bottled up, our markets continue to be highly leveraged and dominated by financial players.

Here are the consequences of that delay in implementing Dodd-Frank. It is more expensive to hedge because the markets continue to be volatile and highly leveraged. Hedging in energy markets is done in part via commodity options, and the option price is the purest measure of volatility. Reduce volatility, and you will reduce hedging costs. Because of the delays in reform, it is more risky for my company to hedge. The risk can't be passed on to the speculator as well anymore because the price discovery mechanism is wrecked, and I can't match Wall Street's advantage in lobbying dollars, political contributions, access to information, paid talent, or computer speed. So when I hedge now, I am taking my risk off my customer and laying it on me.

The consequences are coming from the market and from events. Up to now, there are no positive consequences from reform because reform is bottled up. In order to see change on Main Street, Congress must also provide CFTC with appropriate funding increases for comprehensive implementation and enforcement of Title VII reforms. The House was wrong in its decision to approve a funding

level that is 44 percent below the amount needed for the Commission to fulfill its mission. You can't police the streets without paying the cops.

As a board member of a community bank, I have been witness, as well, to the credit crunch since 2008 and the effect not only on businesses and consumers but on the reduced ability of community banks to serve their customers due to the tilted field in favor of the same players, the too-big-to-fails and the crazy swings of the regulatory environment and the banking industry. The community banks are in the same boat in their world as I am in mine.

This is one factor of an enormous wave of economic chaos, and I have been afraid for 3 years that it is just the warm-up. The taxpaying voters in America, whether Republicans or Democrats, the small and medium-sized businesses, whether Republicans or Democrats, are being swamped from multiple directions. The full faith and credit of the U.S. Government is about to be tested and may be found wanting, but from outside I watch what looks like our elected representatives trying to kick the can down the road just far enough to get to the next election.

People are suffering out in the districts—not the people who fill the campaign coffers, but the people who cast the votes for each of you. Now is a good time for this Committee to send a message to citizens who show up to local caucuses and cast their vote in elections that they still matter. If this Committee would move forward with reform instead of being an impediment, with new attempts to further delay reform, plugging this particular hole in the economic dike would alleviate some of the suffering of all of those voters in a real way.

We are not alone in our perspective. Submitted with my testimony are dozens of academic, governmental, and private studies, reports and analyses from recent years showing the market disruptions caused by excessive financial speculation.

As our representatives, we need you to decide: Are you going to support the heavy campaign contributors or are you going to support most of America—all of us who can't match those kinds of contributions to Congressional campaigns, all of us on Main Street?

The large financial institutions communicate the issues——

The CHAIRMAN. The gentleman needs to wrap it up.

Mr. FRALEY.—in ways that complicate and confuse, but the bottom line is simple, and it is not rhetorical. Wall Street has exploited America, and it is up to you to defend her.

Thank you very much for your time.

[The prepared statement of Mr. Fraley follows:]

PREPARED STATEMENT OF DAVID FRALEY, PRESIDENT, FRALEY AND COMPANY, INC., CORTEZ, CO; ON BEHALF OF PETROLEUM MARKETERS ASSOCIATION OF AMERICA; THE NEW ENGLAND FUEL INSTITUTE; COLORADO PETROLEUM MARKETERS AND CONVENIENCE STORE ASSOCIATION

Thank you, Chairman Lucas, and Ranking Member Peterson for the invitation to testify before you today on the importance of derivatives reform to Main Street businesses and consumers. My name is David Fraley of Fraley and Company, Inc. in Cortez, Colorado. I am also speaking today on behalf of the Petroleum Marketers Association of America, the New England Fuel Institute and the Colorado Petroleum Marketers and Convenience Store Association.

The Petroleum Marketers Association of America (PMAA) is a federation of 49 state and regional trade associations representing 8,000 mostly small business pe-

troleum marketers. Petroleum marketers are engaged in the transport, storage and sale of petroleum products on the wholesale and retail levels. These products include gasoline, diesel fuel, biofuel blends, kerosene, jet fuel, aviation gasoline, racing fuel, lubricating oils, propane, home heating oil as well as ethanol and biodiesel motor fuel blend stocks. Among the customers served by petroleum marketers are retail gasoline stations, commercial transportation fleets, manufacturers, construction companies, Federal, state and local governments, farmers, airports, railroads, marinas and homeowners. Small business petroleum marketers own and operate approximately 60 percent of all retail gasoline stations operating nationwide.

The New England Fuel Institute (NEFI) is an independent trade association based in Massachusetts that represents 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.

The Colorado Petroleum Marketers and Convenience Store Association (CPMCSA) **is . . .**

I am a third generation owner of Fraley and Company, Inc. which operates in several states (PLEASE LIST THE STATES). I have utilized the commodities market over the years to hedge on propane pricing in the winter and I have a customer program as well. My focus with you today is to report what is happening on the street and to petroleum marketers.

We'd like to thank this Committee for its leadership in passing derivatives market reforms included Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L.111–203) last year. We also commend Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler, his fellow Commissioners and their staff for their hard work and dedication to what has been one of the most open and transparent rulemakings in memory.

Mr. Chairman and Members of the Committee, as you are fully aware, petroleum marketers and heating oil and propane dealers have been communicating our strong concerns about the lack of transparency and excess speculation in the commodity markets to the Congress for the past 7 years. We greatly appreciate that this Committee heard our concerns and moved forward with strong legislation designed to bring the commodity market back to the physical players to use as a tool to manage their costs.

The inclusion of derivative market reforms in last year's Wall Street Reform Act was a vital first step toward correction of the market. Unfortunately, delays in final implementation of the regulations leaves Main Street petroleum retailers and home heating providers with no positive change. Excessive speculation continues to create extreme price swings and market volatility, creating an environment where businesses like mine find it difficult to hedge, invest in my business, expand and hire new employees, and maintain healthy lines of credit. And the extreme volatility that is caused by the excess speculation stymies consumer confidence. Also shaken is our confidence in these markets as a legitimate price discovery tool that is reflective of supply and demand fundamentals. We believe the lack of transparency and unprecedented level of speculative activity has disrupted and distorted this function of the markets.

We are not alone. Submitted with my testimony for inclusion in the record are dozens of academic, governmental and private studies reports and analyses from recent years showing the market disruption caused by excessive financial speculation.* Also, earlier this month the CFTC reported that nine in ten traders in the most heavily traded commodities, including crude oil, are financial speculators betting up the price.

Make no mistake, financial speculation in commodities is necessary. Speculation provides the commodity markets with the liquidity needed to facilitate price discovery and appropriate risk mitigation for hedgers. But these markets were not created to serve speculators they were created to serve businesses like mine, and other hedgers and end-users of physical commodities, from wheat growers to corn farmers, oil producers to airlines. And at some point over the last few years, all of these industries have expressed to the Congress and to this Committee concern over the affects that too much speculation and general lack of transparency and oversight was having on their businesses.

