

**HEARING TO REVIEW LEGISLATIVE
PROPOSALS AMENDING TITLE VII OF
THE DODD-FRANK WALL STREET REFORM
AND CONSUMER PROTECTION ACT**

HEARING
BEFORE THE
COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

OCTOBER 12, 2011

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**HEARING TO REVIEW LEGISLATIVE
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AND CONSUMER PROTECTION ACT**

WEDNESDAY, OCTOBER 12, 2011

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

The Committee met, pursuant to call, at 10:08 a.m., in Room 1300 of the Longworth House Office Building, Hon. Frank D. Lucas [Chairman of the Committee] presiding.

Members present: Representatives Lucas, Goodlatte, Johnson, Neugebauer, Conaway, Schmidt, Stutzman, Gibbs, Austin Scott of Georgia, Tipton, Crawford, Gibson, Hultgren, Hartzler, Schilling, Ribble, Noem, Peterson, Holden, McIntyre, Boswell, Baca, David Scott of Georgia, Costa, Schrader, Owens, Courtney, Fudge, Sewell and McGovern.

Staff present: Tamara Hinton, Kevin Kramp, Josh Mathis, Ryan McKee, Nicole Scott, Debbie Smith, Heather Vaughan, Suzanne Watson, Liz Friedlander, C. Clark Ogilvie, Anne Simmons, John Konya, and Caleb Crosswhite.

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

The CHAIRMAN. This hearing of the Committee on Agriculture to review legislative proposals amending Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act will come to order.

I want to thank all of you for joining us today and to our witnesses, each of whom traveled to appear before our Committee, and I would like to thank the many Members of this Committee on both sides of the aisle who have worked so hard in preparing legislation for us to consider today.

This is the seventh hearing we have had regarding Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We have heard from over 30 market participants from a wide range of organizations. In the course of those seven hearings, we have gathered a good deal of information on how the implementation of Dodd-Frank is affecting businesses across the country. We have heard that some regulations may impose significant costs that aren't being accounted for by the CFTC. We have heard that Congressional intent on many proposals including margin exemptions for end-users has not been adhered to. We have heard confusion

about the order of regulations being proposed and concern about the scope of the regulatory definitions, and most importantly, we have heard from businesses that are concerned that some Dodd-Frank regulations will actually inhibit their ability to manage risk. That runs contrary to the purpose of Dodd-Frank, which was to increase stability and transparency in our financial markets. So today we will consider seven legislative proposals aimed at fixing some important areas in implementation where the regulators, my friends at CFTC in particular, simply haven't gotten it right.

Now, none of these bills propose dramatic changes to Dodd-Frank. They are aimed at ensuring that the regulators don't implement rules that conflict with, or are contrary, to what Congress intended. They do not undermine reform and they are not efforts to repeal Dodd-Frank. They are intended to restore the balance that I believe can exist between sound regulation and a healthy economy.

Some may say that looking at legislative remedies is premature, that we should wait until the rules are finalized and let the regulators improve upon the proposed rules. It is my sincere hope that the rules improve. It is my hope that the agencies will listen to the comments that have been filed and to the feedback they have gotten from market participants and from Congress. But with unemployment stuck at nine percent, I am not willing to just stand by and keep my fingers crossed, so to speak, that the flaws in the proposed rules will be fixed. We are facing widespread and potentially severe unintended consequences from these regulations, and that will potentially have a dire effect on our economic recovery. When the rules are final, let us face it, they are final, and businesses across the country including farmers and ranchers need to prepare for the new regulations and related costs now. They will not be able to wait for Congress to act.

I would also note that we will consider three discussion drafts today. I welcome and encourage feedback from our witnesses and Members on this Committee about ways in which we can and should improve upon these proposals. They are aimed at making sure that an overly broad *swap dealer* definition doesn't encumber our energy and ag sectors, that our pensions and government entities do not face prohibitive burdens when accessing swap markets, and that small financial institutions and farm credit banks can continue to pair credit with risk-mitigating tools. All of these proposals aim to keep capital in the hands of businesses that we need to lead our economic recovery.

Thank you again for coming here today. I look forward to hearing from our witnesses.

[The prepared statement of Mr. Lucas follows:]

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

Thank you for joining us today, and to our witnesses, each of whom traveled to appear before our Committee.

I'd also like to thank the many Members of this Committee—on both sides of the aisle—who have worked so hard in preparing legislation for us to consider today.

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In the course of those seven hearings, we've gathered a good deal of information on how the implementation of the Dodd-Frank Act is affecting businesses across the country.

We've heard that some regulations may impose significant costs that aren't being accounted for by the CFTC.

We've heard that Congressional intent on many proposals, including a margin exemption for end-users, has not been adhered to.

We've heard confusion about the order of regulations being proposed and concern about the scope of regulatory definitions.

And most importantly, we've heard from businesses that are concerned that some Dodd-Frank regulations will actually inhibit their ability to manage risk.

That runs counter to the purpose of Dodd-Frank, which was to increase stability and transparency in our financial markets.

So today, we will consider seven legislative proposals aimed at fixing some important areas in implementation where the regulators—the CFTC in particular—simply haven't gotten it right.

None of these bills propose dramatic changes to Dodd-Frank. They are aimed at ensuring that the regulators don't implement rules that conflict with, or are contrary to, what Congress intended.

They do not undermine reform, and they are not efforts to repeal Dodd-Frank.

They are intended to restore the balance that I believe can exist between sound regulation and a healthy economy.

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It is my sincere hope the rules improve. It is my hope that the agencies will listen to the comments that have been filed, and to the feedback they've gotten from market participants and from Congress.

But with unemployment stuck at nine percent, I'm not willing to just stand by and keep my fingers crossed that the flaws in the proposed rules will be fixed.

We are facing widespread and potentially severe unintended consequences from these regulations, that will have a direct effect on our economic recovery.

When the rules are final, they're final. And businesses across the country, including our farmers and ranchers, need to prepare for the new regulations and related costs now. They will not be able to wait for Congress to act.

I'd also note that we will consider three discussion drafts today. I welcome and encourage feedback from our witnesses and the Members on this Committee about ways in which we can and should improve upon these proposals.

They are aimed at making sure that an overly broad swap dealer definition doesn't encumber our energy and agriculture sectors, that our pensions and government entities do not face prohibitive burdens when accessing swaps markets, and that small financial institutions and farm credit banks can continue to pair credit with risk mitigating tools.

All of these proposals aim to keep capital in the hands of the businesses we need to lead our economic recovery.

Thank you again for being here today, and I look forward to hearing from our witnesses.

LEGISLATION

H.R. 1840, To improve consideration by the Commodity Futures Trading Commission of the costs and benefits of its regulations and orders.

I

112TH CONGRESS
1ST SESSION

H. R. 1840

To improve consideration by the Commodity Futures Trading Commission of the costs and benefits of its regulations and orders.

IN THE HOUSE OF REPRESENTATIVES

MAY 11, 2011

Mr. CONAWAY (for himself, Mr. QUIGLEY, Mr. MCHENRY, Mr. BOSWELL, and Mr. NEUGEBAUER) introduced the following bill; which was referred to the Committee on Agriculture

A BILL

To improve consideration by the Commodity Futures Trading Commission of the costs and benefits of its regulations and orders.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. CONSIDERATION BY THE COMMODITY FU-**
4 **TURES TRADING COMMISSION OF THE COSTS**
5 **AND BENEFITS OF ITS REGULATIONS AND**
6 **ORDERS.**

7 Section 15(a) of the Commodity Exchange Act (7
8 U.S.C. 19(a)) is amended by striking paragraphs (1) and
9 (2) and inserting the following:

1 “(1) IN GENERAL.—Before promulgating a reg-
2 ulation under this Act or issuing an order (except as
3 provided in paragraph (3)), the Commission,
4 through the Office of the Chief Economist, shall as-
5 sess the costs and benefits, both qualitative and
6 quantitative, of the intended regulation and propose
7 or adopt a regulation only on a reasoned determina-
8 tion that the benefits of the intended regulation jus-
9 tify the costs of the intended regulation (recognizing
10 that some benefits and costs are difficult to quan-
11 tify). It must measure, and seek to improve, the ac-
12 tual results of regulatory requirements.

13 “(2) CONSIDERATIONS.—In making a reasoned
14 determination of the costs and the benefits, the
15 Commission shall evaluate—

16 “(A) considerations of protection of market
17 participants and the public;

18 “(B) considerations of the efficiency, com-
19 petitiveness, and financial integrity of futures
20 and swaps markets;

21 “(C) considerations of the impact on mar-
22 ket liquidity in the futures and swaps markets;

23 “(D) considerations of price discovery;

24 “(E) considerations of sound risk manage-
25 ment practices;

1 “(F) available alternatives to direct regula-
2 tion;

3 “(G) the degree and nature of the risks
4 posed by various activities within the scope of
5 its jurisdiction;

6 “(H) whether, consistent with obtaining
7 regulatory objectives, the regulation is tailored
8 to impose the least burden on society, including
9 market participants, individuals, businesses of
10 differing sizes, and other entities (including
11 small communities and governmental entities),
12 taking into account, to the extent practicable,
13 the cumulative costs of regulations;

14 “(I) whether the regulation is inconsistent,
15 incompatible, or duplicative of other Federal
16 regulations;

17 “(J) whether, in choosing among alter-
18 native regulatory approaches, those approaches
19 maximize net benefits (including potential eco-
20 nomic, environmental, and other benefits, dis-
21 tributive impacts, and equity); and

22 “(K) other public interest considerations.”.

○

H.R. 2586, Swap Execution Facility Clarification Act

I

112TH CONGRESS
1ST SESSION**H. R. 2586**

To refine the definition of swap execution facility in the provisions regulating swap markets added by title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

IN THE HOUSE OF REPRESENTATIVES

JULY 19, 2011

Mr. GARRETT (for himself, Mrs. MALONEY, Mr. HURT, and Mr. MEEKS) introduced the following bill; which was referred to the Committee on Financial Services, and in addition to the Committee on Agriculture, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

A BILL

To refine the definition of swap execution facility in the provisions regulating swap markets added by title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Swap Execution Facil-
5 ity Clarification Act”.

1 **SEC. 2. DEFINITION OF SWAP EXECUTION FACILITY.**

2 (a) COMMODITY EXCHANGE ACT.—Section 1a(50) of
3 the Commodity Exchange Act (7 U.S.C. 1a(50)) is amend-
4 ed—

5 (1) by striking “The term” and inserting the
6 following:

7 “(A) IN GENERAL.—The term”;

8 (2) by redesignating subparagraphs (A) and
9 (B) as clauses (i) and (ii), respectively; and

10 (3) by adding at the end the following:

11 “(B) INTERPRETATION.—In interpreting
12 or further defining the term ‘swap execution fa-
13 cility’, the Commission shall not require a swap
14 execution facility to—

15 “(i) have a minimum number of par-
16 ticipants receive a bid or offer or respond
17 to any trading system or platform
18 functionality;

19 “(ii) display or delay bids or offers for
20 any period of time;

21 “(iii) limit the means of interstate
22 commerce utilized by market participants
23 to enter into and execute any swap trans-
24 actions on the trading system or platform;

25 or

1 “(iv) require bids or offers on one
2 trading system or platform operated by the
3 swap execution facility to interact with
4 bids or offers on another trading system or
5 platform operated by the swap execution
6 facility”.

7 (b) SECURITIES EXCHANGE ACT OF 1934.—Section
8 3(a)(77) of the Securities Exchange Act of 1934 (15
9 U.S.C. 78c(a)(77)) is amended—

10 (1) by striking “The term” and inserting the
11 following:

12 “(A) IN GENERAL.—The term”;

13 (2) by redesignating subparagraphs (A) and
14 (B) as clauses (i) and (ii), respectively; and

15 (3) by adding at the end the following:

16 “(B) INTERPRETATION.—In interpreting
17 or further defining the term ‘security-based
18 swap execution facility’, the Commission shall
19 not require a security-based swap execution fa-
20 cility to—

21 “(i) have a minimum number of par-
22 ticipants receive a bid or offer or respond
23 to any trading system or platform
24 functionality;

1 “(ii) display or delay bids or offers for
2 any period of time;

3 “(iii) limit the means of interstate
4 commerce utilized by market participants
5 to enter into and execute any security-
6 based swap transactions on the trading
7 system or platform; or

8 “(iv) require bids or offers on one
9 trading system or platform operated by the
10 swap execution facility to interact with
11 bids or offers on another trading system or
12 platform operated by the swap execution
13 facility.”.

○

112TH CONGRESS
1ST SESSION

H. R. 2682

To provide end user exemptions from certain provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JULY 28, 2011

Mr. GRIMM (for himself, Mr. PETERS, Mr. AUSTIN SCOTT of Georgia, and Mr. OWENS) introduced the following bill; which was referred to the Committee on Financial Services, and in addition to the Committee on Agriculture, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

A BILL

To provide end user exemptions from certain provisions of the Commodity Exchange Act and the Securities Exchange Act of 1934, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Business Risk Mitiga-
5 tion and Price Stabilization Act of 2011”.

1 **SEC. 2. MARGIN REQUIREMENTS.**

2 (a) COMMODITY EXCHANGE ACT AMENDMENT.—
3 Section 4s(e) of the Commodity Exchange Act (7 U.S.C.
4 6s(e)), as added by section 731 of the Dodd-Frank Wall
5 Street Reform and Consumer Protection Act, is amended
6 by adding at the end the following new paragraph:

7 “(4) APPLICABILITY WITH RESPECT TO
8 COUNTERPARTIES.—The requirements of paragraphs
9 (2)(A)(ii) and (2)(B)(ii) shall not apply to a swap in
10 which one of the counterparties to the swap is not
11 a financial entity as described in section 2(h)(7)(C),
12 and such counterparty is eligible for the exception
13 under section 2(h)(7)(A).”.

14 (b) SECURITIES EXCHANGE ACT AMENDMENT.—
15 Section 15F(e) of the Securities Exchange Act of 1934
16 (15 U.S.C. 78o–10(e)), as added by section 764(a) of the
17 Dodd-Frank Wall Street Reform and Consumer Protec-
18 tion Act, is amended by adding at the end the following
19 new paragraph:

20 “(4) APPLICABILITY WITH RESPECT TO
21 COUNTERPARTIES.—The requirements of paragraphs
22 (2)(A)(ii) and (2)(B)(ii) shall not apply to a secu-
23 rity-based swap in which one of the counterparties
24 to the security-based swap is not a financial entity
25 as described in section 3C(g)(3), and such

1 counterparty is eligible for the exception under sec-
2 tion 3C(g)(1).”.

•HR 2682 IH



H.R. 2779, To exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

I

112TH CONGRESS
1ST SESSION

H. R. 2779

To exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

IN THE HOUSE OF REPRESENTATIVES

AUGUST 1, 2011

Mr. STIVERS (for himself and Ms. FUDGE) introduced the following bill; which was referred to the Committee on Financial Services, and in addition to the Committee on Agriculture, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

A BILL

To exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. TREATMENT OF AFFILIATE TRANSACTIONS.**

4 (a) COMMODITY EXCHANGE ACT AMENDMENTS.—
5 Section 1a(47) of the Commodity Exchange Act (7 U.S.C.
6 1(a)(47)), as added by section 721(a)(21) of the Dodd-
7 Frank Wall Street Reform and Consumer Protection Act,
8 is amended by adding at the end the following:

1 “(G) TREATMENT OF AFFILIATE TRANS-
2 ACTIONS.—

3 “(i) IN GENERAL.—The term ‘swap’
4 does not include any agreement, contract,
5 or transaction that—

6 “(I) would otherwise be included
7 as a ‘swap’ under subparagraph (A);
8 and

9 “(II) is entered into by a party
10 that is controlling, controlled by, or
11 under common control with its
12 counterparty.

13 “(ii) REPORTING.—All agreements,
14 contracts, or transactions described in
15 clause (i) shall be reported to either a
16 swap data repository, or, if there is no
17 swap data repository that would accept
18 such swaps, to the Commission pursuant
19 to section 4r within such time period as
20 the Commission may by rule or regulation
21 prescribe.”.

22 (b) SECURITIES EXCHANGE ACT OF 1934 AMEND-
23 MENTS.—Section 3(a)(68) of the Securities Exchange Act
24 of 1934 (15 U.S.C. 78c(3)(a)(68)), as added by section
25 761(a)(6) of the Dodd-Frank Wall Street Reform and

1 Consumer Protection Act, is amended by adding at the
2 end the following:

3 “(F) TREATMENT OF AFFILIATE TRANS-
4 ACTIONS.—

5 “(i) IN GENERAL.—The term ‘secu-
6 rity-based swap’ does not include any
7 agreement, contract, or transaction that—

8 “(I) would otherwise be included
9 as a ‘security-based swap’ under sub-
10 paragraph (A); and

11 “(II) is entered into by a party
12 that is controlling, controlled by, or
13 under common control with its
14 counterparty.

15 “(ii) REPORTING.—All agreements,
16 contracts, or transactions described in
17 clause (i) shall be reported to either a se-
18 curity-based swap data repository, or, if
19 there is no security-based swap data repos-
20 itory that would accept such security-based
21 swaps, to the Commission pursuant to sec-
22 tion 13A within such time period as the
23 Commission may by rule or regulation pre-
24 scribe.”.

○

DRAFT LEGISLATION

H.R. ____, Pension Plan Risk Reduction Act of 2011

.....
(Original Signature of Member)

112TH CONGRESS
1ST SESSION

H. R. _____

To . . .

IN THE HOUSE OF REPRESENTATIVES

A BILL

To . . .

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Pension Plan Risk Re-
5 duction Act of 2011”.