The reforms included in Title VII of the Dodd-Frank Act were meant to address these concerns, including new clearing requirements for off-exchange swaps and mandatory position limits for speculative traders. Concerning the latter, the CFTC is 6 months delayed in implementing a final rule. We are hopeful that the Commis-

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*The documents referred to are retained in Committee file.

sion will act soon to finish work on this important rule, and we urge Congress' support in this regard.

Additionally, in order to see real change on Main Street, **Congress must provide the CFTC with appropriate funding increases** for comprehensive implementation and enforcement of Title VII reforms, to respond to emerging market trends and trading practices, and to insure orderly and functional commodities markets. We were disappointed that the House of Representatives approved a funding level that is 44 percent below the amount requested by the Commission as necessary in order to fulfill this mission.

We hope the Senate will fully fund the CFTC at $308 million as requested, and that the House will ultimately side with Main Street over Wall Street. As all parties know, without adequate funding, derivatives reform may not be fully enacted and cannot be vigorously enforced. Inadequate funding or the lack Congressional support for comprehensive implementation and vigorous enforcement of needed reforms will further jeopardize security, stability and confidence in the commodity markets.

Therefore, we also urge Congress to resist calls to water-down, delay or repeal Title VII reforms. This would not benefit Main Street businesses and consumers. Rather, it would benefit financial entities and speculative investors on Wall Street and LaSalle Street who are desperate for opportunities to derail needed reforms, preserve the status quo and continue their speculative profits.

You as our Representatives, you have to decide. Are you going to support the heavy campaign contributors—Wall Street and the Banks, or are you going to support those who have less to contribute to Congressional campaigns financially—Main Street? Representatives of financial institutions communicate to Congress in ways to complicate and to confuse the issue. But the bottom line is simple. Wall Street has exploited America and it is up to you to defend her.

Thank you for your time. I am available to answer any questions you might have.

The CHAIRMAN. Thank you, Mr. Fraley.

The chair now recognizes himself for 5 minutes for questions.

Mr. English, having been around in this process and watched this evolve over the decades—fewer, not many decades, that is—I simply offer the observation to you that one of my concerns throughout this process has been the scope and the volume of the proposals trying to move by rule in a very short period of time—very massive amounts of rules that have potentially tremendous unintended consequences.

Now, in your testimony, you stated that you are concerned that the National Rural Utilities Cooperative Finance Corporation may be subject to the clearing requirement. Is that because they would be defined as a—or deemed a financial entity, Mr. English?

Mr. ENGLISH. Well, I think what it really comes down to is this question of whether or not they are a threat; whether they are hedging, and whether they are trying to reduce risks for the electric cooperatives.

As you know, that organization was set up by the rural electric cooperatives to provide for additional financing of electric cooperatives across the country. It is a not-for-profit. It is owned by the electric cooperatives themselves. And it uses legitimate hedging practices in trying to reduce their risk.

The CHAIRMAN. Can you give us a sense of how a clearing mandate imposed on NRUCFC would impact not just the cooperatives but, most importantly, their member-owners?

Mr. ENGLISH. Well, it all comes down to cost of the electric bill, on all this stuff. And I know, in working with the other body, for instance—I shouldn't say the other body—another committee, in dealing with the Federal Energy Regulatory Commission, they recognize the fact that there are differences between entities such as

electric cooperatives and some of the larger electric utilities in this country.

They chose to go at that from a regulatory standpoint in what is known as a "FERC-lite," as far as the regulation is concerned. In other words, basically, the approach that they were taking is, if we weren't causing a problem, if there wasn't an issue there, if there wasn't a threat, then obviously there shouldn't have these requirements of huge amounts of regulation that you have to comply with that some of the bigger entities did.

And I suppose that we would suggest that this is something that we would hope the CFTC would look to for those who didn't have the systemic risk, that they should take a similar approach.

The CHAIRMAN. Mr. Peterson, Ms. Hall, at some point during the legislative process, the authors decided to focus less on the type of activity—for example, hedges *versus* speculating—and more on the type of entity. As a result, the end-user exemption splits non-financial end-users and financial end-users and places them in different regulatory buckets.

What do you see as the long-term impacts of this policy? What is going to happen down the road if it is implemented in this fashion?

Mr. Sam PETERSON. Sure. I will go first, Mr. Chairman.

The CHAIRMAN. Please.

Mr. Sam PETERSON. I think when we are talking about the split between non-financial and financial end-users, in this case, we are talking in either case about firms that are not major dealers and they are not firms that pose a systemic threat. So, then, we are really, with respect to financial end-users, deciding possibly to impose pretty substantial amounts of regulation, including clearing and margin mandates and other requirements, on a firm that is, by the definitions in Title VII and in the proposed rules, not systemically risky.

So what I worry about is, going forward, a case where we have either a lot of capital sidelined unnecessarily because of that or less hedging because of that. I think we can all agree that neither of those is a good outcome.

Ms. HALL. I would agree with Mr. Peterson. And as a bank, the more capital that we have to put aside for things like margin agreements basically is less capital that we have to make loans. So, at the end of the day, it would inhibit our ability to put our money where we want to, which is in the community.

The CHAIRMAN. So, then, you either are compelled to put up the capital in this scenario to provide the products which benefit your customers, or if you choose not to engage in the product, then the customer potentially doesn't have the access to the tool?

Ms. HALL. If it became so expensive for us—we have a very limited amount of activity. Offering this product to our customer is just one small aspect of the entire relationship that we have with a customer—their deposit, their credit needs. And if we find that this is just too expensive from the cost to set up and maintain clearing, the costs for the margin, if we were to be defined as a *swap dealer* we would take a serious look at whether we would want to continue in this business. And if we then withdraw from it, then those customers may turn to a larger organization, a larger

bank that can provide this product along with all of their other needs.

If I have a minute, we had a situation a few years back where, even though it was very needed in the municipal securities world, they enacted a real-time transaction reporting rule of 15 minutes. We had been a municipal securities dealer; that came under our Bank Powers Act. But the IT that would have been required for us to install in order to meet that 15 minute rule precluded us from continuing to offer that product, and we ended up withdrawing from the market.

And that is why I am here today, and it is why it concerns me so, that just a narrow definition of some of these rules can catch us up in this and make it so it is untenable for us.

The CHAIRMAN. My time has expired. I now turn to, I guess, my Ranking Member *pro tempore,* the gentleman from Vermont, for 5 minutes.

Mr. WELCH. Well, until Mr. Courtney from Connecticut claims my seat. Thank you.

I want to thank the panel. Let me just quickly ask a few questions. I only have 5 minutes, so try to keep your answers short, if you could.

Mr. English, in your written testimony, you stated that your organization wants swap markets to be free of manipulation. But your organization, as I understand it, supports H.R. 1573, which would have delayed a new, strong anti-fraud, anti-manipulation rule, the rules included in Dodd-Frank, until December 2012. And I wondered if, briefly, you could reconcile those two positions.

Mr. ENGLISH. Well, it is rather simple. We would like to get it right. That is what this hearing, as I understood it, is all about.

Mr. WELCH. So have you laid out concretely what it is you would regard as right?