6 **SEC. 2. CLARIFICATION OF THE DEFINITION OF FIDU-**
7 **CIARY.**

8 (a) IN GENERAL.—Section 3(21) of the Employee
9 Retirement Income Security Act of 1974 (29 U.S.C.
10 1002(21)) is amended by adding at the end the following:

1 “(C) No person in his capacity as a swap dealer or
2 major swap participant referred to in section 4s(h)(5)(A)
3 of the Commodity Exchange Act or a security-based swap
4 dealer or major security-based swap participant referred
5 to in section 15F(h)(5)(A) of the Securities Exchange Act
6 of 1934 shall be a fiduciary with respect to a plan solely
7 by reason of any service, act, or duty that such person
8 is required to perform with respect to such plan by reason
9 of section 4s(h) of the Commodity Exchange Act, section
10 15F(h) of the Securities Exchange Act of 1934, or any
11 rule, regulation, or standard prescribed pursuant to such
12 sections.”.

13 (b) CONFORMING AMENDMENT.—Section 3(21)(A) of
14 such Act (29 U.S.C. 1002(21)(A)) is amended by striking
15 “subparagraph (B)” and inserting “subparagraphs (B)
16 and (C)”.

17 **SEC. 3. CLARIFICATION OF DEFINITION OF ADVISOR.**

18 (a) AMENDMENT TO CEA.—Section 4s(h)(4) of the
19 Commodity Exchange Act (7 U.S.C. 6s(h)(4)) is amended
20 by adding at the end the following:

21 “(D) ADVISOR.—For purposes of this sub-
22 section, a swap dealer or major swap partici-
23 pant shall not be treated as acting as an advi-
24 sor to a Special Entity with respect to a swap
25 if the swap dealer or major swap participant

1 represents in writing to the Special Entity that
2 the swap dealer or major swap participant is
3 acting solely as a counterparty, and is not act-
4 ing as an advisor to the Special Entity, with re-
5 spect to the swap.”.

6 (b) AMENDMENT TO 1934 ACT.—Section 15F(h)(4)
7 of the Securities Exchange Act of 1934 (15 U.S.C. 78o-
8 10(h)(4)) is amended by adding at the end the following:

9 “(D) ADVISOR.—For purposes of this sub-
10 section, a security-based swap dealer or major
11 security-based swap participant shall not be
12 treated as acting as an advisor to a special enti-
13 ty with respect to a security-based swap if the
14 security-based swap dealer or major security-
15 based swap participant represents in writing to
16 the special entity that the security-based swap
17 dealer or major security-based swap participant
18 is acting solely as a counterparty, and is not
19 acting as an advisor to the special entity, with
20 respect to the security-based swap.”.

21 **SEC. 4. COUNTERPARTY REQUIREMENTS.**

22 (a) AMENDMENT TO CEA.—Section 4s(h)(5)(A)(i) of
23 the Commodity Exchange Act (7 U.S.C. 6s(h)(5)(A)(i))
24 is amended to read as follows:

1 “(VII) in the case of employee
2 benefit plans, is a fiduciary as defined
3 in section 3 of that Act (29 U.S.C.
4 1002), except that, in such case, sub-
5 clauses (I) through (VI) shall not
6 apply and any duty established pursu-
7 ant to this clause shall be satisfied by
8 the receipt by a swap dealer or a
9 major swap participant of a written
10 representation from the Special Entity
11 or a representative of the Special En-
12 tity that the Special Entity has a rep-
13 resentative that is a fiduciary (as de-
14 fined in section 3 of that Act) with re-
15 spect to the swap; and”.

16 (b) AMENDMENT TO 1934 ACT.—Section
17 15F(h)(5)(A)(i)(VII) of the Securities Exchange Act of
18 1934 (15 U.S.C. 78o-10(h)(5)(A)(i)(VII)) is amended to
19 read as follows:

20 “(VII) in the case of employee
21 benefit plans subject to the Employee
22 Retirement Income Security Act of
23 1974, is a fiduciary as defined in sec-
24 tion 3 of that Act (29 U.S.C. 1002),
25 except that, in such case, subclauses

1 (I) through (VI) shall not apply and
2 any duty established pursuant to this
3 clause shall be satisfied by the receipt
4 by a security-based swap dealer or a
5 major security-based swap participant
6 of a written representation from the
7 special entity or a representative of
8 such special entity that the special en-
9 tity has a representative that is a fi-
10 duciary (as defined in section 3 of
11 that Act) with respect to the security-
12 based swap; and”.

13 **SEC. 5. INDEPENDENT ADVISORS.**

14 Section 4s(h)(5) of the Commodity Exchange Act (7
15 U.S.C. 6s(h)(5)) is amended—

16 (1) in subparagraph (A), by striking “; and” at
17 the end and inserting a period;

18 (2) in subparagraph (B), by striking “the” the
19 1st place it appears and inserting “The”; and

20 (3) by redesignating subparagraph (B) as (C)
21 and inserting after subparagraph (A) the following:

22 “(B) For purposes of the requirement that
23 a swap dealer or major swap participant deter-
24 mine that a Special Entity has a qualified inde-
25 pendent representative, an employee of the Spe-

1 cial Entity may qualify as an independent rep-
2 resentative. In determining that a Special Enti-
3 ty has a qualified independent representative, a
4 swap dealer or major swap participant may rely
5 on a representation unless it knows that the
6 representation is not accurate.”.

7 **SEC. 6. EFFECTIVE DATE.**

8 (a) **IN GENERAL.**—The amendments made by sec-
9 tions 3 and 4 of this Act shall take effect as if included
10 in sections 731 and 764 of the Dodd-Frank Wall Street
11 Reform and Consumer Protection Act, respectively.

12 (b) **ERISA AMENDMENTS.**—The amendments made
13 by section 2 shall take effect as of the same date that
14 the amendments made by sections 3 and 4 take effect.

H.R. ____, **Small Business Credit Availability Act**

[DISCUSSION DRAFT]

112TH CONGRESS
1ST SESSION

H. R. _____

To ensure the exclusion of small lenders from certain regulations of the
Dodd-Frank Act.

IN THE HOUSE OF REPRESENTATIVES

Mrs. HARTZLER introduced the following bill; which was referred to the
Committee on _____

A BILL

To ensure the exclusion of small lenders from certain
regulations of the Dodd-Frank Act.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “: Small Business Cred-
5 it Availability Act”.

6 **SEC. 2. CLARIFICATION OF SWAP DEALER DEFINITION.**

7 Section 1a(49)(A) of the Commodity Exchange Act
8 (7 U.S.C. 1a(49)(A)) is amended by striking all that fol-
9 lows clause (iv) and inserting the following flush language:

1 “provided however, in no event shall an insured
2 depository institution or an institution char-
3 tered and operating under the Farm Credit Act
4 of 1971 be considered to be a swap dealer to
5 the extent that it enters into a swap—

6 “(I) with a customer that is seeking
7 to manage risk in connection with an ex-
8 tension of credit by the institution to, on
9 behalf of, or for the benefit of, the cus-
10 tomer; or

11 “(II) to offset the risks arising from
12 a swap that meets the requirement of sub-
13 clause (I).”.

14 **SEC. 3. EXCLUSIONS FROM FINANCIAL ENTITY DEFINITION.**

15 Section 2(h)(7)(C)(ii) of the Commodity Exchange
16 Act (7 U.S.C. 2(h)(7)(C)(ii)) is amended to read as fol-
17 lows:

18 “(ii) EXCLUSION.—Such definition
19 shall not include an entity that is a small
20 bank, savings association, farm credit sys-
21 tem institution, or credit union if—

22 “(I) the total assets of the entity
23 are \$30,000,000,000 or less; or

24 “(II) the aggregate
25 uncollateralized outward exposure plus

1 aggregate potential outward exposure
2 of the entity with respect to its swaps
3 does not exceed \$1,000,000,000.”.

4 **SEC. 4. EFFECTIVE DATE.**

5 The amendments made by this Act shall take effect
6 as if they had been included in subtitle A of title VII of
7 the Dodd-Frank Wall Street Reform and Consumer Pro-
8 tection Act.

H.R. _____, To amend the Commodity Exchange Act to clarify the definition of swap dealer.

[DISCUSSION DRAFT]

112TH CONGRESS
1ST SESSION

H. R. _____

To amend the Commodity Exchange Act to clarify the definition of swap dealer.

IN THE HOUSE OF REPRESENTATIVES

M. _____ introduced the following bill; which was referred to the Committee on _____

A BILL

To amend the Commodity Exchange Act to clarify the definition of swap dealer.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. CLARIFICATION OF THE DEFINITION OF SWAP**
4 **DEALER.**

5 Section 1a(49) of the Commodity Exchange Act (7
6 U.S.C. 1a(49)) is amended to read as follows:

7 “(49) SWAP DEALER.—

1 “(A) IN GENERAL.—The term ‘swap deal-
2 er’ means any person who is engaged in the
3 business of entering into swaps, and—

4 “(i) holds itself out as a dealer in
5 swaps;

6 “(ii) makes a market in swaps; or

7 “(iii) engages in any activity causing
8 the person to be commonly known as a
9 dealer or market maker in swaps,

10 provided however, in no event shall an insured
11 depository institution be considered to be a
12 swap dealer to the extent it offers to enter into
13 a swap with a customer in connection with orig-
14 inating a loan to the customer.

15 “(B) INCLUSION.—A person may be des-
16 ignated as a swap dealer for a single type or
17 single class or category of swap or activities and
18 considered not to be a swap dealer for other
19 types, classes, or categories of swaps or activi-
20 ties.

21 “(C) EXCEPTION.—The term ‘swap dealer’
22 does not include a person that enters into swap
23 transactions for the person’s own account—

24 “(i) for the purpose of hedging or
25 mitigating commercial risk or otherwise

1 achieving the person's own trading or in-
2 vestment objectives; or

3 "(ii) ancillary to the person's regular
4 business as a producer, processor, or com-
5 mercial user of, or a merchant handling, a
6 commodity (other than an excluded com-
7 modity) or the products or by-products
8 thereof.

9 "(D) DE MINIMIS EXCEPTION.—The Com-
10 mission shall exempt from designation as a
11 swap dealer an entity that engages in swap
12 dealing transactions with or on behalf of the
13 person's customers if the average aggregate
14 gross notional amount of outstanding swap
15 transactions of the entity over the course of the
16 preceding calendar year does not exceed
17 \$3,000,000,000 (or such greater amount as the
18 Commission may establish as market conditions
19 warrant), multiplied by the sum of 1 and the
20 percentage (if any) by which the Consumer
21 Price Index for all Urban Customers published
22 by the Bureau of Labor Statistics of the De-
23 partment of Labor changed for the 12-month
24 period ending the preceding April 30."

The CHAIRMAN. And now I turn to the Ranking Member, the outstanding gentleman from Minnesota, for any comments he may have.

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

Mr. PETERSON. Thank you, Mr. Chairman, and thank you for calling this hearing.

You know, we hear a lot of talk about concern that we need to see the big picture and we need to have certainty with these regulations and so forth. But, I would argue that what we are doing here to some extent is actually adding to the uncertainty and not necessarily focusing on what the real problems are. I understand that the House needs to move but the reality is that these bills are not going anywhere in the Senate. I think they just muddy the water, and frankly, some of the bills don't fix the problems that are some of the most significant problems that are not being caused by the CFTC, they are actually being caused by the Prudential Regulators. For example, the end-user issue which we tried to address in the bill and tried to make sure that end-users were not going to be subject to cash margins, the reason there is a cash margin issue is not because of the CFTC, it is because of the Prudential Regulators who are requiring their banks to have cash margins in the rules that they have adopted, which this Committee has no jurisdiction over. I am also told that apparently the Prudential Regulators have the authority to do this and had the authority prior to the passage of Dodd-Frank. So even if we repeal Dodd-Frank, the Prudential Regulators would have the authority to require the banks to have cash margin requirements on their counterparties.

So one of the questions I have is, we have had seven hearings but we have not had the Prudential Regulators in and we have not had the SEC in in those seven hearings. Now, when I was Chairman, we had them in because they are part of the issue here. You know, the other thing that happened in Dodd-Frank is there was an agreement that they were going to work together, and I would argue that part of the challenge that they are having at the CFTC is trying to work in conjunction with the SEC. The SEC is still largely a dysfunctional agency that is operating 50 years ago with a rules-based regulatory system that is never going to keep pace with what is going on today in the financial community.

So I would ask you, Mr. Chairman, to consider holding a hearing where we get the Prudential Regulators in and the SEC and the CFTC so we can talk about the problems that are being caused by trying to harmonize these rules. Now, we also have a situation where they are trying to harmonize these rules with Europe, which is an even bigger challenge, and that is entering into all of this stuff.

Some of these bills are focused on issues that I am concerned about. I am not sure they are going to fix the problem. You know, we have problems being put on this country by what is going on in Europe, which is a mystery to me. It looks like a setup deal going on there. The entire economy of Greece is \$260 billion. There is no way that the economy of Greece is going to take down this financial market by itself. And now, where we have had these dire

warnings that the whole world is going to collapse because of Greece, it looks to me like they are trying to force Europe into a TARP kind of a deal, a panic kind of a deal similar to what happened in the United States. Yesterday when probably the most significant item that happened was when Slovakia voted down the deal in Europe—where is it? On the Internet this morning it is in the business section, the third one down. So why is it that Greece is the lead story every time but all of a sudden we are going to bury the thing that is actually the problem? I mean, I just wonder what the heck is going on here.

So these bills, the first bill that is here, this cost-benefit analysis by Mr. Conaway, I think it is a good bill. It codifies the Executive Order. But I have a bill, H.R. 3010, that I am a cosponsor of that actually goes much further, that is comprehensive, that doesn't just do it in the CFTC but does it in the whole government. We have other bills here that are trying to fix some of these definitions that are not finalized at this point. We have a bill on inter-affiliate swaps that appears to me would give the Wall Street guys a way to set up subsidiaries to get around these rules.

So my point is, we just have to be careful about what we are doing here. I think we are sending signals out there—I have had people in my office that think that somehow or another this is all going to happen. I don't think any of this stuff is going to happen in the Senate.

So I would just encourage this Committee to take a step back, take a look at the big picture, get the folks, everybody in the room here that is involved in this. As I have said from the start, if there is a way to fix some of these problems that is within our jurisdiction and we can actually get done, I am all for it, but frankly, in a lot of cases, some of these bills will do more harm than good.

So with that tirade, I will 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. This is the seventh hearing this Committee has held concerning the Dodd-Frank Act. Today, we are hearing from witnesses regarding several bills that have been introduced or may be introduced or considered by this Committee to amend that law.

As I have said at previous hearings, I believe amending Dodd-Frank is premature. The Commodity Futures Trading Commission has not finalized many of the rules that concern the issues we are discussing today. We should wait to see the final rules and if the CFTC gets them right or wrong before acting. 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.

The Committee risks jeopardizing our credibility if we take a 'Chicken Little' approach and pass legislation to fix problems that fail to materialize.

That being said the Commission is on tap to vote on many of its proposed rules in the coming months. Therefore, I believe today's hearing is appropriate so the Committee may respond quickly should the CFTC ignore common sense and finalize a faulty rule.

The legislative proposals under discussion this morning attempt to address a wide range of fears expressed by market participants at our earlier hearings. Some of these legislative proposals might work, others may not fix the problem at all and still others would create regulatory loopholes for the Wall Street banks so large you could drive a combine through them.

I sympathize with the concerns we have already heard, and will hear yet again today, from our witnesses. These are not the folks who caused the 2008 financial

collapse and subsequent recession. However, if the so-called solutions to their concerns weaken the law to permit another financial catastrophe, they will not get my support.

Many of these legislative proposals attempt to address concerns that involve other regulators. For some reason, however, the Committee refuses to bring them in to testify. Our witnesses today will address the proposed margin rules by the Prudential Regulators, such as the Federal Reserve, but why haven't these regulators been brought before the Committee to answer our questions?

We will also hear concerns regarding the consistency of rules between regulators, particularly the CFTC and the SEC, and the definitions which must be developed jointly by the CFTC and the SEC. When is Mary Schapiro, the SEC Chairman, scheduled to testify about these matters?

In previous Congresses, we brought all the regulators before the Committee prior to moving on legislation that involved them. Why has the majority abandoned this practice?

I believe it is imperative that the Committee's next hearing on this topic bring together the CFTC, SEC and Prudential Regulators to testify and answer our questions before the Committee moves forward on these legislative proposals. To do otherwise would be legislative malpractice and a disservice not only to ourselves, but to the witnesses here today and from previous hearings who have understandable, if premature, concerns.

Ultimately, I believe the CFTC is taking its 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 the law could succeed. Time will ultimately tell, but I'm holding out hope.

I want to welcome our witnesses here today and with that Mr. Chairman, I yield back.

The CHAIRMAN. The Ranking Member yields back, and the chair has always appreciated the Ranking Member's insights.

With that, I would request that other Members submit their opening statements for the record so the witnesses may begin their testimony and to ensure that there is ample time for questions.

[The prepared statement of Mr. Owens and submitted letter of Mr. Stivers follow:]

PREPARED STATEMENT OF HON. WILLIAM L. OWENS, A REPRESENTATIVE IN CONGRESS FROM NEW YORK

I would like to thank Chairman Lucas and Ranking Member Peterson for their hard work on this issue. Over the last year, I have heard from many groups in my district that are concerned that the CFTC's proposed "swap dealer" definition would unfairly capture commercial energy companies, agricultural cooperatives and community banks, electric cooperatives and farm credit system institutions.