Mr. ENGLISH. Yes. The concern, again, as I mentioned in my testimony earlier, focuses strictly on this definition of *swap.* We were very disappointed that, basically, the CFTC has waited until the last to define what a swaps or swap dealer is and, therefore, including all 900 electric cooperatives as potentially being declared swap dealers.

Now, we have spent a considerable amount of expense as a result of this in filings with the CFTC, a considerable amount, which obviously goes to the electric bills of all of our members.

The concern that we have here is, yes, we would like to see this implemented from the standpoint of transparency to try to make sure that we get rid of manipulation as quick as we could. As I mentioned earlier, we would like to get——

Mr. WELCH. All right.

Mr. ENGLISH.—involved in moving forward on this. But the fact of the matter is, we have to make sure this is right, because——

Mr. WELCH. Yes, I get it. Let me move on.

Mr. ENGLISH.—unless you want to come back and try to revise the law. And I don't think you want to do that.

Mr. WELCH. Thank you. Thank you very much.

Ms. Hall, I was impressed with the record of your bank. I think the community banks are an awful lot different than the Wall Street financial institutions that got us into a lot of this trouble.

But if the CFTC adopted the recommendation, which I think you agree with, that only banks with a net uncollateralized derivatives exposure of $1 billion or more should be required to clear their swaps, how many banks would be subject to the mandatory clearing requirement? Do you know? Not many.

Ms. HALL. I don't know the answer to that offhand. I would be happy to research that and get back to you.

I know we have put into place bilateral netting agreements and——

Mr. WELCH. Okay, you will get back to me with that.

Mr. Howard and Mr. English, both of you, in your written testimonies, advocate for what I guess could be called a "CFTC-lite" regulation. I understand you want to get it right for your organizations, all right? There is nothing meant by that, anything other than that.

If you believe that real-time reporting is too expensive for your institutions and unnecessary for the swaps that your entities engage in, how long should the regulators have to wait for your members to report their swap activities?

Mr. English first, and then Ms. Hall.

Mr. ENGLISH. Very quickly, as I pointed out when I was talking about it earlier, something along the lines of what FERC is doing. Basically, if FERC comes up to—if you are not causing a problem, we are not going to spend a lot of resources, as far as a regulatory agency is concerned, to deal with you. If you become a problem, then you have the full attention of FERC. Something along that line, we think, makes sense in this area.

Mr. WELCH. Okay.

Mr. ENGLISH. If there is no systemic problem, why in the world would you want to spend resources requiring us to and for them to?

Mr. WELCH. Ms. Hall?

Thank you, Mr. English.

Ms. HALL. I agree that there is a need for transparency, and real-time reporting is something to be desired. Many of the transactions that we do are very customized. They are amortizing right along with——

Mr. WELCH. So should those be reported in how much time?

Ms. HALL. I think by end of day is not unreasonable.

Mr. WELCH. Okay.

Ms. HALL. My concern, again, though, is the cost to implement that.

Mr. WELCH. Let me ask my last question. Mr. Fraley, you are a great advocate for greater transparency in these derivatives markets. How would the greater transparency benefit Main Street businesses like yours?

Mr. FRALEY. By reducing volatility that currently keeps prices higher than they should be. It is as simple as that.

Mr. WELCH. Okay, great. Thank you.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back the balance of his time.

The chair now recognizes the gentleman from Illinois for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman.

Let me just address the first questions to the whole panel and take, kind of, a miscellaneous response.

Do you have a sense for whether there is a risk to be realized by not acting to approve the rules before they are final, so to speak? If your concerns aren't addressed once the final rules are issued, what are you going to do? Are you going to start to change your practices immediately, to wait to see if Congress provides the relief? In other words, how does this create a level, if at all, of instability?

Congressman?

Mr. ENGLISH. I will start that off. We are going to come see you the next day. That is going to be the first step. Quite frankly, that is the only relief we have. These co-ops are too darn small to be out there trying to put together the kind of instant reporting system that is being talked about at the CFTC.

The only thing that makes any sense is to recognize that common sense must come into play, and you have to weigh risks against resources. The Chairman was here talking about he didn't have enough resources. Well, if you are spending on places where there is no risk, that doesn't make a whole lot of sense.

So I would hope that that—well, that would be our response. We will come see you.

Mr. JOHNSON. This is a little bit of a rhetorical question, but let me just ask you this, Congressman English.

Mr. ENGLISH. Sure.

Mr. JOHNSON. I guess, knowing that areas that you serve have a higher poverty rate than urban areas do, and with the background that you have and having represented areas that your constituents serve, could you ever have conceived, at any point in your legislative history or at least over the last 2 years, that you would be subject as cooperatives to the same jurisdiction as Goldman Sachs or other entities? Would that be something that you would even have conceived of at any point?

Mr. ENGLISH. I could never have conceived of such a thing. And the fact that Kiwash Electric, my home electric cooperative in Oklahoma, could ever be considered a swaps dealer or in danger of being labeled as a swaps dealer I thought was nuts.

Mr. JOHNSON. To all of you, has there been, or to what extent is there, an impact of all these proposed rules and the Act in your bottom line? And, ultimately, not just to your bottom line; to the consumers, shareholders, and individuals that make up your collective or individual entities? Just maybe a couple of miscellaneous responses.

Mr. HOWARD. Randy Howard. I will just jump in here.

Probably one of our biggest concerns in having this lack of clarity in this period of time and having this potential effective date of December 31, 2011 for the final rules. As I indicated in my testimony, well before the heat wave that is taking place today, the utilities had planned and attempted to hedge to cover extreme weather events. We are making positions now well past December.

Mr. JOHNSON. Right, right.

Mr. Schloss, do you think there would be, and if so what, what is the size of the impact on Ford retirees of your pension fund's inability to engage in swaps or if its savings capacity is cut down?

Mr. SCHLOSS. Thank you for the question. I think from the perspective of our pensioners and our corporate balance sheet, the inability to hedge our interest rate exposure in our pension fund really is—will be a reflection of what interest rates do as we go forward. And I can't predict, nor do I try to predict where interest rates are going. Historically when we have used derivatives, we have saved multi-billions of dollars of funded status by hedging that interest rate exposure, and that goes directly to the bottom line.

Mr. JOHNSON. Last question. And as I said with the Chairman before, I really don't mean these questions or this question to sound adversarial, but I guess it is.

Mr. Fraley, I listened to the other five witnesses here all talk about facts concerning this legislation's impact on their industry, what the ramifications will be in the rules. And I gleaned from your testimony somehow a belief that either Members of Congress, or the Committee, or somewhere else are bought and sold by American industry, or that somehow—your testimony is completely at odds, not necessarily at odds, but entirely different from these other five. I don't know whether to resent it or whether to simply ask you what you meant. But quite frankly, it really occurred to me that you were making an onslaught a little bit on your colleagues and certainly on Members of this Committee and otherwise, and I hope that wasn't the case.

Mr. FRALEY. That was not my intent and I apologize if that was the way it was received.

Mr. JOHNSON. I guess we will look at the testimony and have it transcribed and read it back, but I have to say I was a little troubled by your belief that somehow big industry and big business has bought and sold the Members of this Committee or otherwise. Maybe you want to reexamine what you said.

The CHAIRMAN. The gentleman's time has expired. The chair now turns to the gentleman from Connecticut for his 5 minutes.

Mr. COURTNEY. Thank you, Mr. Chairman.

Let me just say, Mr. Fraley, I am a big boy and I can handle it, and what you expressed is something that frankly is really what Main Street is talking about. When you go to Main Street and you see the challenges that people are facing to survive these days in terms of basic commodities like food and fuel, and they just don't have any confidence in markets that, as you described are opaque and accessible and volatile, that is what is driving the anger and cynicism that is out there every single day.

In southeastern Connecticut the oil dealers that I talk to who—as Ms. Hall knows, in Connecticut we have cold winters and people lock in their home heating contracts year in and year out, you have to hedge in order to really design a system, a pricing system, for your customers to make that work. This year in southeastern Connecticut, oil fuel dealers have just completely abandoned the market. They will not sell a lock-in contract for next winter.

And to me that is the canary in the coal mine. If we have markets that are designed for end-users to be able to hedge risk so that

they can actually do what commodities markets are supposed to do, and people are just heading for the exits, then we have a broken system. And that is just something that people feel in their bones right now, and that is really the disappointment that they feel about what is going on out there.

And I guess you represent The New England Fuel Institute. I suspect southeastern Connecticut is not the only place where people have just given up in terms of the commodities markets.

Mr. FRALEY. That is true.

Mr. COURTNEY. You are seeing that through your trade association?

Mr. FRALEY. Both in our associations and in my individual conversation with marketers all over the nation. The last 3 years, especially since the crash, all of us are operating in the dark. Very many of us in 2009, after oil came off at $147 a barrel and all the way back to $30, we were crushed in our hedging programs that year. And one of the reasons that you see marketers all over the country now being shy to come back in and offer those programs, which are intended to—and the best we can do is delay the impact of the ongoing increase in energy prices by about a year at a time to our customers. And that is what these price protection programs that we come up with and hedge for accomplish, is that we delay that increase by about 1 year at a time to our customers.

So many people were hammered so badly, so many dealers and marketers were hammered so badly in 2009, that now we have again Brent Crude Oil pushing $120 a barrel a day, close to it; WTI, going back to $100 today. And we are all concerned that we are looking at 2008 and 2009 all over again.

Many companies can't financially afford to take that hit one more time. They will be out of business.

Mr. COURTNEY. Well, what I hear when I go home is that Dodd-Frank which, as Mr. Gensler testified earlier today, was really—the language says it is just to set appropriate limits on non-commercial interests in terms of positions in the energy markets. What I hear is, why do they have any right to participate in the market? It should only be people who take delivery of the product that should be able to participate in that market, which obviously is a much more extreme position than the legislation that is out there.

But I just think the Chairman is doing a great job holding these hearings. It has been just great to flush out these issues and to raise the red flag, which has been done here by many witnesses. But, at some point, people also have to put in perspective that the public out there just feels completely unprotected still, since 2008. And we just cannot delay in a dilatory fashion implementation of rules that will set up—that should create a functioning market. You need rules.

That is what they taught us in law school to regulate the sale of property in the functioning markets. It is just not chaos. You have rules, and we need rules. And hopefully that is something that these witnesses will help the Commissioner and the Chairman get right with your input.

And again, these hearings have done a terrific job in terms of getting it out in the public and I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back and the chair now recognizes the gentleman from Pennsylvania for 5 minutes.

Mr. THOMPSON. Thank you, Mr. Chairman. Thank you to the witnesses for bringing your experience and expertise on this important issue that we are taking a look at.

Congressman English, it is good to see you again. I wanted to start with you in terms of your history certainly as a part of and before this Committee and with NRECA. Could you have imagined that rural electric cooperatives would be the subject of such broad CFTC jurisdiction?

Mr. ENGLISH. Well, I never would have, just simply because of the fact that we are looking to hedge our risk. We try to keep electric bills affordable for our membership. We have to figure out some way we can do that and do it as cheaply as we possibly can. I fully recognize and understand that we were remiss through the years, the CFTC was remiss through the years in not vigorously pursuing a good deal of oversight and effort with regard to some of these markets. But the overreaction going the other way is just as big a problem.

And what I am concerned about is what I keep hearing out of the CFTC particularly, not nailing down this issue of drawing a nice bright line of what is a swap and what is not, and what is a swap dealer and what is not. And the fact that our membership would even be in the mix astounds me, I have to say.

So that is one of the reasons I am very delighted to see that this Committee is holding these hearings and giving us an opportunity to raise that flag and wave it big-time, but for goodness' sake this thing is too important not to get right. So these definitions have to be right and I hope the CFTC gets them right.

Mr. THOMPSON. My observation is what we are dealing with today on this issue is like most solutions that come out of Washington. Somebody a lot smarter than me I heard once say—and it fits—a solution in search of a problem when it comes to how it impacts some of our end-users, these regulations.

Obviously, the members you represent by definition represent rural America, are our breadbasket, agriculture. Do you think these regulations help or hurt agriculture, and in what ways?

Mr. ENGLISH. Well the problem that we have here is like anything else. If it is done in moderation and in proportion to what the problem is, then that is good. But these things have a tendency it seems to sometimes get out of balance, and that appears to be what we are being threatened with here today.

I am hopeful that the CFTC will get this right and will be very sensitive about how they do it. But there is a big difference between trading on financial instruments with people who are dealing with this day in and day out and speculators, as opposed to folks who are trying to hedge risk and to minimize risk, who are such a minuscule portion of what this market will ever be. It can never have an impact one way or the other as to what direction the markets go. I think the CFTC should focus their resources on where the problem is and not on those people who are simply trying to hedge risk.

Mr. THOMPSON. One of the premises I live my life by is the best predictor of future performance is past performance. And so I want-

ed to see if you could just reflect briefly on how has the volume of regulations impacted rural electric cooperatives in the past?

Mr. ENGLISH. Well, obviously, anytime you get into regulations they are costly, and that always has an impact on our membership. And you were talking about the very fact about rural America, we have more people below the poverty line than they do in urban America. So that falls heavier on our members perhaps than it does on people who are receiving electric power in urban areas of this country.

So it is not just the impact that it has on rural America in general, it falls heavier on rural America than it does on urban America.

Mr. THOMPSON. Thanks.

Mr. Peterson, it is good to be joined by someone else from the Keystone State here. When you say that end-users don't pose systematic risk, what data are you basing that assertion on.

Mr. Sam PETERSON. Thanks for the question. There is limited data on end-user transactions, but the Bank for International Settlements does put out a report on volumes of trades and breaks down different categories. And if you look at that report, non-financial end-users comprise less than ten percent of the overall market by notional.

On the other side of the market we know that there is great concentration at the higher end. So among banks, for instance, out of all the banks in the U.S. that use derivatives, five banks, the top five, control 96 percent of the notional and 86 percent of the credit exposure, and credit exposure is really the metric we should look at here.