Congress included two exceptions from the "swap dealer" definition in Dodd-Frank that were intended to exclude these entities from falling into this regulatory category. The first exception relates to the entity's transacting in a dealing capacity "as a part of a regular business." In other words, because none of the witnesses here represent companies that engage in swap activity as their main or usual business, but rather use swaps to hedge their business risk, Congressional intent is clear—they should be exempt from these regulations. The second exception is the *de minimis* exception, which gives the CFTC broad discretion in determining which entities are exempt. Very few entities would qualify for the very low threshold in the proposal, which only exempts entities that engage in fewer than twenty swaps a year.

In July, 71 of my colleagues joined Congressman Conaway and me in sending a letter to Chairman Gensler asking for clarification of the Commission's proposal. The Chairman's response indicated that the Commission is "committed to implementing the statutory definition and closely following Congressional intent," but there was little explanation given regarding the discrepancies between the proposal and Congressional intent.

As a cosponsor of H.R. 2682, I believe this legislation is necessary to ensure that the CFTC implements the intent of Congress in exempting true end-users from derivatives regulations. If forced to comply with the increased requirements for posting capital and margin, reporting requirements, record keeping and other regulations, the services currently offered by end-users could become cost prohibitive, im-

peding their ability to conduct business, resulting in higher prices for my constituents, and diverting of capital that could otherwise be invested in their business and used to help create jobs.

These financial instruments are particularly important for dairy farmers in my district, who depend on their cooperatives for tools to manage price risk and lock in margins. For example, a dairy farmer might want to get a guaranteed price on future deliveries of milk from his co-op, but might be concerned that input costs for corn and soybean meal will fluctuate, cutting into expected returns. By purchasing a financially settled swap from their co-op, the dairy farmer can hedge his or her input costs, while receiving a guaranteed price for their milk. Without the co-op, the farmer would have to go to a futures exchange to hedge their input costs. The farmer would have to post margin and buy contracts that are larger than the volume of his feed needs and don't necessarily correspond with the farmer's monthly purchases. The co-op is able to aggregate the small contracts with its dairy farmers and then offset its exposure either in the futures market or with a more customized product in the swaps market.

The derivatives market needs to be better regulated and certain participants need to post margin to cover these trades. However, this legislation is needed to ensure that community banks, agricultural coops, energy utilities, community banks and other end-users can continue to hedge against risk. It is imperative that we move forward with this legislation and I respectfully request that the other Members of this Committee support this bipartisan effort.

SUBMITTED LETTER BY HON. STEVE STIVERS, A REPRESENTATIVE IN CONGRESS FROM OHIO

Dear Mr. Chairman:

I have introduced, along with our colleague Ms. Fudge, H.R. 2779, which is set for a legislative hearing in your Committee today. The purpose of this legislation is simple and straightforward. The Federal Government should not penalize companies of any size by over-charging them for the way in which they do business.

Regulators under Dodd-Frank were given broad authority to issue rules and regulations for reforming our nation's financial system, and there is a fear that those regulators will draft proposals that will decentralize the financial business model used by American corporations across the country and around the world.

Inter-affiliate swap contracts are an accounting method used to assign ownership to a contract which has been collateralized by another corporate affiliate which aggregates risk across multiple companies, thus providing a method for managing that risk more efficiently. Companies that establish financial service corporations for the purposes of aggregating risk do so because it allows them to centralize financial transactions and utilize the skills and knowledge of financial experts who manage complicated financial transactions every day.

Without this bill, the government could intrude into how businesses manage their finances by regulating even internal swaps transactions that do not create systemic risk. The legislation your Committee is discussing today provides an exemption for any swap contracts between two companies that are either in a parent-subsidiary relationship, or are under common control. In no way does it preclude the oversight or regulation of transactions between the parent company and the marketplace. This bill would simply prevent those companies employing a business structure, which allows it to manage risk more efficiently, from being charged twice or three times as much.

I look forward to continuing to work with you and our fellow colleagues on this important issue.

I would like to welcome our panel of witnesses to the table: Mr. Scott Cordes, President, Country Hedging, for the National Council of Farmer Cooperatives; Mr. Douglas Williams, President and Chief Executive Officer, Atlantic Capital Bank; Bella Sanevich, General Counsel, NISA Investment Advisors, for the American Benefits Council; Mr. Chris Giancarlo, Executive Vice President, GFI Group, for the Wholesale Markets Brokers Association, Americas; Brenda Boulwood, Chief Risk Officer and Senior Vice President, Constellation Energy for the Coalition for Derivatives End-Users; and Todd

Thul, Risk Manager, Cargill AgHorizons for the Commodity Market Council.

Mr. Cordes, please begin when you are ready, sir.

STATEMENT OF SCOTT CORDES, PRESIDENT, COUNTRY HEDGING, INC., INVER GROVE HEIGHTS, MN; ON BEHALF OF NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. CORDES. Chairman Lucas, Ranking Member Peterson and Members of the Committee, thank you for holding this hearing on proposed legislation to amend the Dodd-Frank Act.

I am Scott Cordes, President of Country Hedging, a commodity brokerage subsidiary of CHS Inc. CHS is an energy, grains and food cooperative owned by approximately 55,000 individual farmers and ranchers and approximately 1,000 local cooperatives. CHS is proud to be a member of the National Council of Farmer Cooperatives, and I am here today to testify on behalf of NCFC.

Farmer cooperatives are an important part of success of American agriculture. By providing commodity price risk management tools to their member-owners, farmer co-ops help mitigate commercial risk in the production, processing and marketing of a broad range of agriculture, food and energy products.

Please refer to my written statement for the record for greater details but at this time I would provide comment on four key provisions NCFC believes are critical to preserving risk management tools for farmers and their cooperatives.

We ask for your support of the following. One, treat agriculture cooperatives as end-users. Two, exclude agriculture cooperatives from the definition of *swap dealer*. Three, consider the aggregate costs associated with new regulations that impact agriculture. And four, maintain a *bona fide* hedge definition that includes common commercial hedging practices.

The end-user exemption: First and foremost, agriculture cooperatives should be treated as end-users because they aggregate the commercial risk of their individual farmer-members. Due to market volatility in recent years, cooperatives are increasingly using swaps to better managing their exposure by customizing their hedges. The practice increases the effectiveness of risk mitigation and reduces cost to cooperatives, their farmer owners and customers. At CHS, entering into commodity swaps frees up working capital. This allows us to continue forward contracting grain from farmers. Therefore, we are concerned with the so-called Prudential Regulators market proposal that requires bank swap dealers to collect margin from end-users. We fear this would negatively affect our ability to continue offering forward contracts. We also fear mandatory margin would increase costs to hedging operations and ultimately discourage prudent hedge operations and practices. Congressional intent was clear on this point. End-users were not to be required to post margin. We support legislation that would reaffirm this intent.

Swap dealer definition: The uncertainty created by the entity definition rules is NCFC's greatest concern as implementation continues. Specifically, we believe agriculture cooperatives should not be defined as *swap dealers*, and we support legislation to further clarify what entities would be classified and regulated as such. The proposed legislation clarifies swap dealers do not include those

using swaps to hedge or which enter into swaps ancillary to one's business. It also provides for a commercially meaningful threshold under the *de minimis* exception. This would ensure there are options for hedgers to find commercial swap counterparties. However, some cooperatives are at risk of being designated as a swap dealer due to their unique structure. Unlike a traditional corporation structure, cooperatives look to transfer risk from the local level to the federated affiliated cooperative. Using swaps as a tool to transfer risk should not lead them to be defined as dealers. We are very interested in having those transactions addressed in the proposed inter-affiliate legislation.

Regulatory costs to agriculture: As you know, agriculture is a high-volume, low-margin industry. Incremental increases in cost will trickle down and affect producers. Taken one rule at a time, the cost may not seem unreasonable, but to those who have to absorb or pass on collective costs of numerous regulations, it is evident those costs are significant. We encourage this Committee to seek a more thorough analysis to consider the aggregate affect of these regulatory actions.

Bona fide hedge definition: Finally, we advocate maintaining a *bona fide* hedge definition that includes common commercial hedging practices. I bring this issue to your attention as the Commission is scheduled to vote on this rule in the near future. I would encourage the Committee to take a close look at the definition when the final rule is issued.

In conclusion, we ask that you consider those four points I outlined above. Thank you again for the opportunity to testify today before the Committee on behalf of farmer-owned cooperatives. I look forward to answering any questions you may have. Thank you.

[The prepared statement of Mr. Cordes follows:]

PREPARED STATEMENT OF SCOTT CORDES, PRESIDENT, COUNTRY HEDGING, INC.,
INVER GROVE HEIGHTS, MN; ON BEHALF OF NATIONAL COUNCIL OF FARMER
COOPERATIVES

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, thank you for the opportunity today to discuss the role of the over-the-counter (OTC) derivatives market in helping farmers and farmer-owned cooperatives manage commodity price risks. I am pleased to be here representing the National Council of Farmer Cooperatives (NCFC) and provide input on the key issues concerning implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) as well as potential legislative reforms this Committee may take under consideration in the near future.

I am Scott Cordes, President of Country Hedging, a commodity brokerage subsidiary of CHS Inc. CHS is a farmer-owned energy, grains and foods cooperative committed to providing essential resources that enrich lives around the world. CHS is owned by approximately 55,000 individual farmers and ranchers who own shares by selling us grain directly or as customer-owners of one of five dozen CHS Country Operations retail units. We are also owned by about 1,000 local cooperatives who represent another 350,000 producers. You might also be interested to know I grew up on a grain and dairy farm in Southeastern MN that my brother still operates today.

I also serve on NCFC's Commodity Futures Trading Commission (CFTC) working group, which was formed to provide technical assistance to NCFC on commodity markets, including implementation of Title VII of the Dodd-Frank Act. On behalf of the CHS farmer-owners, and more broadly the more than two million farmers and ranchers who belong to farmer cooperatives, I thank the Committee for holding this hearing to discuss proposed legislation to amend the Dodd-Frank Act.

Farmer cooperatives—businesses owned, governed and controlled by farmers and ranchers—are an important part of the success of American agriculture. This owner-

ship structure that has served CHS owners well for 80 years helps individual family farmers and ranchers thrive despite the ups and downs of weather, commodity markets, and technological change. Through their cooperatives, producers are able to improve their income from the marketplace, manage risk, and strengthen their bargaining power, allowing farmers to compete globally in a way that would be impossible to replicate as individual producers. In all cases farmers are empowered, as elected board members, to make decisions affecting the current and future activities of their cooperative. Earnings derived from these activities are returned by cooperatives to their farmer-members on a patronage basis, thereby enhancing their overall farm income and improving rural economies.

In particular, by providing commodity price risk management tools to their member-owners, farmer cooperatives help mitigate commercial risk in the production, processing and selling of a broad range of agricultural and food products. America's farmers and ranchers must continue to have access to new and innovative risk management products that enable them to feed, clothe and provide fuel to consumers here at home and around the world. Any regulatory action that could jeopardize access to these tools should be avoided.

As such, we have been working to ensure that the implementation of the Dodd-Frank Act preserves risk management tools for farmers and their cooperatives.

During the rulemaking process, NCFCA has advocated for the following:

- Treat agricultural cooperatives as end-users because they aggregate the commercial risk of individual farmer-members and are currently treated as such by the CFTC;
- Exclude agricultural cooperatives from the definition of a swap dealer;
- Consider aggregate costs associated with the new regulations and the impact on the agriculture sector; and
- Maintain a *bona fide* hedge definition that includes common commercial hedging practices.

Even though it has been more than a year since the Dodd-Frank Act was signed into law, we are still uncertain as to how farmer cooperatives will be classified and what regulations they will be subject to. The resulting uncertainty has put business plans on hold and has delayed investment to increase the capacity for cooperatives to expand their risk mitigation services.

Cooperatives' Use of the OTC Market

As processors and handlers of commodities and suppliers of farm inputs, farmer cooperatives are commercial end-users of the futures exchanges, as well as the OTC derivatives markets. Due to market volatility in recent years, cooperatives are increasingly using OTC products to better manage their exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer-owners.

OTC derivatives are not just used for risk management at the cooperative level. They also give the cooperative the ability to provide customized products to smaller local cooperatives and individual farmer-members to help them better manage their risk and returns. Much like a supply cooperative leverages the purchasing power of many individual producers, or a marketing cooperative pools the production volume of hundreds or thousands of growers, a cooperative can aggregate its members-owners' commodity price risk. It can then offset that risk with a futures contract or by entering into another customized hedge via the swap markets.

Some examples include:

- Local grain cooperatives offer farmers a minimum price for future delivery of a specific volume of grain. The local elevator then offsets that risk by entering into a customized swap with an affiliated cooperative in a regional or federated system.
- Since most individual farmers do not have the demand necessary to warrant a standard 42,000 gallon monthly NYMEX contract, individual farmers can hedge their fuel costs by entering into swaps in 1,000 gallon increments through the co-op.
- Local supply cooperatives use swaps to mitigate their price risk in both crop nutrients and propane.
- Cooperatives facilitate hedging for dairy farmers by offering a fixed price for their milk and a swap to hedge their feed purchases. Dairy cooperatives also use swaps to offset the risk of offering forward contracts to their farmers, as well as to hedge the risk of offering forward price sales contracts to their customers.

- Cooperatives offer livestock producers customized contracts at non-exchange traded weights to better match the corresponding number of animal units they have while also reducing producers' financial exposure to daily margin calls.

While my colleagues from dairy or livestock cooperatives could provide greater details on how the above programs work for those sectors, they are all similar in concept and purpose to the risk management programs we provide to our CHS member-owners. We enter into OTC derivatives to hedge the price risk of commodities that we purchase, supply, process or handle for our members.

Swaps also play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. Because commodity swaps are not currently subject to the same margin requirements as the exchanges, cooperatives can use them to free up working capital.

For example, considerable amounts of working capital have been tied up to cover daily margin calls as a result of increased volatility in grain and oilseed markets. For farmers to continue to take advantage of selling grain forward during price rallies, cooperatives have to either increase borrowing or look for alternative ways to manage such risk. Using the OTC market has become that alternative. In 2008, multinational grain companies were running out working capital due to extreme grain volatility. CHS was able to enter into swaps to free up working capital so that it could continue to contract and forward price grain with its members. As was the case during the volatile markets in 2008, swaps today allow cooperatives to free up working capital and continue to forward contract with farmers.

Definition of Swap Dealer

The uncertainty created by the "definitions" rules is NCFC's greatest concern as implementation continues. While the CFTC has proposed regulations for swaps and swap dealers, it is unclear to us who, or what transactions, will be subjected to those additional regulations. As the rule was proposed, some activities of cooperatives such as those previously mentioned would appear to push cooperatives into the "swap dealer" category.

Regulating farmer cooperatives as dealers would increase requirements for posting capital and margin on swaps it uses with other dealers to offset the risk of providing risk management products and services to its members and customers. This requirement, combined with the cost of complying with other regulatory requirements intended for large financial institutions, could make providing those services to a cooperative's member-owners uneconomical. Such action would result in the unintended consequence of increasing risk in the agricultural sector. In addition, it would severely limit the number of non-financial entities that could provide risk management tools in the form of financially settled instruments (swaps).

The two main issues in the proposed rule are the application of the "interpretive approach for identifying whether a person is a swap dealer," and the very low thresholds on the "*de minimis* exception." As such CFTC would likely capture a number of entities, including farmer cooperatives, which were never intended to be regulated as swap dealers. Yet farmer cooperatives do not resemble what is generally and commonly known in the trade as a swap dealer—ones that profit from the spread between the buying and selling of swaps. Cooperatives are not driven by that profit motive, but rather are hedging, or assisting their members and customers in hedging the price risks inherent to the agriculture industry. Farmer cooperatives mitigate risk as opposed to others in the marketplace who take on risk for profit.

Therefore, we support legislation to clarify what entities would be classified and regulated as swap dealers. The proposed legislation clarifies that swap dealers do not include those using swaps to hedge, or which enter into swaps ancillary to one's business as a producer, processor, or commercial user of a commodity. Both of those "prongs" capture the essence of farmer cooperatives' and their members' utilization of swaps. By providing for a commercially meaningful threshold under the "*de minimis* exception," the bill would ensure there are options for hedgers to find commercial swap counterparties other than just financial entities.

Further, some cooperatives, such as CHS, are currently at risk of being designated as swap dealers due to their unique structure. For example, a federated grain or farm supply cooperative is owned by many local cooperatives which are separate business entities. Unlike a traditional corporate structure where risk can be transferred internally, the ability to transfer risk from the local level to the federated cooperative—in this case in the form of a swap—is treated as an external transaction under the draft rules. Thus we are very interested in having those transactions addressed in the "inter-affiliate" legislation introduced by Representatives Marcia Fudge and Steve Stivers. While their legislation as introduced is specific to affiliate transactions between parties under common control, the same jus-

tification can be made for similar transactions between affiliated cooperatives and their affiliated member-owners. Because of the bottom-up ownership structure of a cooperative, the affiliates are not under “common control” of the larger cooperative. Therefore, we would like to see an additional provision included in this legislation to include transactions between a cooperative and its member-affiliates, taking into account the differing structure of cooperative ownership from that of a traditional corporate entity.

Many agricultural cooperatives, like CHS, borrow from CoBank, which is also a cooperative. We are concerned that CFTC would classify CoBank as a swap dealer because CoBank sells swaps to its customers in conjunction with providing loans. Congress specifically exempted these types of swaps from qualifying a commercial bank as a swap dealer. The exemption, however, was inadvertently limited only to “insured depository institutions,” and as a Farm Credit System institution, CoBank is not an insured depository institution. We urge CFTC to ensure CoBank’s swaps are treated the same as other regulated lenders and do not qualify the bank as a swap dealer. Otherwise, our co-op, as well as others like us who borrow from CoBank, will be penalized.