Mr. THOMPSON. When you talk about number of banks, any idea of what percentage or how many small banks are—provide swaps to their customers?

Mr. Sam PETERSON. Correct me if I'm off, and this is just an estimate, but my firm works with about 90 community and regional banks and about 50 of those banks offer swaps to customers in exactly the way that Ms. Hall described. I would guess, based on just knowing how many banks there are and their sizes, that the number might be somewhere between 150 and 400, but that is a guess.

Mr. THOMPSON. Is that consistent, Ms. Hall, with your thoughts?

Ms. HALL. Yes.

The CHAIRMAN. The chair now turns to the gentleman from Colorado.

Mr. TIPTON. Thank you, Mr. Chairman. I would like to take just a moment to welcome a friend of mine and fellow Coloradoan, David Fraley, and appreciate your taking the time to be able to come here. You and I are probably the only two people in this room that know where Egnar, Colorado is. So it is great to have another rural guy here.

I will ask this, Mr. Fraley, and open it up on the rest of this panel as well. I am a small businessman. And one thing that I have always seen that is very frustrating, not being a career politician out of Washington, D.C., is when I see what is coming out, Congressman Thompson just alluded to it. Past performance will probably guarantee future results. Congress will pass broad-based

legislation and then allow the bureaucracy to be able to fill in the blanks.

We just had Chairman Gensler. He said he believes that they are on track to do what Congress intended us to. That is called legislative intent.

Do you think that it would be appropriate before these rules go active, for them to bring the rules back to the authoritative body which empowered them to be able to write these rules and give them a last look-over to make sure that that legislative intent was truly being applied?

Mr. Fraley, if you would like to start.

Mr. FRALEY. Congressman, I have absolutely no issue with that. I think part of what the CFTC is attempting to do right now is make sure that they don't get caught up in litigation later, 2 or 3 years from now, because something was missed. And I have no issue with the idea of them coming back and getting a review for that reason. No.

Mr. TIPTON. Thanks. Congressman.

Mr. ENGLISH. I think it is a fantastic idea, and I would love to see it take place. I think it makes a whole lot of sense and keeps us out of a whole lot of trouble. I hate to say it, we have already tried that. We did that, I believe it was 1977, 1978, something like that, and we passed a one-house veto so that any rules and regulations carried out, that the Congress would have an opportunity to review that and if any one—and they were brought to the floor in an expeditious manner, I believe it was 10 days or something like that. Vote up or down, it either does or doesn't follow the intent. And we thought that we were solving the exact problem you are talking about. You are absolutely right.

The problem was the Supreme Court said it was unconstitutional, and I believe it was Judge Scalia I believe that came out and said, well, a rule or regulation has the same force of law; therefore, it takes a law to repeal it.

I don't agree with that, and it is unfortunate that we got that. But I think you are right on track, I would have loved to have seen that.

Mr. TIPTON. We are working on some legislation. I would like to be able to visit with you to be able to do that. That is one of my concerns. I have had the opportunity to be able to read through your testimony. I apologize, I was tied up and couldn't listen to it verbally as you delivered it. But one of the great concerns is, is we see the bureaucracy seeming to effectively almost rush to regulate.

When we are talking—I believe it is Mr. Howard; can you tell me what are some of the costs? Do you have any projected costs on these new regulations for your communities?

Mr. HOWARD. It is expected, depending on whether we are defined as a *swap dealer* or not. It changes pretty dramatically if we are defined as a *swap dealer*. And we have large collateral positions we have to post that could be in the several hundred million dollars range.

Mr. TIPTON. Who pays the bill? Who will pay that bill?

Mr. HOWARD. Our ratepayers will pay that.

Mr. TIPTON. Are any of them struggling to be able to pay their bills right now? Can they afford any more expenses at the hands of Congress regulating?

Mr. HOWARD. I know we have heard about the rural electrics and some of the poverty there. In the City of Los Angeles I have about 280,000 low-income customers that pay our bill monthly.

Mr. TIPTON. So the poor, struggling families, senior citizens, they will be the ones that will be paying the price for overzealous regulation.

Mr. HOWARD. That is correct.

Mr. TIPTON. That is correct. I think that is something we all need to make sure we are keeping in mind.

I would like—any one of you can take this question. Mr. Fraley, since you came so far I will ask you. Are you going to be subject to SEC regulations as well as CFTC regs?

Mr. FRALEY. No, I don't anticipate that I will.

Mr. TIPTON. Anybody else?

Ms. HALL. We may, just in that we deal with municipalities and not directly under this, but if you are a swap adviser, then you would be regulated by the SEC.

Mr. TIPTON. And you are still going to have the CFTC involved as well?

Ms. HALL. Yes.

Mr. TIPTON. Yes, sir.

Congressman?

Mr. ENGLISH. Yes, we will have the utility industry, electric utility industry will have both Federal Energy Regulatory Commission as well as CFTC regulating us in this area.

Mr. TIPTON. Mr. Chairman, would you mind if I continue for just one moment please? Thank you for your indulgence.

The CHAIRMAN. Proceed.

Mr. TIPTON. My concern—and this again gets back to the regulatory end of it. Congress establishes something, and in Mr. Fraley's case it is not an issue. But we have this integration financial services cross-over of interest that stretches through all of our communities through our different states as well, and we get the competing interests of two different bureaucracies. Which master do we serve? Do you have a solution for that? Who gets to make the call? Congressman, you just said the Supreme Court was going to allow Congress to be able to do its job.

Mr. ENGLISH. It would also be helpful if we—if you would get the two committees together. Here you have in one case Energy and Commerce Committee with Federal Energy Regulatory Commission, and with this Committee with CFTC. And there needs to be some way to work out in which there is an interface there where you don't try to respond to two masters.

But unfortunately, the way we are moving forward now, we are likely, we are very likely to do that unless the two agencies themselves come together and work those differences out. But as you know, so often these agencies have a tendency to kind of get in these turf battles as to who is going to do what. And that is a problem and it is an extra cost, it is an extra burden, and it is a real challenge for us.

Mr. TIPTON. I guess just my final question, and it is just small-town—my business is plankton in the sea of business. But it just would be sensible to me, I would think, we are talking about swaps; if we are going to start to regulate, shouldn't we define what swap dealers are to begin with? Would that make sense to our panel?

[Nonverbal response.]

Mr. TIPTON. It makes sense to me as well. So thank you, Mr. Chairman, for your indulgence.

The CHAIRMAN. Thank you. And once again one privilege of the Chairman is to make sure that nobody on the panel escapes unscathed. And Mr. Schloss, you have come pretty close to being unscathed so far. I would note that I watched with great interest your facial expressions when the Chairman and I had our discussions about margin requirements and definitions.

Would you expand for a moment on what the implications for Ford Motor Credit and Ford Motor in general would be if Ford Motor Credit is deemed a high-risk financial end-user for the purpose of margin requirements and other costs?