Cost-Benefit Analysis

Agriculture is a high-volume, low-margin industry. Incremental increases in costs, whether passed on from a swap dealer or imposed directly on a cooperative, will trickle down and affect producers. It is important to keep in mind the aggregate costs associated with the many new regulations and the implications it will have for the agriculture sector. Taken one rule at a time, the costs may not seem unreasonable to those who are writing the rules. But to those who have to absorb or pass on the collective costs of numerous regulations, it is clearly evident those costs are significant. While the Commission believes it is doing its due diligence in providing cost-benefit analyses of the regulations it is proposing, we think better analysis is called for to consider their aggregate effect.

For example, one so-called “small” change in the regulations is contained in the conforming amendments proposed rule and has to do with additional recording requirements. We are concerned this proposal would not only add swaps to the new recordkeeping requirements, but also extend the new requirements to cash purchase and forward cash contracts entered into by any member of a designated contract market (DCM).

As a result, all farmer cooperatives that are members of DCMs (Chicago Mercantile Exchange, Kansas City Board of Trade, Minneapolis Grain Exchange, *etc.*), and by extension every one of their local facilities, to be bound by this regulation. Farmer cooperatives that are members of DCMs have an integrated network of grain elevators to originate and store grain purchased from farmers. The proposed change would require those elevators to record, among other things, all oral communications (telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device or other digital or electronic media) that lead to execution of cash transactions with farmers. In addition, each transaction record must be maintained as a separate electronic file identifiable by transaction and counterparty and kept for 5 years.

While some traders now record certain conversations in order to provide a record of order execution, the CFTC’s proposal would require employees at hundreds of operations to record all face-to-face and phone conversations with farmers, even when tape recording has never been their practice in the past. Such a requirement would impose huge regulatory burdens and costs on cooperatives and other businesses and farmers in rural America. For example, CHS buys grain at over 350 grain elevators across the United States. To install and maintain such recordkeeping systems would cost us over \$6 million. In fact, the necessary investment to put in place and maintain such a system would not only greatly add to the cost of doing business, but would be an extreme compliance burden for the cash grain community. Since farmers would not be too keen having all their marketing conversations recorded and kept for 5 years, this would penalize those who are members of DCMs relative to other facilities. For those reasons, we believe this will have a net effect of driving grain industry participants to drop their membership in the exchanges. Further, we do not believe this regulatory burden is necessary to achieve the stated goals in the cash commodity markets. I would note that this “small” change tucked into one of the thousands of pages of proposed rules was not called for under the Dodd-Frank Act but rather has been initiated by the CFTC.

End-User Exemption From Margin Requirements

Consistent with Congressional intent, NCFE supports the CFTC’s proposed rules to clarify that it “would not impose margin requirements on non-financial entities,”

and that “parties would be free to set initial and variation margin requirements in their discretion and any thresholds agreed upon by the parties would be permitted.” Farmer cooperatives are an extension of their members who are end-users. By extension, a farmer cooperative should also be an end-user.

However, we are concerned the so-called “Prudential Regulators” margin proposal requires bank swap dealers to collect margin from end-users. As I noted earlier, swaps play a critical role in the ability of cooperatives to provide forward contracts, especially in times of volatile markets. This is because commodity swaps are not currently subject to margin requirements such as contracts on the exchanges and can be used to free up working capital.

As end-users, cooperatives use swaps to hedge interest rates, foreign exchange, and energy in addition to agricultural commodities. Often, cooperatives look to their lender to provide those swaps. Under the proposed rule requiring end-users to post margin, costs to businesses will increase as more cash is tied up to maintain those hedges. The additional capital requirements will be siphoned away from activities and investment in cooperatives’ primary business ventures. Furthermore, cash for margin is often borrowed from lenders through the use of credit lines. As a result, we could see a situation where a commercial end-user would have to borrow cash from its lender, and pay interest on it, just to give it back to the same lender to hold as margin. Congressional intent was clear on this point—end-users were not to be required to post margin. We support legislation that would reaffirm this intent.

Bona Fide Hedge Definition

Although legislation has not yet been introduced to address the *bona fide* hedge definition in the position limits rule, I bring this issue to your attention as the Commission is scheduled to vote on that rule in the near future. Once again, it appears the Commission may be going well beyond what Congress intended in the Dodd-Frank Act. In the draft rule, CFTC has classified common commercial hedging practices as speculative in nature. These include such practices as anticipatory hedging and cross hedging. For example, an anticipatory hedge could involve selling a corn future Friday afternoon, knowing that grain will be bought throughout the weekend. Common cross hedges would include hedging a dried distillers grain position with corn or hedging a cheese position with Class III milk, butter and whey.

For NCFC’s dairy cooperative members, the “5 day rule” poses a significant problem. Six of the seven dairy futures contracts, and the swaps that use these futures for settlements, are cash-settled instruments. Five of the six cash-settled futures contracts have open interest of less than 5,000—spread across 24 months of futures contracts. One of the dairy contracts that has physical delivery currently has zero open interest.

Due to these instruments settling against U.S. Department of Agriculture determined cash prices, there is perfect convergence of futures to cash. There are not any issues associated with deliverable contracts held during the last few days prior to settlement. Since this is the case, the dairy industry users hold these instruments until their positions close out on the settlement date. If these instruments were required to close out prior to settlement date, it would result in unusual price changes in the last few days—especially for the contracts that have very low open interest. Imposing the 5 day rule in the dairy sector would reduce the effectiveness of hedges and possibly reduce the use of these instruments by dairy farmers and their cooperatives, resulting in increased risk.

I would encourage this Committee to take a close look at this definition when the final rule is issued. The implications are not only contained to the position limits themselves, but also other rules, such as what will be considered hedging or mitigating commercial risk for the purposes of commercial end-users being able to access the end-user exception to the clearing requirement.

In summary, we hope you will give consideration to the following: treating agricultural cooperatives as end-users; excluding agricultural cooperatives from the definition of a swap dealer; consider the aggregate costs associated with the new regulations that impact agriculture; and, maintain a *bona fide* hedge definition that includes common commercial hedging practices.

Thank you again for the opportunity to testify today before the Committee on behalf of farmer-owned cooperatives. Your leadership and oversight in the implementation of the Dodd-Frank Act is to be commended. We especially appreciate your role in ensuring that farmer cooperatives will continue to be able to effectively hedge commercial risk and support the viability of their members’ farms and cooperatively owned facilities. I look forward to answering any questions you may have.

Thank you.

The CHAIRMAN. Thank you.
Mr. Williams, when you are ready.

**STATEMENT OF DOUGLAS L. WILLIAMS, PRESIDENT AND
CHIEF EXECUTIVE OFFICER, ATLANTIC CAPITAL BANK,
ATLANTA, GA**

Mr. WILLIAMS. Chairman Lucas, Ranking Member Peterson, and Members of the Committee, I appreciate the opportunity to testify today regarding the impact of derivatives regulation on community banks and to add my support for legislation under consideration by the Committee.

My name is Douglas Williams and I am the President and Chief Executive Officer of Atlantic Capital Bank. Located in Atlanta, Georgia, Atlantic Capital is a commercial bank with assets of approximately \$870 million. We focus primarily on serving the banking needs of small- to mid-sized enterprises across Georgia. These enterprises are the engine of economic recovery and job creation in our region.

Since opening in 2007, we have provided our customers with superior levels of service and local knowledge of a community bank by offering access to the expertise and capital typically found at larger banks. In 4 short years, we have created a better banking experience for over 350 companies and are proud of the relationships we have built with them.

Atlantic Capital uses interest rate derivatives to manage risks that are inherent in banking and to help our customers manage their risks. We do not enter into credit default swaps or speculate with derivatives. Neither our use, nor our customers' use, of derivatives poses systemic risk. Systemic risk in the derivatives market is concentrated among a few large financial institutions. Just 25 banks hold 99.86 percent of the total notional volume. The remaining banks together comprise just .14 percent of the notional volume held at all U.S. banks. Certain proposed rules released by the CFTC could unnecessarily jeopardize our ability to manage risk, provide the services our clients need and remain competitive against larger institutions. I will focus on two issues: the *swap dealer* definition and the potential exemption from the *financial entity* definition for small banks.

Community and regional banks are concerned that the *swap dealer* definition in the CFTC's proposed rule could capture hundreds of smaller banks that offer risk management products to commercial customers. Title VII provided an exemption from this definition for any swap offered by a bank to a customer in connection with originating a loan with that customer. However, the CFTC's proposed rule interpreting this exemption is unnecessarily narrow. In my written testimony, I elaborate on the specific ways in which this rule could hurt small banks.

The Small Business Credit Availability Act clarifies that swaps offered by a bank in connection with an extension of credit that the bank has facilitated should be excluded from the definition of *swap dealer*. This bill will decrease the likelihood that many smaller banks will be forced to choose between limiting the services they offer to customers and complying with the same substantial regulatory burdens imposed on Wall Street dealers. Additionally, we

are concerned that the CFTC's proposed thresholds for the *de minimis* exception are extremely low. Absent an increase in these thresholds, many small banks will be forced to cease offering these services to customers to avoid facing the regulatory burden applicable to swap dealers. The bill to amend the Commodity Exchange Act to clarify the definition of *swap dealer* modifies the *de minimis* exception to the *swap dealer* definition to alleviate this unnecessary burden for small banks.

Additionally, many community banks are concerned that the clearing and trading requirements attendant to classification as financial entities could have the effect of shutting them out of the derivatives market. Initial estimates suggest that a community bank may have to pay a clearing member over \$100,000 per year just to maintain the ability to clear swaps. While large buy-side firms and hedge funds may do enough trading per year to justify these costs, smaller banks may have no choice but to stop using derivatives. These banks would no longer be able to offer customers the risk management products they need and would have a more difficult time managing basic risks that are inherent in banking.

We urge the Committee to pass the Small Business Credit Availability Act, which would provide an explicit exemption for the *financial entity* definition for small banks and smaller institutions that have \$30 billion or less in assets or whose swaps exposure is no greater than \$1 billion. Notably, the notional amount held at U.S. banks with \$30 billion or less in assets comprises just .09 percent of the total notional amount held by all U.S. banks.

We applaud the work of the Committee and the regulators to strengthen the OTC derivatives market, and we appreciate the Committee's consideration of these important pieces of legislation to address the specific concerns of small banks. I thank you for opportunity to testify today and I am happy to answer any questions.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF DOUGLAS L. WILLIAMS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ATLANTIC CAPITAL BANK, ATLANTA, GA

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, I appreciate the opportunity to testify today regarding the impact of derivatives regulation on community banks, and to add my support for three pieces of legislation under consideration by the Committee. My name is Douglas Williams, and I am the President and Chief Executive Officer of Atlantic Capital Bank ("Atlantic Capital").

Located in Atlanta, GA, Atlantic Capital is a commercial bank with assets of approximately \$870 million and deposits of more than \$720 million. We focus primarily on serving the banking needs of small to mid-sized enterprises in metropolitan Atlanta and across Georgia. These enterprises are the engine of economic recovery and job creation in our region.

Since opening our doors in 2007 we have provided our customers with the superior levels of service and local market knowledge often associated with smaller community banks while offering access to the banking expertise and capital typically found at larger money center banks. At Atlantic Capital Bank, our bankers have, on average, more than twenty-five years of banking experience.

We take a relationship approach—rather than a transactional approach—to banking. In 4 short years we have created a better banking experience for over 350 emerging growth companies, small businesses and mid-market enterprises, and we are proud of the relationships we have built with them.

As is the case with hundreds of community and regional banks, Atlantic Capital uses interest rate derivatives to prudently manage risks that are inherent in the business of commercial banking and to help our customers meet their risk management needs. We do not enter into credit default swaps or use derivatives for specula-

tion, trading or proprietary investment. At Atlantic Capital, we use derivatives to hedge the interest rate risk associated with financing we provide to our clients.

Here are three brief examples:

- (1) We offered a borrower a competitive construction financing that upon completion converted to a long-term financing. This allowed our customer to meet its objective of locking in its future interest expense on the long-term financing, while also allowing the bank to avoid taking on any incremental interest rate risk. Importantly, we could not have assisted this customer without interest rate swaps.
- (2) Atlantic Capital provided financing to a small developer in a low-income area of downtown Atlanta that was leased to a commercial user. Our interest rate swap fixed the rate so that the lease payments exceed the cost of debt in any interest rate environment.
- (3) Atlantic Capital financed a Georgia-based exporter of agricultural products and helped them lock in their interest expense with an interest rate swap, allowing them to reduce uncertainty in their business.

Neither our use nor our customers' use of derivatives poses systemic risk. As was shown during the financial crisis, systemic risk in the derivatives market is concentrated among a few very large and interconnected financial institutions. According to the Office of the Comptroller of the Currency's (OCC's) Quarterly Report on Bank Trading and Derivatives Activities, the derivatives market is "dominated by a small group of large financial institutions." While 1,071 banks and trust companies in the U.S. use derivatives, five banks hold 96% of the total notional volume and 86% of the total credit exposure. Looking beyond the top five, just 25 banks hold 99.86% of the total notional volume, and the remaining 1,046 banks together comprise just 0.14% of the entire notional volume held at all U.S. banks.¹

In addition to the vast differences in the size and volume of trades done by small banks as compared to the largest financial institutions, there are important differences in the types of derivatives used by smaller banks and their purposes. Small banks typically use derivatives to hedge their own balance sheet risk or to facilitate the risk management needs of their customers. Small banks generally use interest rate, foreign exchange and, to a lesser extent, commodity derivatives. Use of credit derivatives among small banks is rare. Indeed, only 18 commercial banks in the U.S. currently use the credit default swaps made infamous by AIG Financial Products.²

My comments today reflect concern that certain proposed rules released by the Commodity Futures Trading Commission ("CFTC")—including those relating to the key definitions in Title VII—could unnecessarily jeopardize our ability to manage risk, provide the services our clients need and remain competitive against much larger financial institutions. Indeed, this Committee has heard the testimony of representatives from two other community banks, Susquehanna Bank and Webster Bank, regarding the potential consequences of being swept into the "financial entity"—or worse—"swap dealer" definition in Title VII of Dodd-Frank. We share those concerns and strongly support the common-sense legislation recently introduced in the House that seeks to protect smaller banks from the substantial and unnecessary regulatory burden associated with the financial entity and swap dealer classifications. This legislation does not dilute or detract from the important features of Title VII designed to protect against systemic risk and promote transparency in the OTC derivatives market; rather, these bills strengthen the framework established in Title VII.

I would like to focus today on two key issues: the swap dealer definition and the potential exemption from the financial entity definition for small banks.

(1) Swap Dealer Definition

Several community and regional banks have expressed concern that the swap dealer definition in the CFTC's proposed rule could capture hundreds of community and regional banks that offer risk management products to commercial customers. One only need look at the comment file on the CFTC's website for the entity definitions rule to get a sense for the concerns that numerous smaller banks have regard-

¹Please see the attached † and refer to page 1 of the report at: <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf>.

† [This document is retained in Committee files.]

²Based on publicly available call report data on the website of the Federal Deposit Insurance Corporation.

ing an overly broad swap dealer definition.³ A broad definition would hamper the ability for many smaller banks to compete with larger financial institutions without any appreciable benefit in terms of enhanced market oversight or reduction in systemic risk.

Title VII provided 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; 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. It is important to stress that the word "contemporaneously" is not found in the statute. As it is 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. In addition, we would urge the CFTC to consider excluding from the swap dealer definition swaps offered by a bank in connection with syndicated loans, loan participations and bond issuances that are facilitated by the bank, as bank customers that benefit from these financings often use derivatives to hedge the associated interest rate risk.⁴

The Small Business Credit Availability Act modifies the swap dealer definition to clarify that swaps offered by a bank in connection with an "extension of credit" that the bank has facilitated should be excluded from the definition of swap dealer. This language is intended to clarify that the CFTC should not take an overly narrow read of the exclusion for these important transactions. This bill will decrease the likelihood that many smaller banks will be forced to choose between limiting the services they offer to customers and complying with the same substantial regulatory burdens imposed on the big Wall Street dealers.

Additionally, we are concerned that the CFTC's proposed thresholds for the so-called "*de minimis* exception" from the swap dealer definition are extremely low and should be increased. For example, if a bank were to offer just 21 hedges to customers in one year, it could be subject to the full panoply of regulation applicable to swap dealers, depending on the CFTC's interpretation of the swap dealer definition. Atlantic Capital has been offering interest rate risk management products to our customers for only 18 months, and we currently have 21 swaps with an aggregate notional amount of \$88 million on our books. We fear that many small banks, including Atlantic Capital, would simply be forced to cease offering these risk management services to customers to avoid facing the costly regulatory burden associated with registration as a swap dealer.

We urge regulators to compare the thresholds for the *de minimis* exception against the volume of dealing done by the large financial institutions that control the vast majority of the OTC derivatives market. Available data⁵ suggest that the CFTC could substantially increase the thresholds without running afoul of Congressional intent. For example, at number one on the OCC's list of banks with the largest derivatives books, J.P. Morgan has more than \$78 trillion in notional volume of active trades in place. The number ten firm on the OCC's list, PNC Bank, has 0.43% of J.P. Morgan's book, at around \$337 billion in notional volume. Assuming that just 10%, or \$33 billion, of PNC's total book was done with customers and that these trades were spread over 10 years would give you \$3.3 billion per year—33 times the threshold above which a firm would be deemed a swap dealer under the current *de minimis* threshold of \$100 million. Given the relatively infinitesimal level of activity by small financial institutions and the substantial regulatory burden that would be imposed if these institutions were deemed swap dealers, we believe the cost of additional oversight over smaller financial institutions would substantially outweigh any benefits to the financial system.

The discussion draft that amends the Commodity Exchange Act to clarify the definition of swap dealer modifies the *de minimis* exception to the swap dealer definition to exempt entities from registering as a swap dealer if the average aggregate gross notional volume of its outstanding swaps over the preceding 12 months does not exceed \$3 billion as adjusted by the Consumer Price Index for the 12 month period ending the preceding April 30. The bill's modifications to the swap dealer definition and the inclusion of a specific threshold for the *de minimis* exception would

³ Please see comment file here: <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933>.

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

⁵ Please refer to pages 5–6 of the comment letter submitted by Atlantic Capital 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>.

result in the regulatory capture of firms which dominate the derivatives market while alleviating the burden for small banks which collectively comprise a fraction of the derivatives market.

(2) Potential Exemption for Small Banks

Congress provided the regulators with the authority to exempt small banks from the financial entity definition. If such an exemption were granted, these small banks would only be exempt from the clearing and trading requirements if they are hedging commercial risk and report certain information to the regulators.⁶ Moreover, small banks already are subject to existing regulations and supervisory guidance aimed at protecting against counterparty credit risks, including rules that require adequate capital to be held against all assets, including derivatives, and that dictate the maximum exposures a bank could take to one customer or counterparty. Furthermore, existing regulations allow examiners to take certain actions to prevent default, or to limit bank losses in the event of default. Atlantic Capital and other small banks employ sound risk management practices to manage our exposures to bank counterparties to a modest level including the use of collateral agreements with these counterparties which require them to post liquid collateral for our benefit as exposure is created. These protections adequately mitigate risks associated with an exception for small banks.

Many community banks are concerned that the clearing and trading requirements attendant to classification as “financial entities” could have the effect of shutting them out of the derivatives market altogether. Initial estimates of clearing costs suggest that a community bank may have to pay a clearing member—in most cases an affiliate of a large Wall St. bank—over \$100,000 per year just to maintain the ability to clear swaps. Additional fees would be charged by the clearinghouses and trading platforms, and legal counsel may be required to negotiate clearing-related documentation.

While large buy-side firms and hedge funds may do enough trading per year to justify these costs, smaller banks may have no choice but to stop using derivatives. If so, these banks would no longer be able to offer customers the risk management products they need and would have a more difficult time managing basic risks that are inherent in banking. These would be unfortunate and entirely avoidable outcomes that would have the effect of weakening the banking system and the economy.

We urge the Committee to prevent such outcomes by passing the Small Business Credit Availability Act which would provide a targeted exemption for smaller banks from the financial entity definition. The bill would modify Title VII and provide an explicit exemption from the financial entity definition for small banks, savings associations, credit unions and farm credit system institutions that have \$30 billion or less in assets or whose current and potential future exposure for swaps is no greater than \$1 billion. It should be noted that this \$1 billion exposure threshold is just 1/8 the exposure threshold proposed by the CFTC in its definition for so-called “major swap participants” that have derivatives exposures large enough to pose a threat to the financial system. In addition, the OCC’s stats show that the notional amount held at U.S. banks and trust companies with \$30 billion or less in assets comprises just 0.09% of the total notional amount held by all U.S. banks and trust companies.

We recognize that it is important to resist legislative changes that run counter to the core objectives of Dodd-Frank by creating loopholes that would permit firms or activities that pose a risk to our financial system to escape regulatory capture; however, neither of these bills would have such an effect. Indeed, the targeted application and careful wording of these bills would strengthen Dodd-Frank by limiting unintended harm to smaller banks. The large dealers and major market players would still be subject to registration, supervision and substantial regulations aimed at reducing systemic risk and promoting transparency in the derivatives market. In addition, any market participant using derivatives for speculating, trading or investing still would be subject to the clearing, trading and margin requirements.

I also wish to show support for H.R. 1840, an extremely important piece of legislation that enhances Title VII for the benefit of all market participants, including small banks. H.R. 1840 requires the CFTC to perform a qualitative and quantitative cost-benefit analysis and to make a reasoned determination that the benefits of new regulatory requirements justify the costs. H.R. 1840 lists specific factors, including available alternatives to regulation, that the CFTC must consider as part of its cost-benefit analysis. We urge the Committee to pass H.R. 1840 and to take steps to en-

⁶Any exempt small financial institution still would have to meet the conditions required for the end-user exception to mandatory clearing and trading.

sure that the regulators prioritize quality over expedience in their rulemaking effort.

Conclusion

It is essential that small banks have continued access to interest rate risk management tools to support recovery and job creation at the small and middle-market businesses that form the foundation of the U.S. economy. We applaud the work of the Committee and the regulators to strengthen the OTC derivatives market, but we urge caution against finalizing rules that would place undue burdens on small banks that are incapable of posing future systemic risk and collectively engage in a fraction of the derivatives traded by the large dealers. We urge this Committee to address the specific concerns of small banks by passing the Small Business Credit Availability Act and the bill that would amend the Commodity Exchange Act to clarify the definition of swap dealer.

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

The CHAIRMAN. Thank you.

And Ms. Sanevich, whenever you are ready.

**STATEMENT OF BELLA L.F. SANEVICH, GENERAL COUNSEL,
NISA INVESTMENT ADVISORS, L.L.C., ST. LOUIS, MO; ON
BEHALF OF AMERICAN BENEFITS COUNCIL; COMMITTEE ON
INVESTMENT OF EMPLOYEE BENEFIT ASSETS**

Ms. SANEVICH. Good morning. Thank you for holding this hearing. My name is Bella Sanevich, and I am the General Counsel of NISA Investment Advisors. NISA is an investment advisor with over \$75 billion under management for over 130 clients including private and public plans. I am testifying today on behalf of the American Benefits Council and the Committee on Investment of Employee Benefits Assets. These two organizations represent the vast majority of the nation's private pension plans. Thank you for the opportunity to testify on the issues raised for ERISA plans by the proposed swap regulations.

We very much appreciate the open and frank dialogue we have had with the agencies to date. The agencies have been very open to hearing our concerns. However, a number of issues remain, and I will focus on two critical issues for ERISA pension plans under the proposed business conduct standards and the need to modify the anomalous treatment of ERISA plans under the proposed margin regulations.

ERISA pension plans use swaps to manage risk inherent in a pension plan's liability and to manage plan funding obligations. If swaps are less available or more costly to pension plans, funding volatility and cost would increase substantially. This would put Americans' retirement security at very great risk. It would also force companies to reserve billions of additional dollars to satisfy possible funding obligations, thus diverting those assets from job creation and economic growth.

With respect to the business conduct standards, there are three main issues: the fiduciary issue, the advisor issue and the dealer retail issue. On the fiduciary issue, the rules proposed by the CFTC and the SEC would require swap dealers to review the qualification of an ERISA plan's advisor. Such a review would make the dealer a fiduciary under current ERISA rules. Under ERISA, a fiduciary to a plan is not permitted to enter into a transaction with the plan, so if the swap dealer is a plan fiduciary, then any swap entered into with an ERISA is an illegal prohibited transaction. The solu-

tion is clear: No action required by the business conducts standards should cause a swap dealer to be treated as a fiduciary. This would simply be a clarification that there is not an irreconcilable conflict between two sets of regulations. The legislative discussion draft does exactly this and should be enacted.

With respect to the advisor issue, under the Dodd-Frank Act, if a swap dealer acts as an advisor to a plan, then the swap dealer must act in the best interests of the plan. Unfortunately, the CFTC's proposed rules interpret acting as an advisor so broadly that virtually every dealer would be treated as an advisor. This is an unworkable conflict of interest that would render swaps unavailable to plans. The reality is that contrary to the CFTC's apparent assumptions, ERISA plans are prohibited by law from relying on their counterparty for advice. The business conduct standards should state that a dealer is not an advisor to a plan if the dealer represents that it is functioning as a counterparty and not as an advisor and the plan represents that it has its own internal or external advisor. In general, this is a structure adopted by the SEC in its proposed rules and by the legislative discussion draft. We strongly support these solutions.

On the dealer veto issue, under the proposed CFTC and SEC rules, dealers have significant leverage over plans, contrary to Congressional intent. Congress's intent to ensure that special entities are advised by a qualified advisor is satisfied by current ERISA law. This must be reflected in the business conduct rules, and the legislative discussion draft would do this with respect to ERISA plans.

Last, the proposed margin regulations issued by the CFTC and the Prudential Regulators would, without consideration of the unique nature of ERISA plans, treat plans as high-risk financial end-users and impose the same burdensome margin requirements as are imposed on, for example, hedge funds. This classification is inconsistent with Congressional intent because ERISA plans are among the lowest risk end-users. They are highly regulated, subject to mandatory funding requirements and cannot file for bankruptcy. Treating ERISA plans as high-risk financial end-users will actually create an increased risk by significantly reducing or eliminating the use of a very powerful risk mitigation tool. This would have significant adverse consequences on the retirement security of millions of Americans and divert assets from job creation. As one of the safest counterparties, no mandated margin requirements should apply to ERISA plans on cleared swaps.

We thank the Committee for holding this hearing and for the opportunity to testify. I will be happy to answer any questions.

[The prepared statement of Ms. Sanevich follows:]

PREPARED STATEMENT OF BELLA L.F. SANEVICH, GENERAL COUNSEL, NISA INVESTMENT ADVISORS, L.L.C., ST. LOUIS, MO; ON BEHALF OF AMERICAN BENEFITS COUNCIL; COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

My name is Bella Sanevich and I am the General Counsel of NISA Investment Advisors, L.L.C. NISA is an investment advisor with over \$75 billion under management for over 130 clients, including private and public retirement plans. I am testifying today on behalf of the American Benefits Council (the "Council"), with respect to which NISA is a member, and the Committee on Investment of Employee Benefit Assets ("CIEBA").

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

CIEBA represents more than 100 of the country's largest corporate sponsored pension funds. Its members manage more than \$1 trillion of defined benefit and defined contribution plan assets, on behalf of 15 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

We very much appreciate the opportunity to address the swap-related issues raised by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") for private retirement plans governed by the Employee Retirement Income Security Act of 1974 ("ERISA")¹. And we applaud the Committee for holding a hearing on this critical set of issues.

We believe that the agencies—the Commodity Futures Trading Commission ("CFTC"), which has jurisdiction over the types of swaps most important to plans, the Securities and Exchange Commission ("SEC"), and the Prudential Regulators—have been working extremely hard to provide needed guidance. Also, the agencies have been very open to input on the swap issues from the ERISA plan community. We very much appreciate the open and frank dialogue we have had with the agencies to date.

However, certain proposed regulations affecting ERISA plans could have very adverse effects on plans, none of which were intended by Congress. Accordingly, for reasons discussed in more detail below, we testify today in support of:

- This hearing's legislative discussion draft that would address critical issues arising under the proposed business conduct standards;
- Needed legislation that would modify the anomalous treatment of ERISA plans under proposed regulations addressing margin requirements; and
- H.R. 1840, which would set forth specific factors that must be considered by the CFTC in connection with a cost-benefit analysis of any regulation or proposed regulation.

Importance of Swaps to ERISA Plans

At the outset, it is important to discuss why the use of swaps is so important to ERISA pension plans and why any material disruption of that use could have significant adverse effects on plans, the companies sponsoring plans, and the participants whose retirement security depends in large part on plans.

ERISA pension plans use swaps to manage the risk resulting from the volatility inherent in determining the present value of a pension plan's liability, as well as to manage plan funding obligations imposed on companies maintaining defined benefit plans. The risk being managed is largely interest rate risk. If swaps were to become materially less available or become significantly more costly to pension plans, funding volatility and cost could increase substantially. This would put Americans' retirement assets at greater risk and force companies in the aggregate to reserve billions of additional dollars to satisfy possible funding obligations, most of which may never need to be contributed to the plan because the risks being reserved against may not materialize. Those greater reserves would have an enormous effect on the working capital that would be available to companies to create new jobs and for other business activities that promote economic growth. The greater funding volatility could also undermine the security of participants' benefits.

Let me explain this volatility issue further. In a defined benefit pension plan, a retiree is promised payments in the future. The obligations of a pension plan include a wide range of payments, from payments occurring presently to payments to be made more than 50 years from now. The present value of those payments varies considerably with interest rates. If interest rates fall, the present value of liabilities grows. So if interest rates drop, the present value of liabilities can grow, creating additional risk for participants and huge economic burdens for the company sponsoring the plan. Swaps are used to address this risk, as illustrated in a very simplified example below.

Assume that a plan has \$15 billion of assets and \$15 billion of liabilities so that the plan is 100% funded and there is thus no shortfall to fund. Assume that interest rates fall by one percentage point. That alone would increase liabilities substan-

¹ For convenience of presentation, the references in this testimony to swaps, swap dealers, and major swap participants include security-based swaps, security-based swap dealers, and major security-based swap participants, respectively.

tially. Based on a real-life example of a plan whose interest rate sensitivity is somewhat higher than average, we assume a 13% increase in plan liabilities to \$16.95 billion. Based on a realistic example, we assume that assets increase to \$15.49 billion. Thus, the decline in interest rates has created a \$1.46 billion shortfall. Under the general pension funding rules, shortfalls must be amortized over 7 years, so that the plan sponsor in this example would suddenly owe annual contributions to the plan of approximately \$248 million, starting with the current year. A sudden annual increase in cash outlays of \$248 million can obviously present enormous business challenges as well as increased risks for participants.

Swaps are a very important hedging tool for plan sponsors. Hedging interest rate risk with swaps effectively would avoid this result by creating an asset—the swap—that would rise in value by the same \$1.46 billion if interest rates fall by one percentage point. Thus, by using swaps, plan sponsors are able to avoid the risk of sudden increases in cash obligations of hundreds of millions of dollars. If, on the other hand, plans' ability to hedge effectively with swaps is curtailed by the new rules, funding obligations will become more volatile, as illustrated above. This will, in turn, increase risk for participants and force many employers to reserve large amounts of cash to cover possible funding obligations, thus diverting cash from critical job retention, business growth projects, and future pension benefits.

Without swaps, some companies would attempt to manage pension plan risk in other ways, such as through the increased use of bonds with related decreases in returns. One company recently estimated that its expected decrease in return that would result from using bonds in lieu of interest rate swaps would be approximately \$100 million. And this pain will be felt acutely by individuals. Companies that lose \$100 million per year may well need to cut jobs and certainly will have to think about reducing pension benefits.

We also note that the bond market is far too small to replace swaps entirely as a means for plans to hedge their risks. There are not nearly enough bonds available, especially in the long durations that plans need. Furthermore, a flood of demand for bonds would drive yields down, increasing the present value of plan liabilities dramatically. In short, a shift from swaps to bonds would be costly, insufficient, and potentially harmful for plans, the U.S. markets, and the economy in general.

Summary of Key Concerns

We have four main concerns to discuss today. Those concerns are summarized below.

- **Business conduct standards.** The Dodd-Frank Act directed the SEC and the CFTC to impose business conduct standards on swap dealers and major swap participants ("MSPs"), with heightened standards applicable when dealers and MSPs enter into swaps with a "Special Entity" (which includes ERISA plans). These rules were intended to protect ERISA plans that enter into swaps. As proposed by the CFTC and, to a lesser extent, the SEC, these standards would have very harmful effects on ERISA plans and could operate to eliminate their ability to use swaps. The legislative discussion draft raised for discussion in connection with this hearing would address this issue very effectively.
- **Margin requirements.** The CFTC and the Prudential Regulators have proposed margin requirements that would treat ERISA plans as high-risk financial end-users (*i.e.*, treating ERISA plans as entities that pose a systemic risk to the financial system). Accordingly, the proposed rules would impose very costly margin requirements on ERISA plans that enter into swaps. These requirements will create more risk for ERISA plans, and will divert plan assets away from more productive uses that could benefit participants. In some cases, the requirements could even discourage plans from entering into swaps due to the significant increase in opportunity cost as well as actual cost. These results are clearly unjustified, since ERISA plans are among the safest counterparties, for reasons discussed below. Legislation may well be needed to solve this problem.
- **Cost-benefit analysis.** We believe that an appropriately thorough cost/benefit analysis would clearly reveal that the treatment of ERISA plans in the proposed business conduct standards and the margin requirements would have significant costs and no real benefit. We are concerned that the unique nature of ERISA plans has not been taken into account in the regulatory process, and a more detailed cost-benefit analysis is needed to avoid serious unintended consequences. H.R. 1840, as introduced by Representatives Conaway, Quigley, McHenry, Boswell, and Neugebauer, would be very helpful in addressing this issue.
- **Effective date.** The retirement plan community will need substantial time to prepare to comply with an entirely new system. Near-term effective dates can

only bring substantial harm by triggering confusion and misunderstandings that undermine our country's retirement security. In this regard, it is essential that the rules have sufficiently long implementation dates so that plans and their advisors can plan for an orderly transition to the new system without unnecessary, harmful, and costly disruptions. Moreover, plans and their advisors will need to establish additional operational and compliance systems, and the rules should be sequenced in a manner so that new systems do not have to be modified to take into account rules issued subsequently. Of course, it is also critical that no rules apply to swaps entered into before the regulatory effective date.

Discussion

Business Conduct Standards

Under the proposed business conduct rules, a swap dealer or MSP entering into a swap with an ERISA plan is required to provide counsel and assistance to the plan. The underlying rationale of these rules was that swap dealers are more knowledgeable than plans and are likely to take advantage of plans unless compelled to help them. This rationale has no application to ERISA plans. By law, ERISA plans are prohibited from entering into swaps unless they have an advisor with an expertise in swaps. Accordingly, ERISA plans do not have any need for any assistance or counsel from dealers. And ERISA plans surely have no interest in counsel from their counterparty. So at best, the rules have no effect. Unfortunately, the rules as proposed by the CFTC and, to a lesser extent, the SEC would actually have very serious adverse effects. Here are just three examples, although there are other issues with respect to these proposed rules.