Mr. SCHLOSS. Thank you, Mr. Chairman. And I did appreciate a lot of the clarity that came out of the first panel discussion, because it is one area that we have had a lot of debate and a lot of discussions with many folks both on the Hill, but also with the Chairman himself.

Our biggest concern with the credit company is, and it really centers around the way we fund our business. And first and foremost, more than ½ of our funding comes through the securitization market, and within our securitization structures there are hedges to protect the underlying investor who buys those assets, who have a different interest rate component than the assets themselves. And as a result of that, with the structures not allowed to do margin, we would have to restructure somewhere between $15 and $20 billion worth of our capacity today. And that is a blow to the asset-backed market that I think puts a huge delay in our ability to fund, and that directly then correlates to our ability to support our customers and our dealers who support the sale of our cars, which is in the end what we are in the business of doing.

And so the cost of that margin, the restructuring of that and then the cost to hold margin against the derivatives we do have, would add several billion dollars of margin, which is investment that could be lent to consumers, it could be paid to our parent company, who then can invest in products and jobs.

The CHAIRMAN. Ultimately, the consumer has less competition and fewer options then?

Mr. SCHLOSS. Absolutely.

The CHAIRMAN. Well, this has been a very worthwhile process today. And I would like to thank the panels, both panels, for their testimony and note that under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplemental written responses from the witnesses from any question posed by a Member.

This hearing of the Committee on Agriculture is adjourned.

[Whereupon, at 4:51 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY HON. SCOTT D. O'MALIA, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION

July 21, 2011

I concur with the Chairman's testimony. However, I have repeatedly and strongly urged the Commission to publish in the *Federal Register* for notice and comment both a schedule outlining the order in which it will consider final rulemakings made pursuant to the Dodd-Frank Act and an implementation schedule for those rulemakings. I am disappointed that when the Commission recently issued a notice in the *Federal Register* providing for an additional 30 day comment period on most of the Dodd-Frank rule proposals it did not take the opportunity to be fully transparent with the market by providing a proposed schedule for final rule implementation. Making the process as transparent as possible will accelerate implementation because participants will be able to plan ahead and make the technology and staffing investments necessary to comply with the rules. As a result, I am once again requesting that the Commission provide participants with a complete implementation schedule that will be open for public comment.

SUPPLEMENTARY LETTER SUBMITTED BY DENISE B. HALL, SENIOR VICE PRESIDENT, TREASURY SALES MANAGER, WEBSTER BANK

July 29, 2011

Hon. PETER WELCH,
Member,
House Committee on Agriculture,
Washington, D.C.

Reference: Derivatives Reform: The View from Main Street—Testimony from Denise B. Hall, Webster Bank

Dear Representative Welch:

Thank you again for the opportunity to testify in regard to the implementation of Title VII of the Dodd-Frank Act, and its implications for community banks such as Webster. During the question and answer period, you asked me how many banks have net uncollateralized derivative exposure less than $1 billion. I offered to research that question as I did not have the information. Thank you for the question and please accept this letter in response as part of the official testimony.

I have been unable to find statistics that address your question directly. Uncollateralized *versus* total derivative exposure is not information required in a bank's financial Call Reports. There are, however, a number of statistics available that you may feel are pertinent, and highlight the difference in risk posed by the largest banks and the "Main Street Banks."

- The top 5 dealers hold 96 percent of the total banking industry derivatives notional and *83 percent* of the total net current credit exposure held by all U.S. banks, according to the OCC's quarterly report on derivatives.[i]
- It follows that the exposure for all but the top 5 dealers equals in total only 17% of the total credit exposure figure. This 17 percent is dispersed among approximately 1,000 different banks.
- Banks and savings associations with $30 billion or less in assets account for only 0.09 percent of the notional value of the bank swaps market as of March 2011.
- For comparison purposes, Webster Bank is an $18 billion commercial bank with branches in Connecticut, Massachusetts, Rhode Island and New York. As of June 30, 2011 our parent company Webster Financial was ranked No. 50 of the top 50 bank holding companies by the National Information Center based on data collected by the Federal Reserve System. (See the link below.) *http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx*. Webster would be ranked 35th in asset size if you were to confine the list to the 50 largest banks (not thrifts) that are publicly traded in the U.S. This would exclude the non-U.S. entities in the above referenced link. As previously mentioned in my written testimony, Webster utilizes derivatives to manage the bank's interest rate risk, and to provide our commercial clients with the ability to manage their interest rate risk. We have been engaged in this activity for over 10 years, and have risk

[i] Please refer to page 1 of report at: *http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq111.pdf*

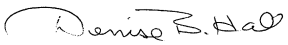
policies in place to manage derivative exposure. As of today, we have $3 million in uncollateralized net derivative exposure and a total notional outstanding of $1.7 billion.

In addition, I think that it is important to note that Congress already anticipated the need for the regulatory capture of the largest dealers in derivatives as well as the major market players that pose a threat to the financial system. Title VII of the Dodd-Frank Act requires dealers to register as regulated "swap dealers" or "security-based swap dealers." In addition, Congress created a separate category for "major swap participants" ("MSP") and "major security-based swap participants" ("MSBSP") to capture firms that are not dealers, but that have "substantial positions" derivatives or whose derivatives create "substantial counterparty exposure" that could harm the financial system. In further defining these terms, the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have issued a proposed rule which lists specific exposure levels at which a firm poses a potential systemic threat and therefore would be required to register as a MSPs or MSBSPs. The $1 billion exposure threshold I suggested during the hearing is ⅕ of the "systemic" threshold specified by the regulators in their proposed rule; if you were to include "potential future exposure," a $1 billion exposure threshold is ⅛ the level specified by the regulators.

In sum, the large dealers and the major players in the derivatives market already will be subject to extensive regulatory supervision, including clearing, margin, capital, trading, business conduct and reporting requirements. Moreover, other banks that are very active in the swaps market will have to monitor their uncollateralized exposure and potential future exposure going forward in order to determine whether or not they are required to register as MSPs or MSBSPs. Through the comprehensive reporting requirements, the CFTC and SEC will have information about all banks and can take action to ensure that banks and other firms submit to any applicable registration and regulatory requirements.

I hope that I have been able to provide useful information and that it gives credence to our belief that small banks should be exempt from clearing and that the parameters for qualifying for the small bank exemption should focus on our lack of risk to the financial system. I am very happy to answer any questions or provide further information. I can be reached at [**Redacted.**]

Regards,



DENISE B. HALL,
Senior Vice President, Treasury Sales Manager,
Webster Bank.

SUBMITTED STATEMENT BY AMERICAN BANKERS ASSOCIATION

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, the American Bankers Association (ABA) appreciates the opportunity to submit this statement for the record on derivatives rules and their impact on businesses—including banks. The ABA represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.

ABA appreciates the efforts being made by this Committee to oversee the implementation of the Dodd-Frank Act with regards to derivatives regulation and to ensure that implementation agrees with the intent of the Congress. Indeed, ABA has consistently supported the objective of increasing transparency and appropriate supervision of credit default swaps and other financial products of systemic importance. However, it is critical that regulatory implementation preserves banks' ability to serve as engines for economic growth and job creation by providing credit to businesses and offsetting the customary risk these transactions create through internal risk management functions.