- **Requiring actions that would make swaps impossible.** The counsel that a swap dealer is required to provide to a plan under the rules proposed by the CFTC would make the swap dealer a plan fiduciary under ERISA; the SEC's rules may have the same effect. This is the case because the proposed rules would require the swap dealers and MSPs to review the qualifications of the plan's advisor. Such a review would make the swap dealer or MSP a fiduciary under ERISA. (Under the proposed regulations issued by the Department of Labor ("DOL") regarding the definition of a "fiduciary," other actions required by the proposed business conduct standards would also convert a swap dealer or MSP into a fiduciary. The announcement that the DOL will re-propose the fiduciary regulations provides some help on these issues, but does not address the present-law problem.)

Pursuant to the DOL's prohibited transaction rules, a fiduciary to a plan cannot enter into a transaction with the plan. So, if the swap dealer or MSP is a plan fiduciary, then any swap entered into with an ERISA plan is an illegal prohibited transaction under the DOL rules applicable to plans. Thus, the business conduct rules would require a swap dealer or MSP to perform an illegal action or refrain from entering into a swap with a plan. Generally, the only way to avoid violating the law would be for swaps with plans to cease, with the adverse results described above.

Congress clearly never intended to indirectly prohibit plans from utilizing swaps. The CFTC, SEC, and DOL should jointly announce that no action required by the business conduct rules will cause a swap dealer or MSP to be treated as fiduciary. This would simply be a clarification that there is not an irreconcilable conflict between two sets of regulations. If the agencies do not do this, Congress needs to step in and enact the legislative discussion draft which does exactly this.

- **Acting as an advisor.** Under the Dodd-Frank Act, if a swap dealer acts as an advisor to a Special Entity, such as an ERISA plan, the swap dealer must act in the best interests of the Special Entity. Unfortunately, the CFTC's proposed business conduct standards interpret "acting as an advisor" so broadly that all swap dealers would be treated as advisors, *e.g.*, by reason of providing information on the risks of the swap. Even if that were not the case, the CFTC's proposed business conduct standards do not distinguish between selling (*e.g.*, a dealer pitching a swap might describe a swap as meeting the objectives of a plan) and advising (where a relationship of reliance exists based on shared objectives).

If a dealer is treated as an advisor and thus must act in the best interests of its counterparty, this is an unworkable conflict of interest that in virtually every circumstance would render swaps unavailable to plans. It is not clear to us how a swap dealer that owes a fiduciary duty to its shareholders to obtain

the best possible deal with the plan can simultaneously act in the best interests of the plan, which is the dealer's counterparty. Absent clarification of this issue, if the proposed business conduct standards are finalized as proposed, we are concerned that virtually all swaps with ERISA plans would likely have to stop, due to this conflict.

The core point is that it would be a violation of ERISA for an ERISA plan to rely on its counterparty for advice. Based on that point and business common sense, our members do not rely on their counterparty for advice. A dealer makes its pitch to an ERISA plan. The plan representatives then take the dealer's pitch and fully analyze it with their own advisors. That is how the ERISA plan world works. ERISA plans may not, and do not, rely on their counterparties. The CFTC needs to revise its regulations to reflect this.

We believe that the business conduct standards should state that a dealer is not an "advisor" if (1) the dealer represents in writing that it is functioning as a counterparty and not as an advisor, and (2) the Special Entity represents in writing that it has its own internal or external advisor. In general, this is the structure adopted by the SEC in its proposed business conduct standards and by the legislative discussion draft. We believe this provides a very workable framework on this issue.

- **Dealers' right to veto plan advisors.** Under the proposed CFTC and SEC rules, swap dealers and MSPs are required to carefully review the qualifications of a plan's advisor; as noted above, this could effectively preclude swaps with plans by making the swap dealer or MSP a fiduciary. In addition, this requirement would give swap dealers and MSPs the ability to veto any advisor advising a plan with respect to a swap. We are not suggesting that a dealer or MSP would use this power, but the fear of that result could have a significant effect on advisors' willingness to zealously represent plans' interests against a dealer or MSP. In addition, a dealer or MSP could use this requirement to demand information regarding the plan or the advisor, potentially giving the dealer or MSP an unfair informational advantage in the swap transaction.

Also, the specter of liability for not vetoing an advisor that subsequently makes an error may have an adverse impact on the dealers' or MSPs' willingness to enter into swaps with plans; this may result in the dealers and MSPs demanding additional concessions from the plans or their advisors, or may cause the dealers and MSPs to cease entering into swaps with plans. In all of the above cases, the effect on plans' negotiations with dealers and MSPs would be extremely adverse. This, too, was never intended by Congress.

Congress' intent in the business conduct standards was to ensure that Special Entities are being advised by a qualified advisor. Congress' objective is by law met in the case of an ERISA plan, so there is no need for swap dealers or MSPs to be given a counterproductive veto power. By law, ERISA fiduciaries must have expertise in the area in which they are advising and must use their expertise prudently. Consistent with the statute, a dealer or MSP should be deemed to meet the business conduct standards relating to dealers or MSPs acting as counterparties if a plan represents that it is being advised by an ERISA fiduciary. The legislative discussion draft would do exactly this with respect to ERISA plans.

Margin Requirements

The CFTC and the "Prudential Regulators" (*i.e.*, banking regulators such as the Board of the Federal Reserve System and the FDIC) have proposed very burdensome margin requirements on uncleared swaps entered into by ERISA plans. The CFTC and Prudential Regulators would treat ERISA plans as "high-risk financial end-users" and impose the same margin requirements on ERISA plans as are imposed on, for example, hedge funds. As explained below, this treatment is inappropriate and inconsistent with Congressional intent because ERISA plans are highly regulated, and subject to mandatory funding requirements, and cannot file for bankruptcy; thus, they are actually the lowest risk end-users. Treating ERISA plans as high-risk financial end-users will actually create risk, rather than reduce it, thereby adversely affecting plan participants. We strongly believe that, as one of the safest counterparties, no mandated margin requirements should apply to the uncleared swaps entered into by ERISA plans.

Background. The Dodd-Frank Act directed the CFTC, the SEC, and the Prudential Regulators to adopt rules for swap dealers and MSPs that impose margin requirements on uncleared swaps. The Dodd-Frank Act directed the agencies to use this authority to protect the financial integrity of the markets by ensuring that the

margin requirements are appropriate in light of the risk associated with an uncleared swap.

The precise nature of the statutory direction to the agencies is not clear. But, as described below, the agencies have used this statutory provision to impose margin requirements on all end-users, which is hardly consistent with the statute.

Proposed regulations. The CFTC and the Prudential Regulators have issued proposed regulations under the Dodd-Frank provisions described above. The proposed regulations establish three levels of risk, and place all end-users in one of the following categories:

- High-risk financial end-users (the riskiest),
- Low-risk financial end-users, and
- Non-financial end-users (the lowest risk).

The “high-risk financial end-users” include, for example, hedge funds and ERISA plans. End-users in the “high-risk” category are subject to the most onerous margin requirements. The “low-risk financial end-users” are financial entities that are subject to regulatory capital requirements, like insurance companies and banks. End-users in the “low-risk” category are subject to somewhat less onerous margin requirements. Non-financial end-users are considered the lowest risk group under the rules and are subject to the least onerous requirements.

Our view. The treatment of ERISA plans as high-risk financial end-users does not make sense; ERISA plans are at the least some of the lowest risk end-users:

- Unlike almost any other counterparty, ERISA plans cannot avoid their obligations to their counterparties by filing for bankruptcy. If an ERISA plan’s sponsor files for bankruptcy and the plan has outstanding liabilities, the PBGC assumes those liabilities. We are not aware of any instance where the PBGC has avoided, or could have avoided, any assumed swap liabilities.
- ERISA plans are subject to stringent funding requirements. In addition to ERISA plans having their own assets, plan sponsors are obligated to make contributions to satisfy plan liabilities. Virtually no other counterparty has that type of “credit enhancement”.
- ERISA plans are not operating entities with the corresponding business risks.
- ERISA plans are tightly regulated by, for example, prudent diversification rules and strict fiduciary rules.
- ERISA plan assets must be held in a trust that is not subject to the creditors of the plan sponsor.
- Informal surveys indicate that no ERISA plan has ever failed to pay off its swap liabilities.

In this context, onerous margin requirements for ERISA plans do not make sense. The margin requirements would result in a significant increase in both opportunity cost as well as the actual cost of swaps. The proposed margin requirements are so onerous that some plans will find it prohibitively expensive to enter into the swaps necessary to hedge their risks. This would undermine the retirement security of millions of Americans, and leave plans and plan sponsors exposed to very significant market and interest rate risk. To the extent some plans continue to use some swaps, the increased costs will result in more potential risk (due to a reduction of a risk mitigating strategy, such as interest rate swaps), benefit reductions, and freezes, thus hurting the plan participants we are all trying to protect. In light of the absence of risk posed by ERISA plans, we believe that ERISA plans should not be subject to any mandated margin requirements.

Cost-Benefit Analysis

ERISA plans are subject to a regulatory regime under ERISA which makes them unlike any other counterparty. We are not suggesting that ERISA plans deserve better treatment, but they do deserve the right treatment taking into account their unique circumstances. As demonstrated above, the agencies have not recognized these unique aspects in their rulemaking. We believe that a requirement that, prior to issuing any proposed or final regulation, the agencies must engage in an appropriately thorough cost-benefit analysis might well address this shortcoming. If ERISA plans are already required by law to have expert advisors, there is no benefit and there is substantial cost to giving dealers and MSPs veto power over plan advisors. Similarly, if it is illegal for an ERISA plan to rely on a dealer to act as its advisor, and there is no evidence that this has ever happened, there is no benefit attributable to a rule that treats dealers as advisors based on normal selling activi-

ties. In contrast, the cost of effectively precluding ERISA plans from using swaps is enormous.

The agencies need a more effective and more specific means of assessing the costs and benefits of their regulations. H.R. 1840 would be a major step forward in that regard.

Effective Date

A \$600 trillion market cannot be restructured overnight without devastating consequences. As discussed above, the use of swaps is critical to the ability of plans to manage very significant risks. If a regulatory structure is imposed in haste, the possibilities for damage to the retirement system and the retirement security of millions of Americans are very high. In that context, three principles should be followed.

Time to comply. Plans and their advisors will need substantial time to comply with complex and significant new rules. A sufficiently long implementation time is essential so that plans and their advisors can plan for an orderly transition to the new system without unnecessary, harmful, and costly disruptions. If there is not sufficient time to design compliance systems, plans may be unable to enter into needed swaps. In other cases, confusion and misunderstandings will lead to unnecessary disputes, which will in turn create costs and disruption.

Ordering guidance. When an entire market is being restructured, there are substantial interrelationships between the different parts of the restructuring. If one set of rules has an earlier effective date, systems will have to be built to accommodate those rules. In building those systems, ERISA plans and others will need to make judgments about how to comply with other parts of the Dodd-Frank Act for which there is no guidance. When subsequent rules are issued, and those rules inevitably vary in some respect from the systems built by market participants, the compliance systems will need to be rebuilt, requiring a whole new transition period. This is very costly and disruptive. To avoid this, it is essential that the agencies coordinate the timing of guidance on related issues, including providing guidance first on definitional issues.

Prospective effect. It almost goes without saying that no new rules should apply directly or indirectly to swaps entered into prior to the effective date of such rules. The dollars involved in swap transactions can be enormous, and accordingly, the transactions are very carefully negotiated. In that context, it would be fundamentally unfair to impose new rules on prior transactions that were negotiated by the parties in good faith based on the law in effect at the time. Moreover, the effect of disrupting the financial arrangement of the parties could be extremely adverse for one or both of the parties.

Conclusion

We thank the Committee for holding this hearing and for the opportunity to testify. Swaps are very important instruments for ERISA plans, giving plans a means to manage risks that are potentially very disruptive. We applaud the agencies for their hard work and openness to input. However, we remain very concerned that certain proposed rules have been issued that are inconsistent with the structure of ERISA plans and could cause very significant disruption for ERISA pension plans and the participants who rely on those plans for retirement security. We would like to continue to work with this Committee, the other Committees of jurisdiction, and the agencies to address these concerns so that we have a system that provides the important protections intended by the Dodd-Frank Act without unintended adverse consequences.

I would be happy to answer any questions.

The CHAIRMAN. Thank you.

Mr. Giancarlo, when you are ready.

**STATEMENT OF J. CHRISTOPHER GIANCARLO, J.D.,
EXECUTIVE VICE PRESIDENT—CORPORATE DEVELOPMENT,
GFI GROUP INC.; BOARD MEMBER, WHOLESALE MARKETS
BROKERS ASSOCIATION, AMERICAS, NEW YORK, NY**

Mr. GIANCARLO. Thank you, Mr. Chairman, Ranking Member, and Members of this Committee. My name is Chris Giancarlo. I am Executive Vice President of GFI Group. I testify today on behalf of the Wholesale Markets Brokers Association, Americas, the WMBAA, representing the largest inter-dealer brokers operating in

wholesale markets across a broad range of swap and other products. Our trading systems are the prototypes for swap execution facilities, or SEFs, under Dodd-Frank. We support H.R. 2586, the SEF Clarification Act.

As we speak this morning, GFI and other WMBAA member firms are hard at work employing many thousands of people, executing billions of dollars of swaps that account for over 90 percent of brokered swap trades taking place around the globe. The liquidity created by WMBAA members helps to reduce the cost of risk management for American businesses. Before John Deere enters into a contract to sell tractors to an Argentinean co-op, it generally finds a hedge for the foreign exchange risk. That hedge is often provided by a dealer firm or a bank that undertakes the balance sheet knowing it can offset the exposure on one of the hybrid systems that we operate for wholesale transactions.

So how is this done? Imagine a large room filled with long desks, not just in New York City but in places like Louisville, Kentucky, Jersey City, New Jersey, and Sugarland, Texas. Each desk has a group of professional men and women set up with several computer screens and telephone squawk boxes that transmit prices to our customers. These professionals use sophisticated trading technology such as central limit order book, request for quote, or RFQ systems, electronic workup and auction and matching sessions. Each method we use is geared to the specific dynamics of the financial products we broker. We call this range of trading methods hybrid brokerage. It is what CFTC Commissioner Bart Chilton described in a press interview after touring our firm as “big dynamic operations, not just a couple of guys in a back room with a phone.”

Swap markets are different than futures markets. Participants are all institutional, not retail. We deal with an infinitely larger number of complex products than in the highly commoditized futures markets. Even in the most liquid swaps products, trading is quite variable. The most active single named credit default swap contracts trade a little over 20 times a day and the majority trade less than once a day. It is because of this trading on liquidity characteristic of swaps that are so unique that our firms have developed the hybrid brokerage methods I have described. Developing and operating these hybrid systems creates thousands of well-paying American jobs.

Turning to the regulatory process, I include in my written testimony a recent comment letter that lays out simple, straightforward recommendations for changes to the proposed SEF rules to better accord with the law. For example, Congress made very clear in Dodd-Frank that SEFs may conduct business using “any means of interstate commerce.” Congress’s words are clear. Any means of interstate commerce includes the full range of hybrid brokerage methods that I have described.

We are very concerned with the CFTC’s proposed SEF rules restricting trading methods to only electronic central limit order book or RFQ systems for non-block cleared swaps. This approach is inconsistent with the plain reading of Dodd-Frank and its legislative history. Henry Ford famously told Model T buyers that they could have any color they wanted as long as it was black. Here, the CFTC is interpreting Dodd-Frank to say that for many trades,

SEFs can use any means of interstate commerce as long as it is limited to electronic systems.

We also question what substantive analysis has been done on the economic effect of these restrictions which may diminish trading liquidity and run up transaction costs for American companies and businesses. Getting those rules wrong will impact not just banks and investment managers but thousands of American companies that use swaps to hedge risk and better manage their capital for growth and reinvestment into the economy. As Commissioner Chilton said in a recent interview, it is important that “we do not mess up platforms that are currently working well. This is a delicate balancing act.”

Mr. Chairman, consideration and passage of the SEF Clarification Act will provide regulators with a clear expression of Congress’s intent to permit SEFs to use any means of interstate commerce to execute swaps transactions. We commend this Committee for considering these bipartisan proposals. Thank you for your time this morning.

[The prepared statement of Mr. Giancarlo follows:]

PREPARED STATEMENT OF J. CHRISTOPHER GIANCARLO, J.D., EXECUTIVE VICE PRESIDENT—CORPORATE DEVELOPMENT, GFI GROUP INC.; BOARD MEMBER, WHOLESALE MARKETS BROKERS ASSOCIATION, AMERICAS, NEW YORK, NY

Introduction

Thank you Chairman Lucas, Ranking Member Peterson, and Members of the Committee for providing this opportunity to participate in today’s hearing.

My name is Chris Giancarlo. I am Executive Vice President of GFI Group Inc., a global wholesale broker of swaps and other financial products. I am also a member of the Board and former Chairman of the Wholesale Markets Brokers Association, Americas (the “WMBAA”).¹ I am testifying today on behalf of the WMBAA.

I welcome the opportunity to discuss with you legislative proposals amending Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) from the perspective of the primary intermediaries of over-the-counter (“OTC”) swaps operating today here in the United States and across the globe.

My company, GFI, and the other members of the WMBAA, each have generations of experience operating at the center of the global wholesale financial markets by aggregating and disseminating prices and fostering trading liquidity for financial institutions around the world. While I am speaking to you now, wholesale brokers, sometimes called “inter-dealer” brokers, are facilitating the execution of hundreds of thousands of OTC trades corresponding to an average of \$5 trillion in size across the range of foreign exchange, interest rate, Treasury, credit, equity and commodity asset classes in both cash and derivative instruments.

Our trading systems or platforms are the prototypes for “swap execution facilities,” or “SEFs” under the Dodd-Frank Act. There is a misconception that a “swap execution facility” is a new concept created by the Dodd-Frank Act. In fact, long before, during and after the financial crisis, GFI and my WMBAA brethren have been hard at work, employing thousands of people—many here in the United States—executing swaps transactions that account for over 90% of intermediated swaps transactions taking place around the globe.

¹ The WMBAA is an independent industry body representing the largest inter-dealer brokers (“IDBs”) operating in the North American wholesale markets across a broad range of financial products. The WMBAA and its member firms have developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets*. Using these *Principles* as a guide, the WMBAA seeks to work with Congress, regulators, and key public policymakers on future regulation and oversight of institutional markets and their participants. By working with regulators to make wholesale markets more efficient, robust and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country’s capital markets. The five founding members of the WMBAA are BGC Partners; GFI Group; ICAP; Tradition and Tullett-Prebon. More about the WMBAA can be found at: www.WMBAA.org.

CFTC Commissioner Bart Chilton had this to say about a recent visit he made to GFI's New York brokerage floor, "I was surprised by what I didn't know. GFI and others like them were always in OTC land. Why would I know about what they do? Well, these are big, dynamic operations, not just a couple of guys in a back room with a phone. I don't think we have a full appreciation of the OTC markets yet."²

SEF Proposed Rulemakings

In the past year, the WMBAA has carefully considered and publicly responded to the many SEF rule proposals announced by the CFTC and SEC. For your reference, I have included a recent comment letter as an appendix to this testimony that lays out our primary concerns and makes simple, straightforward recommendations for changes to the proposed rulemakings.

The WMBAA appreciates the thoughtful approach of both Commissions and their staffs in implementing Dodd-Frank. It is clear that the two staffs have worked hard to generally try to balance the compelling interests of fostering growth in competitive OTC markets while ensuring that regulatory oversight will be in place to monitor for risks to these vital markets.

The WMBAA generally supports the SEC's interpretation of the SEF definition as it applies to trade execution through "any means of interstate commerce," including the full range of request-for-quote ("RFQ") systems, order books, auction platforms or voice brokerage trading that are used in the market today.³ Such an approach is consistent with the letter and spirit of the Dodd-Frank Act and ensures flexibility in the permitted modes of execution.

On the other hand, the WMBAA is concerned with the CFTC's proposed SEF rules that work to restrict trading methods that are not exclusively central limit order book or RFQ for non-block, cleared swaps. We believe this approach is inconsistent with the requirement in the statute that SEFs may utilize "any means of interstate commerce." The CFTC's proposed rule is a one size fits all approach that limits market efficiency and customer choice.

Henry Ford famously told Model T buyers that they could have any color they wanted as long as it was black. Here, the CFTC is interpreting the Dodd Act to say that, for many trades SEFs can use any means of interstate commerce, as long as it is limited to RFQ or central limit order book systems.

The commercial flaw with the CFTC's approach is that it is largely the liquidity characteristics of a given swap product, not whether or not the instrument is cleared or part of a block transaction, that determines which blend of hybrid brokerage is most suited for trade execution. We know from decades of experience that, if a swap trades in high volume with great liquidity, then central limit order book systems may work fine. If, however, the particular swap instrument trades in lower volume with limited liquidity, then electronic order book systems will not succeed and other "hybrid" methods are more suitable. For these reasons, it is the position of the WMBAA that hybrid brokerage should be clearly recognized as an acceptable mode of trade execution for all swaps whether "Required" or "Permitted" under the CFTC's proposal.

We believe this rule proposal is not supported by a plain reading or the legislative history of the Dodd-Frank Act. Worse, it will constrain the very "hybrid" systems that are currently relied upon for liquidity formation in U.S. swaps markets. In swaps markets without retail customer participation, the WMBAA questions what useful protections are afforded to swap dealers and major swap participants by regulations that would limit the methods by which they may execute their swaps transactions.

These regulatory proposals need to be carefully considered not only in their own right, but more so for their snowball effect that could impact U.S. economic growth, competitiveness and, most critically, much needed American job creation. Getting

² *Energy Metro* DESK, February 7, 2011, p. 6. The article further states, "Chilton says his trip North to GFI changed his opinion about SEFs and OTC transparency in general. He says the hybrid broker model (voice and screens) for example, which actually is the rule and not the exception around the market, was news to him."

³ Wholesale brokers provide highly sophisticated trade execution services, combining teams of traditional "voice" brokers with sophisticated electronic trading technology. As in virtually every sector of the financial services industry in existence over the past 50 years, wholesale brokers and their dealer clients began connecting with their customers by telephone. As technologies advanced and markets grew larger, more diverse and global, these systems have advanced to meet the changing needs of the market. Today, these systems include fully electronic central limit order books, RFQ systems, automated "work up," auction and matching sessions and pricing screens. The particular blend of human interaction and trading technology utilized is based on the unique liquidity characteristics and market dynamics of individual swaps products for the purpose of best enhancing trading liquidity. We refer to this integration of voice brokers with the range of electronic brokerage systems as "hybrid brokerage".

those rules wrong will impact not just banks and investment managers, but thousands of American businesses that use swaps to hedge risk and better manage their capital for growth and reinvestment into the economy.

SEF Clarification Act

Mr. Chairman, introduction, consideration, and passage of the SEF Clarification Act will provide regulators with a clear expression of Congress' legislative intent and ensure that the final rules remain within the framework of competitive OTC markets. The WMBAA commends this Committee for considering this very important bipartisan proposal. This hearing is sending a loud and clear message to the CFTC that its proposed SEF rule is inconsistent with the intent of the authors of Section 733 of the Dodd-Frank Act.

The WMBAA appreciates the bipartisan efforts of Congressmen Scott Garrett, Robert Hurt, Gregory Meeks and Congresswoman Carolyn Maloney to try and make sure that the interpretations of the Dodd-Frank Act rules governing swap execution facilities foster competitive sources of liquidity for market participants. We agree with their concern to promote the transparent evolution of swaps trading on SEFs to ensure that a vibrant swap market continues to develop in the U.S.

The WMBAA continues to work with the CFTC and SEC to help create a regulatory framework that promotes a competitive marketplace for SEFs. The WMBAA remains concerned, as it has expressed in its comment letters to the SEC and the CFTC, that limitations on permitted modes of trade execution or requirements to display or delay quotes will cause significant disruptions to OTC swaps markets with the potential to drive trading offshore. We question what substantive analysis has been done on the economic effects of the CFTC proposed rule, which could run up transaction costs in the U.S. swaps markets.

Similarly, the WMBAA does not believe that there is any justification or legislative authority for the RFQ requirement of five possible respondents. Rather, consistent with the Dodd-Frank Act's SEF definition, the threshold analysis should consider whether the system meets the "multiple to multiple" requirement set forth in the SEF definition. The WMBAA finds it inconsistent that the CFTC's proposed rules permit a SEF to operate a "multiple to one" RFQ system, while at the same time (without clear explanation), impose arbitrary limits on the various multiple-to-multiple hybrid execution platforms utilized by wholesale brokers. By contrast, the SEC's proposed rule merely requires that a RFQ system has the "ability" to send the request to many participants, but not an obligation. We believe that the SEC's approach is more consistent with the statutory language of the Dodd-Frank Act.

Just as regulators were intimately involved in the debate surrounding the legislation that resulted in the Dodd-Frank Act, we encourage Congress to remain vigilant in its oversight of the regulatory rulemaking process. We applaud legislators for providing additional guidance to a regulatory agency misinterpreting statutory language and Congressional intent.

WMBAA Suggested Revisions to the CFTC SEF Rulemaking

In our most recent comment letter to the CFTC, the WMBAA identified the following as highest priority issues for attention:

- **"Permitted"/"Required" Transaction Classification System.** The WMBAA does not believe that distinguishing between "Permitted" and "Required" swaps is beneficial to the continued operation of competitive, liquid OTC markets. Such artificial designations of swap transactions may result in perverse consequences to OTC swaps markets. Further, the proposed restriction for "Required Transactions" to only those traded on order books or RFQ systems is contrary to the Commodity Exchange Act ("CEA's") permitted transaction of swaps "by *any* means of interstate commerce" (emphasis added). Under the current classifications, many hybrid brokerage methodologies may be prohibited or face an uncertain future, as each would require individual analysis by the Commission for compliance with the core principles. While certain requirements should be mandated during trade execution (*i.e.*, audit trail, trade processing, and reporting), limitations on methodologies used in trade execution should be considered in accordance with Congress' authorization of trade execution through "any means of interstate commerce" and weighed against any potential implications on liquidity formation and American market competitiveness.
- **The "15 Second Rule."** The WMBAA believes that the CFTC's proposed 15 second timing delay before a trader can execute against a customer's order or a SEF can execute two customers against each other is not contemplated by CEA, as amended by the Dodd-Frank Act, nor is it supported by legislative history. This concept, which seems to have originated in the futures exchange markets, will create uncertainty and risk in the swaps markets. This requirement

does not appear to be consistent with the protection of investors. Even asset management firms, acting on behalf of state and local government pension funds, endowments, ERISA funds, 401(k) and similar types of retirement funds, all of whom have a statutory fiduciary duty to their clients, are opposed to this requirement.⁴ The WMBAA recognizes that this approach may work in the highly liquid futures market. However, the 15 second delay ignores the episodic nature of liquidity in the swaps markets and will have a detrimental impact on transactional efficiency, cost and market liquidity. The WMBAA questions what substantive analysis has been done on the economic effects of 15 Second Rule, which could run up transaction costs in the U.S. swaps markets frustrating American companies' ability to hedge commercial risk, particularly end-users.

- **SEF Impartial Access.** The WMBAA has requested that the CFTC delete the provision in the Proposed Rules providing impartial access to SEFs for independent software vendors ("ISVs"). The WMBAA believes this requirement is beyond the legal authority granted in the CEA and expands the impartial access statute beyond "market participants" to include entities lacking any intent to transact in swaps. There is no Congressional intent or legislative history to indicate that the term "market participants" should be read beyond the commonly understood definition as used by the industry today.
- **Margin Assumptions.** In the CFTC's proposed rule for risk management requirements for derivatives clearing organizations ("DCOs"), DCOs must establish initial margin requirements that, in part, take into account the amount of time needed to liquidate a defaulting clearing member's position. To that end, the DCO must use a five business day liquidation horizon for cleared swaps not executed on a designated contract market ("DCM"), but a one business day liquidation horizon for all other products that it clears. The result of this proposed arrangement would be that DCOs would impose higher margin requirements for swaps executed on SEFs than swaps executed on DCMs. This result would be inconsistent with the competitive trade execution landscape envisioned by the Dodd-Frank Act. Such a regulatory scheme may also violate specific provisions of the Dodd-Frank Act which require a DCO to adopt rules providing that all swaps with the same terms and conditions submitted to the DCO for clearing are economically equivalent within the DCO and may be offset with each other within the DCO.

Harmonization

While the substance of the proposed requirements for SEF registration and core principles are extremely important, it is equally, if not more, important that the final regulatory frameworks are harmonized between the two agencies. A failure to achieve harmonization will lead to regulatory arbitrage and unreasonably burden market participants with redundant compliance requirements. As the recent SEC-CFTC joint proposed rule recognized, "a Title VII instrument in which the underlying reference of the instrument is a 'narrow-based security index' is considered a security based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (*i.e.*, the index is broad-based) is considered a swap subject to regulation by the CFTC." Any discrepancy in the Commissions' regulatory regimes will give market participants incentive to leverage the slight distinctions between these products to benefit from more lenient rules.

Similarly, in a world of competing regulatory regimes, business naturally flows to the market place that has the best regulations—not necessarily the most lenient, but certainly the ones that balance execution flexibility with participant protections. For example, GFI businesses are operating and subject to oversight in the UK by the FSA and globally by regulatory agencies in France, Singapore, Hong Kong, Japan and Korea. European and Asian markets are not imposing restrictions on methods of execution. U.S. regulations need to be in harmony with those of foreign jurisdictions to avoid driving trading liquidity away from U.S. markets to those offering greater flexibility in modes of trade execution.

"Rule of Construction"—Pre-Trade Price Transparency

Section 5h of the CEA, as amended by Section 733 of the Dodd-Frank Act, includes a "rule of construction" indicating that "the goal of this section is to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market."

⁴See, *e.g.*, letter from Timothy W. Cameron, Esq., Managing Director, Asset Management Group, Securities Industry and Financial Markets Association, to CFTC, dated March 8, 2011.

This rule of construction, which was added during the House-Senate Conference Committee, is an aspirational and undefined goal. It must be considered subordinate to the required statutory provisions of the Dodd-Frank Act. According to a Congressional Research Services report, longstanding principles of statutory interpretation indicate that particular substantive requirements, such as the mandate that regulators consider the impact of certain actions on market liquidity, override general canons of statutory construction. There are no operative provisions for pre-trade price transparency in the Dodd-Frank Act that correspond to the non-binding rule of construction. However, there exist other substantive provisions which were designed to increase transparency in OTC swaps markets.

For example, Section 2a(13)(E) of the CEA requires that, for rules providing for the public availability of transaction and pricing data for swaps, the CFTC shall contain provisions “that take into account whether the public disclosure will materially reduce market liquidity.” The same provision requires that the CFTC consider an “appropriate time delay for reporting large notional swap transactions (for block trades) to the public.” These post-trade reporting requirements are indicative of Congressional recognition that OTC swaps markets thrive when the need for transparency is balanced against the impact on market liquidity. Congress clearly sought to preserve market liquidity and protect businesses’ ability to hedge commercial risk and to appropriately plan for the future, promoting economic growth and job creation.

Further, the SEF core principles in Section 5h(f) of the CEA require a SEF to make public timely information on price, trading volume, and other trading data on swaps and electronically capture and transmit trade information with respect to transactions executed on the facility. These statutory requirements precede any legislative “goals” that may be imposed by regulatory rulemakings. The SEF core principles ensure that market information is promptly and accurately reported to both regulators and to market participants without materially impeding liquidity formation. To impose requirements in any other manner would disrupt the competitive trade execution marketplace, where trading systems or platforms vie with each other to win their customers’ business through better price, provision of superior market information and analysis, deeper liquidity and better service.

It is important to recognize that the “goal” of pre-trade price transparency is not inconsistent with the traditional operations of wholesale brokers. Because revenue is generated from commissions paid on executed trades, wholesale brokers seek to complete more transactions with more customers. It is in each wholesale brokers economic interest to naturally and consistently disseminate pre-trade price information—bids and offers—to the widest practical range of customers with the express purpose of price discovery and the matching of buyers and sellers. The trading systems and platforms employ a number of means of pre-trade transparency, including software pricing analytics, electronic and voice price dissemination, and electronic price work up technology.

Wholesale brokers generally maintain extensive trade reporting systems supported by sophisticated technology that can provide regulators with real-time trading information, increasing transparency and providing critical information on financial conditions and market dynamics. Wholesale brokers also increase transparency in OTC markets by publishing market and pricing data and facilitating enhanced audit trails to monitor against market fraud and manipulation.

Different Characteristics of Futures and OTC Markets

While the relationship between exchange-traded and OTC markets generally has been complementary, each market provides unique services to different trading constituencies for products with distinctive characteristics and liquidity needs. As a result, the nature of trading liquidity in the exchange-traded and OTC markets is often materially different. It is critically important that regulators recognize the difference.

Highly liquid markets exist for both commoditized, exchange-traded products, and the more standardized OTC instruments, such as U.S. treasury securities, equities and certain commodity derivatives. Exchange-traded markets provide a trading venue for the most commoditized instruments that are based on standard characteristics and single key measures or parameters. Exchange-traded markets with central counterparty clearing rely on relatively active order submission by buyers and sellers and generally high transaction flow. Exchange-traded markets, however, offer no guarantee of trading liquidity as evidenced by the high percentage of new exchange-listed products that regularly fail to enjoy active trading. Nevertheless, for those products that do become liquid, exchange marketplaces allow a broad range of trading customers (including retail customers) meeting relatively modest margin requirements to transact highly standardized contracts in relatively small amounts.

As a result of the high number of market participants, the relatively small number of standardized instruments traded, and the credit of a central counterparty clearer, liquidity in exchange-traded markets is relatively continuous in character.

In comparison, many swaps markets and other less commoditized cash markets feature a broader array of less-standardized products and larger-sized orders that are traded by fewer counterparties, almost all of which are institutional and not retail. Trading in these markets is characterized by variable or non-continuous liquidity. To offer one simple example, of the over 4,500 corporate reference entities in the credit default swaps market, 80% trade less than five contracts per day.⁵ Such thin liquidity can often be episodic, with liquidity peaks and troughs that can be seasonal (certain energy products) or more volatile and tied to external market and economic conditions (*e.g.*, many credit, energy and interest rate products).

General Comparison of OTC Swaps Markets to Listed Futures Markets⁶

Characteristic	OTC Swaps	Listed Futures
Trading Counterparties	10s–100s (no retail)	100,000s (incl. retail)
Daily Trading Volume	1,000s	100,000s
Tradable Instruments	100,000s ⁷	1,000s
Trade Size	Very large	Small

Drawing a simple comparison, the futures and equities exchange markets generally handle on any given day hundreds of thousands of transactions by tens of thousands of participants (many retail), trading hundreds of instruments in small sizes. In complete contrast, the swaps markets provide the opportunity to trade tens of thousands of instruments that are almost infinitely variable. Yet, on any given day, just dozens of large institutional counterparties trade only a few thousand transactions in very large notional amounts.