ABA is very concerned about new rules being formulated to implement the Dodd-Frank Act that would add swap margin and clearing requirements for all banks unless the regulators provide an exemption. If not crafted properly, the new swaps rules could also discourage banks from offering customers the option to use swaps to hedge their loan-related risks. Our members and their customers use swaps to manage and mitigate the risks inherent in everyday business transactions. Banks underwrite all loans and swaps using the credit risk assessment standards that apply to the overall lending relationship with that customer. Loans and swaps may be collateralized by, among other things, real property, equipment, inventory, or accounts receivable. Alternatively, some loans and swaps may be cross-collateralized

with another loan or may not be collateralized at all. ***This is the essence of commercial lending—banks assess credit and market risk of the borrower, negotiate loan terms, and accept the repayment and market risk.***

ABA has a diverse membership including banks of all sizes that use swaps in a variety of ways depending on the complexity of their business activities. Hundreds of our member banks use swaps to mitigate the risks of their ordinary business activities. ***Margin and clearing requirements would make it difficult or impossible for many banks to continue using swaps to hedge the interest rate, currency, and credit risks that arise from their loan, securities, and deposit portfolios.*** This would increase the risk in the system, not reduce risk, which is the primary purpose of hedging.

There are three points we would like to make today:

- ➢ **Small banks should be exempt from new clearing requirements just as other "end-users" are.**
- ➢ **All common lending practices should be included in the exemption from the swap dealer definition for swaps entered into in connection with originating a loan.**
- ➢ **End-users—including banks with limited swaps activities—should not be subject to margin requirements.**

Before we explain these points in detail, we would like to address a separate but related concern. In prior testimony before this Committee, the $231 billion Federal Farm Credit System (FCS or System) argued that they should be exempted from an asset test regarding their derivatives activities. We urge this Committee to reject this request.

The Federal Farm Credit System is a tax advantaged, retail lending, Government Sponsored Enterprise (GSE). The Federal Farm Credit System suggested to this Committee that regulators "look through" their corporate structure to the smallest entities that make up the System, the retail lending associations. Each of these entities are ***jointly and severally liable for each other's financial problems.*** The FCS would like this Committee to now ignore their joint and several liability to each other and would like to be treated as if they were a multitude of small entities. They are not.

The Federal Farm Credit System presents the same kind of potential liability to the American taxpayer as other GSEs—taxpayers are the ultimate back stop should the Federal Farm Credit System develop financial problems. In fact, this has already happened. An earlier near collapse of the Federal Farm Credit System in the late 1980s as a result of irresponsible farm lending foreshadowed what taxpayers would confront more than twenty years later with the housing GSEs. At that time, the Federal Farm Credit System received $4 billion in financial assistance from the U.S. taxpayer. Therefore, due to its enormous size and the potential risk it poses to the economy, we urge this Committee to reject the Federal Farm Credit System's arguments for exemptions from the derivatives title of Dodd-Frank.

I. Small Banks Should Be Exempt from New Clearing Requirements Just as Other "End-Users" Are

The Dodd-Frank Act mandates new clearing requirements for swaps. If these requirements were applied equally to all financial institutions—regardless of risk—the result would limit their ability to hedge or mitigate risk. Many banks would not be able to afford the additional burdens of such a broad application of the new law. This is why it is critical that regulators take into account the flexibility the Dodd-Frank Act gives to provide a clearing exception for "end-users" that use swaps to hedge or mitigate risk. Indeed, the Dodd-Frank Act ***requires*** regulators to consider whether to exempt small banks from the new mandatory swaps clearing requirements.

Absent an exemption, even small banks would be deemed "financial entities," and would not be eligible for the exception from clearing requirements available to other end-users. Unless the regulators exercise their exemptive authority, banks that have limited swaps activities—including some of the smallest institutions in the country—will have to comply with the new clearing requirements even if they use swaps as a normal part of their business strategy to hedge or mitigate commercial risk.

Many banks use swaps the same ways that other end-users do. For example, banks use swaps to hedge interest rate risk both on their own balance sheet and to provide long-term fixed rate financing to commercial borrowers. The SEC recognized this activity and stated that it believes that small banks should be exempt from clearing requirements as end-users.

Small bank swap transactions account for a very small part of the overall swaps market. They generally transact in smaller notional amounts and need to customize swaps to loans that they originate. An appropriate risk-based approach to clearing requirements should take into account not just total assets, but also the risk that an institution's swaps activities pose for the overall swaps market and to that institution. Even banks and savings associations with $30 billion or less in assets account for ***only 0.09 percent*** of the notional value of the bank swaps market as of March 2011. Moreover, banks using swaps to hedge or mitigate commercial risk have standard risk management practices that set limits on exposure to swap dealers and also are subject to regulatory oversight. Banks engaging in these limited swaps activities should be exempt from the clearing requirements because they do not pose a risk to the swaps market nor do these swaps activities pose a risk to the safety and soundness of the banks.

If appropriate exemptions from clearing requirements are not established, small banks would be discouraged from using swaps. The time and expense to establish a clearing agency relationship as well as the increased complexity and costs would be prohibitive for many institutions that use swaps sparingly. They are least able to afford the overhead costs required to establish a clearing relationship and pay the ongoing clearing fees. Further, they may need to establish multiple clearing relationships depending on their business model.

If a bank with limited swaps activities could no longer afford to engage in swaps transactions, then it would not only increase costs and risk for its customers but also decrease the institution's ability to manage its own financial risk. It would also place these banks at a competitive disadvantage relative to larger financial entities. The result would be reduced credit options, which would adversely affect small businesses—and many other entities—at precisely the time when we need them to serve as an engine for economic growth and job creation.

II. All Common Lending Practices Should Be Included in the Exemption from the Swap Dealer Definition for Swaps Entered Into in Connection With Originating a Loan

The Dodd-Frank Act exempts banks and other insured depository institutions from the definition of swap dealer if they enter into "a swap with a customer in connection with originating a loan to that customer." Banks commonly enter into swaps with customers so that customers can hedge their interest rate or loan-related risks.

The joint CFTC and SEC rule proposal on the swap dealer definition asks for comment on whether this exemption should be limited to a swap entered into contemporaneously with the loan. ***Limiting the exemption to swaps and loans entered into at the same time would be too narrow and would not capture common swap transactions used to hedge and mitigate loan-related risks.*** While some swaps are entered into simultaneously with loans, many swaps are entered into before or after a loan is made. For example, it is common for a customer to enter into a swap to lock in an interest rate in anticipation of a future loan. If a loan has a variable interest rate, it is also common for a customer to enter into a swap during the course of the loan to convert to fixed-rate payment obligations. A loan and swap may also be purchased by another lender or they may be assigned and novated if the lender stops lending. These are common loan transactions and should be exempt from the swap dealer definition.

If these common lending practices are not taken into consideration, a bank that is not excluded from the swap dealer definition would have to create a separate entity to conduct swaps activities, because swap dealers are ineligible for "Federal assistance," including FDIC insurance. Forming an affiliate to continue engaging in swaps would be expensive and require additional regulatory capital, so it would not be an option for most banks, particularly small ones. Instead, most banks would likely stop using swaps in connection with originating loans, ***which would raise costs for borrowers and discourage banks from making certain types of loans that are common today.***

Lending and financial risk management are vital to our economic stability and growth. Accordingly, the exemption from the swap dealer definition for swaps entered into in connection with originating a loan should be broad enough to ensure that banks are not hindered from engaging in common loan-related hedging transactions.

III. End-Users—Including Banks with Limited Swaps Activities—Should Not Be Subject to Margin Requirements

The Dodd-Frank Act mandates that the prudential regulators, CFTC, and SEC impose margin requirements on swap entities engaging in uncleared swaps transactions. Fortunately, the statute does not require regulators to impose the margin

requirements on end-users that use swaps to hedge or mitigate commercial risk. Indeed, the CFTC has issued a rule proposal that would not impose margin on end-users, but rather would allow end-users to continue negotiating any collateral and margin on loans and swaps and even to continue participating in unsecured loans and swaps. This is consistent with the clearing exception for end-users, which was intended to ensure that end-users can continue to hedge market risk without incurring burdensome costs.

The prudential banking regulators and the CFTC recently issued rule proposals that acknowledge that swaps with non-financial entities pose less risk to swap entities and the U.S. financial system than swaps with other types of entities. Even so, the prudential regulators' proposed margin rule would impose margin requirements on end-users ***despite a finding that they pose minimal risk.*** We believe that the CFTC's decision not to impose margin requirements on non-financial end-users that use swaps to hedge or mitigate commercial risk is more consistent with statutory language and intent.

As we note above, ***banks with limited swaps activities are end-users*** and use swaps to hedge interest rate risk on their balance sheet or loan exposure just as other end-users do to hedge or mitigate risk from their ordinary business activities. Adding both initial and variation margin requirements would make engaging in swaps prohibitive for banks with limited swaps activities just as requiring clearing would. If regulators do impose margin on bank end-users, then they should not impose any initial margin requirements but rather require only mark-to-market margin on any collateral agreed upon by the swap counterparties.

Regulators should take into account current market practice in establishing margin requirements and should allow all end-users—including banks with limited swaps activities—to continue to negotiate any collateral or margin terms for uncleared swaps.

Conclusion

ABA member banks use swaps to mitigate the risks of their ordinary business activities, just like their business counterparts. Banks that engage in swaps transactions that are substantially similar to the types of transactions used by other businesses should be included in the definition of "end-user" and exempted from clearing and margin requirements. Not doing so would make it prohibitively expensive to engage in these ordinary business activities and restrict banks from making certain types of loans at a time when lending is most needed.

SUBMITTED QUESTIONS

Response from Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission

Submitted Questions by Hon. Eric A. "Rick" Crawford, a Representative in Congress from Arkansas

Question 1. Many market participants have express concern that the current proposed rules related to the definition of "swap dealer" appear to cast a very wide net and will potentially capture a large number of institutions not generally recognized as "swap dealers" in the market. How is the Commission intending to address this concern?

Answer. In December 2010, the CFTC (jointly with the SEC) issued a proposed rulemaking to further define the term "swap dealer." The proposal noted that the Dodd-Frank Act defines a swap dealer in terms of whether a person engages in certain types of activities involving swaps. Specifically, the statutory definition encompasses an entity that holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties as an ordinary course of business for its own account, or is commonly known in the trade as a dealer or market maker in swaps.

The Dodd-Frank Act directs that the Commission exempt from the definition any entity that engages in a *de minimis* quantity of swap dealing. The proposed joint rule included a description of the factors and thresholds proposed to be used for determining the *de minimis* exemption to the swap dealer definition, and specifically requested that the public provide comments. Many commenters that responded to the proposal addressed the factors and thresholds that should be applied, as well as the application of the swap dealer definition. After taking the public's comments into account, the final rule will address the factors and thresholds for the *de minimis* exemption and the application of the swap dealer definition to affected entities.

To date, there are more than 200 comments responding to the proposal. Many of the commenters addressed one or more prongs of the statutory definition of the term

"swap dealer," and discussed why the swap dealer definition should or should not encompass particular types of entities. The particular characteristics and activities that would require an entity to register as a swap dealer will be addressed in the final rulemaking relating to the swap dealer definition, after taking the comments into account.

Question 2. Also related to the definition of swap dealer, does the Commission intend to increase the scope of the "insured depository institution" exception to the swap dealer definition to ensure that the exception relates not just to transactions executed with the Bank's lending clients, but to transactions (executed with dealers in the market) which in turn hedge those client transactions?

Answer. The Dodd-Frank Act's definition of the term "swap dealer" provides that an insured depository institution is not to be considered a swap dealer to the extent if offers to enter into a swap with a customer in connection with originating a loan with that customer. The proposed rulemaking issued in December 2010 by the CFTC (jointly with the SEC) to further define the term "swap dealer" included a discussion of this exception. To date, there are more than 200 comments responding to the proposal, including comments regarding this exception. Some commenters addressed the issue of which types of transactions should be covered by the exception. The scope and interpretation of the statute's provisions will be addressed in the final rulemaking relating to the swap dealer definition, after taking the comments into account.

Question 3. To the extent that the rule relating to swap dealers remains broadly drafted, and given the relative lack of resources, the need to outsource technology and to secure vendors which will be required for implementation, will the Commission address concerns raised by smaller swap dealers to allow for phased-in implementation for these smaller swap dealers?

Answer. On September 8, 2011, the CFTC approved proposed rules that would establish a schedule to phase-in swap transaction compliance with the trade documentation, margin, clearing, and trade execution requirements. The proposed rules would provide swap dealers with at least an additional 90 days to come into compliance with these requirements. The CFTC is currently accepting comments on this phased implementation schedule, including whether the timeframes that it has proposed are appropriate.

Question 4. The execution of swap transactions by small businesses that may not qualify as "eligible contract participants" is an important aspect of these small businesses' risk management strategy. Does the Commission intend to clarify that the "line of business" exemption will continue in effect under the new DFA rules?

Answer. The proposed rulemaking on entity definitions issued in December 2010 by the CFTC (jointly with the SEC) included a proposal to further define the term "eligible contract participant" (ECP). The proposal requested comment on whether any additional categories of ECPs should be added to the statutory definition of the term, specifically including "firms using swaps as hedges pursuant to the terms of the CFTC's Swap Policy Statement." To date, there are more than 200 comments responding to the proposal, including comments regarding the ECP definition. Some of those comments suggested that the CFTC and SEC should define an ECP to encompass the "line of business" provision that was a part of the CFTC's Swap Policy Statement. The question of whether the ECP definition should incorporate a "line of business" element will be addressed in the final rulemaking relating to this definition, after taking the comments into account.

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