The effect of these very different trading characteristics results in fairly continuous liquidity in futures and equities compared with limited or episodic liquidity in swaps. There is richness in those differences, because taken together, this market structure has created appropriate venues for trade execution for a wide variety of financial products and a wide variety of market participants. But the difference is fundamental and a thorough understanding of it must be at the heart of any effective rule making under Title VII of the Dodd-Frank Act. The distinct nature of swaps liquidity has been the subject of several studies and comment letters presented to the CFTC and the SEC.⁸

The unique nature of swaps markets liquidity was recently analyzed by the New York Federal Reserve.⁹ Their study found that the most active of single-name CDS contracts traded a little over 20 times per day, and the majority of single name CDS contracts trade less than once a day, but in very large sizes. This is wholly different than the hundreds of thousands of trades that take place each day in many exchange traded instruments.

It is because of the limited liquidity in many of the swaps markets that they have evolved into “dealer” marketplaces for institutional market participants. That is, corporate end-users of swaps and other “buy side” traders recognize the risk that, at any given time, a particular swaps marketplace will not have sufficient liquidity to satisfy their need to acquire or dispose of swaps positions. As a result, these counterparties may chose to turn to well capitalized sell-side dealers that are willing to take on the “liquidity risk” for a fee. These dealers have access to secondary trading of their swaps exposure through the marketplaces operated by wholesale and inter-dealer brokers such as GFI Group. These wholesale marketplaces allow dealers to hedge the market risk of their swaps inventory by trading with other primary dealers and large, sophisticated market participants. Without access to wholesale markets, the risk inherent in holding swaps inventory would cause dealers to have to charge much higher prices to their buy side customers for taking on their liquidity risk, assuming they remain willing to do so.

⁵ ISDA & SIFMA, “Block Trade Reporting for Over-the-Counter Derivatives Markets,” January 18, 2011, (“ISDA/SIFMA Block Trade Study”). Available at <http://www.isda.org/speeches/pdf/Block-Trade-Reporting.pdf>.

⁶ See ISDA/SIFMA Block Trade Study.

⁷ Inclusive of all tenors, strikes and duration.

⁸ ISDA/SIFMA Block Trade Study; Comment Letter of JPMorgan (January 12, 2011).

⁹ Kathryn Chen, Michael Fleming, John Jackson, Ada Li, and Asani Sarkar, *An Analysis of CDS Transactions: Implications for Public Reporting* (September 2011), available at http://www.newyorkfed.org/research/staff_reports/sr517.pdf.

American Capital Markets Risk Being Driven Offshore—Again

In closing, it is clear that the U.S. over-the-counter swaps markets are on the cusp of seismic changes that could have unintended, yet far reaching, consequences if not enacted with prudence and common sense.

We are reminded of the sensitivity of the regulatory process by the effects of a whole other set of U.S. financial market regulations that were put in place several decades ago. Those regulations remind us of the eternal law of unintended consequences.

Many professionals in the swaps brokerage industry began work in the late 1970s and 1980s in London. In those days, London was the central marketplace for bank deposits of billions of U.S. Dollars held outside the U.S.—the so-called Euro-dollar market. The most critical stimulus for the development of the Euro-dollar market was Regulation Q promulgated under the Glass-Steagall Act. Under Reg Q, the Federal Reserve fixed maximum interest rates that U.S. member banks could pay on U.S. Dollar deposits. Because of these ceilings, Dollar deposits in non-U.S. banks, paying a higher interest rate, became more attractive than deposits in U.S. banks. As a result, the overseas Euro-dollar market grew rapidly. Combined with various U.S. foreign exchange controls, Reg Q led to the development of a major non-U.S. marketplace for deposits of U.S. currency. That non-U.S. marketplace stimulated all manner of economic development and job creation—NOT jobs here in the United States, but overseas in London and elsewhere.

It is useful to keep in mind this ill-fated financial regulation in the course of today's hearing of proposed U.S. regulations of SEFs. We must look carefully at these regulations not only in their own right, but also for their impact on U.S. economic growth, market vibrancy and, most critically, job creation. It is well worth our time to ask ourselves:

- Which regulations being proposed *today* will constrict liquidity *tomorrow* in U.S. swaps markets?
- Will the “15 second rule” be the new Reg. Q shifting U.S. markets offshore?
- Will regulatory bias toward electronic trading for clearable, non-block swaps drive markets to places that allow trading to be done through the greater flexibility of hybrid execution?
- Will certain rule proposals lead to the loss of jobs for U.S. hybrid brokerage employees and their replacement with workers abroad?

In posing these questions, we should be aware that the answers are not only important to us in America, but are also being weighed by the Lord Mayors of London and Geneva, the exchange operators of Singapore and the financial industrialists of Hong Kong and Beijing. Their gain is our loss. As American businesses and employers, we must get it right for the sake of the American economy and jobs.

APPENDIX—WMBAA LETTER TO THE SEC & CFTC—JUNE 3, 2011

June 3, 2011

<p>Hon. GARY GENSLER, <i>Chairman,</i> Commodity Futures Trading Commission, Washington, D.C.;</p>	<p>Hon. MARY SCHAPIRO, <i>Chairman,</i> Securities and Exchange Commission Washington, D.C.</p>
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Re: Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act; Core Principles and Other Requirements for Swap Execution Facilities (RIN 3038-AD18); Real-Time Public Reporting of Swap Transaction Data (RIN 3038-AD08); Reporting and Dissemination of Security-Based Swap Information (File 3235-AK80); Registration and Regulation of Security-Based Swap Execution Facilities (RIN 3235-AK93)

Dear Chairman Gensler and Chairman Schapiro:

As a follow-up to the participation of Wholesale Markets Brokers' Association Americas (“WMBAA”)¹ members in the joint staff roundtable hosted by the Com-

¹The Wholesale Markets Brokers' Association Americas is an independent industry body representing the largest inter-dealer brokers (“IDBs”) operating in the North American wholesale markets across a broad range of financial products. The WMBAA and its member firms have

Continued

modity Futures Trading Commission (“CFTC” or “Commission”) and the Securities and Exchange Commission (“SEC” or “Commission”) on May 3 and May 4, 2011 dedicated to discussing the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), the WMBAA appreciates the opportunity to provide additional comments related to the importance of proper harmonization of and implementation by the two agencies as the rulemaking process advances.

The WMBAA believes that it is vital to the stability and liquidity provided by OTC swaps and security-based swaps (collectively referred to as “swaps”) markets to ensure that swap and security-based swap execution facilities (collectively referred to as “SEFs”) are brought under the new regulatory regime in such a way that fosters the competitive nature of OTC markets and continues to provide a deep source of liquidity for market participants.

In addition to the formal comments previously submitted with respect to the CFTC and SEC’s proposed rules,² the WMBAA offers additional comments on the appropriate implementation of the proposed rules and substantive requirements that would pose significant burdens unless harmonized between the CFTC and SEC.

The WMBAA also recognizes that certain provisions of the Commodity Exchange Act (“CEA”) and the Securities Exchange Act of 1934 (“1934 Act”), as amended by the Dodd-Frank Act, impose specific requirements on market participants as of the effective date, July 16, 2011. In particular, we note the statutory provisions could be read to require on and after July 16, 2011 the “trading” of swaps only on registered designated contract markets (“DCMs”), national securities exchanges and SEFs.

Congress envisioned that the Title VII rulemaking process would move quickly and that all rules and regulations would be in place prior to the July 16, 2011 effective date. It is clear that final rules for the registration of SEFs will not be in place by the July 16, 2011 effective date. Further, the Commissions have not made any determinations about which swaps will be subject to the mandatory clearing requirement, which will dictate which swaps are required to be traded on a SEF.

The WMBAA is concerned that, absent regulatory relief by the Commissions, existing trade execution systems or platforms such as those provided by WMBAA members, and the swaps transactions entered into thereon will be subject to significant legal uncertainty due to the incomplete rulemaking process. Further, we believe IDBs should not be required to register as futures commission merchants (“FCMs”), introducing brokers (“IBs”) or broker-dealers to “broker” swaps while the Commissions are in the process of finalizing the SEF registration and regulation rules.³ The WMBAA strongly encourages the Commissions to issue as soon as possible a legal opinion, no action position or guidance which clarifies that swaps entered into after July 15, 2011 are not required to be traded on a registered DCM, national securities exchange and/or SEF or brokered by a registered FCM, IB or broker-dealer until the Commissions have issued final rules which are effective regarding the registration of SEFs and issued final rules which are effective with respect to the mandatory trading of swaps. The WMBAA looks forward to discussing

developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets*. Using these principles as a guide, the Association seeks to work with Congress, regulators and key public policymakers on future regulation and oversight of over-the-counter (“OTC”) markets and their participants. By working with regulators to make OTC markets more efficient, robust and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country’s capital markets. For more information, please see www.wmbaa.org.

²See, e.g., letter from J. Christopher Giancarlo, Chairman, WMBAA, to SEC and CFTC, dated July 29, 2010; see also letter from Julian Harding, Chairman, WMBAA, to SEC and CFTC, dated November 19, 2010; letter from Julian Harding, Chairman, WMBAA, to SEC and CFTC, dated November 30, 2010; letter from Julian Harding, Chairman, WMBAA, to SEC, dated January 18, 2011; letter from Stephen Merkel, Chairman, WMBAA, to CFTC, dated February 7, 2011; letter from Stephen Merkel, Shawn Bernardo, Christopher Ferreri, J. Christopher Giancarlo and Julian Harding, WMBAA, to CFTC, dated April 4, 2011.

³The WMBAA notes that, among the extensive Dodd-Frank Act rulemakings, the CFTC has not comprehensively addressed the regulation of brokers engaged in swap-related activities. Section 721 of the Dodd-Frank Act amends the definitions of “futures commission merchants” and “introducing brokers” in the CEA to permit these intermediaries to trade swaps on behalf of customers. As of the effective date, these intermediaries may be required to register with the CFTC and become members of the National Futures Association. As such, these intermediaries would be subject to the National Futures Association’s rules and examinations, for example Series 3 examination, which is based on futures-related activity. The WMBAA urges the CFTC to provide clarity on this issue by delaying the implementation of swap introducing broker and futures commission merchant registration and issuing interpretive guidance to assist swap intermediaries in understanding what activities might mandate registration and the requirements for Commission registration.

the impact of the self-effectuating provisions in the CEA and 1934 Act with the Commissions.

Importance of Harmonization between Agencies and Foreign Regulators

While the substance of the proposed requirements for SEF registration and core principles are extremely important, it is equally, if not more, important that the final regulatory frameworks are harmonized between the two agencies. A failure to achieve harmonization will lead to regulatory arbitrage and unreasonably burden market participants with redundant compliance requirements. As the recent SEC-CFTC joint proposed rule recognized, “a Title VII instrument in which the underlying reference of the instrument is a ‘narrow-based security index’ is considered a security-based swap subject to regulation by the SEC, whereas a Title VII instrument in which the underlying reference of the instrument is a security index that is not a narrow-based security index (*i.e.*, the index is broad-based), the instrument is considered a swap subject to regulation by the CFTC.”⁴ Any discrepancy in the Commissions’ regulatory regimes will give market participants incentive to leverage the slight distinctions between these products to benefit from more lenient rules.

The Dodd-Frank Act’s framework was constructed to encourage the growth of a vibrant, competitive marketplace of regulated SEFs. Final rules should be crafted that encourage the transaction of OTC swaps on these trading systems or platforms, as increased SEF trading will increase liquidity, and transparency for market participants and increase the speed and accuracy of trade reporting to swap data repositories (“SDRs”). Certain provisions relate to these points, such as the permitted methods of trade execution, the scope of market entities granted impartial access to SEFs, the formulation of block trade thresholds and compliance with SEF core principles in a flexible manner that best recognizes the unique characteristics of competitive OTC swaps markets.

Based upon its review of both the SEC and the CFTC’s Proposed Rules, the WMBAA suggests that the agencies consider the release of further revised proposed rules incorporating comments received for additional review and comment by market participants. This exercise would ensure that the SEC and CFTC have the opportunity to review each of their proposals and integrate appropriate provisions from the proposed rules and comments in order to arrive at more comprehensive regulations. Further, the WMBAA encourages the CFTC and SEC to work together to attempt to harmonize their regulatory regimes to greatest extent possible. While some of the rules will differ as a result of the particular products subject to each agency’s jurisdiction, inconsistent rules will make the implementation for SEFs overly burdensome, both in terms of time and resources.

As an example, the WMBAA encourages the CFTC and the SEC to adopt one common application form for the registration process. While regulatory review of the application by the two agencies is appropriate, reducing the regulatory burden on applicant SEFs to one common form would allow for a smoother, timelier transition to the new regulatory regime. Because the two proposed registration forms are consistent in many respects, the WMBAA believes the differences between the two proposed applications could be easily reconciled to increase regulatory harmonization and increase efficiency.

Similarly, there needs to be a consistent approach with respect to block trades. Not only should the threshold calculations be derived from similar approaches, allowing for tailored thresholds that reflect the trading characteristics of particular products, but the methods of trade execution permitted by the Commissions should both be flexible and within the framework of the SEF definition.

U.S. regulations also need to be in harmony with regulations of foreign jurisdictions to avoid driving trading liquidity away from U.S. markets toward markets offering greater flexibility in modes of trade execution. In particular, European regulators have not formally proposed swap execution rules with proscriptive limits on trade execution methodology. We are not aware of any significant regulatory efforts in Europe to mandate electronic execution of cleared swaps by institutional market participants.

In a world of competing regulatory regimes, business naturally flows to the market place that has the best regulations—not necessarily the most lenient, but certainly the ones that have the optimal balance of liquidity, execution flexibility and participant protections. In an OTC swaps market that excludes retail participants, the WMBAA questions what useful protections are afforded to swap dealers and major swap participants by regulations that would limit the methods by which they

⁴Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 *Fed. Reg.* at 29 845 (May 23, 2011).

may execute their orders. U.S. regulations need to be in harmony with regulations from foreign jurisdictions to avoid driving trading liquidity away from U.S. markets towards markets offering greater flexibility in modes of trade execution.

Implementation of Final Rules

Compliance Timeline

The WMBAA believes that the timeline for implementation of the final rules is as important, if not more important than, the substance of the regulations. The WMBAA members recognize and support the fundamental changes to the regulation of the OTC swaps markets resulting from the passage of the Dodd-Frank Act and will commit the necessary resources to diligently meet the new compliance obligations. However, the CFTC and SEC must recognize that these changes are significant and will result in considerable changes to the operations and complex infrastructure of existing trading systems and platforms.

It is necessary that any compliance period or registration deadline provides sufficient opportunity for existing trade execution systems or platforms to modify and test systems, policies and procedures to ensure that its operations are in compliance with final rules. It is very difficult to determine the amount of time needed to ensure compliance with the rules until the final requirements are made available. However, providing market participants with an insufficient time frame for compliance could harm the efficient functioning of the markets if existing entities can no longer operate until they have built the requisite platforms to comply with every measure in final rules.

The vast number of changes required to existing trading systems or platforms to register as a SEF will impose a substantial burden in the short term. Upon implementation of the Dodd-Frank Act and final rules, wholesale brokers that register as SEFs will be required to undertake activities that include, but are not limited to: (i) developing extensive rulebooks; (ii) meeting new substantive and reporting-related financial requirements; (iii) implementing sophisticated trading, surveillance, monitoring and recordkeeping processes and technology; (iv) creating extensive self-regulatory capabilities and entering into arrangements with their customers setting forth the terms of this new arrangement; (v) potentially restructuring the governance structure of their companies, including identifying and recruiting independent board members and establishing required governance committees; (vi) potentially altering the mix of their existing customer base and adding new customers; (vii) implementing appropriate contractual and technological arrangements with clearing houses and SDRs; (viii) hiring staff and creating a compliance program structured to meet the Commissions' specifications; and (ix) educating staff on the requirements relating to trade execution, clearable vs. non-clearable trades, blocks vs. non-blocks, bespoke and illiquid trades, end-users vs. non-end-users and margin requirements.

As this list indicates, these undertakings are monumental. This burden is compounded when considering that the users of intermediary services will themselves be going through dramatic change, responding to new clearing, margin and capital requirements, new business conduct standards and changes to the means by which they are able to interact with their end customers. The WMBAA would suggest the SEC and CFTC consider the implementation of other regulatory regimes with lesser burdens than the Dodd-Frank Act, such as the introductions of TRACE reporting for corporate bonds and Regulations SHO and NMS in the equity markets. The imposition of these new regimes was far less drastic of a change to the markets and required participants to expend far fewer resources. Yet, the imposition of these regimes, particularly Regulation NMS, was conducted over a staged period to allow market participants sufficient time to comply.

Appropriate "Phasing" of Final Rules

Based upon the plain language of the Dodd-Frank Act, the mandatory trade execution requirement will become effective at the time that swaps are deemed "clearable" by the appropriate Commission. Accepting the premise that the mandatory trade execution requirement cannot be enforced until there are identified "clearable" swaps and swaps are "made available for trading," the Commissions need to ensure that a functioning and competitive marketplace of registered SEFs exists at the time the first trade is cleared and made available for trading. As such, it is necessary that SEFs be registered with the CFTC or SEC, as applicable and available to execute transactions at the time that trades begin to be cleared under the new laws. The WMBAA estimates that its members currently account for over 90% of inter-dealer intermediated swaps transactions taking place around the world today. If the SEF registration process is not effectively finalized by the time various swaps

are deemed clearable, there could be serious disruptions in the U.S. swaps markets with adverse consequences for broader financial markets.

Furthermore, requiring absolute compliance with final rules within a short time frame is particularly troublesome for likely future SEFs, as such a result may provide DCMs or national securities exchanges with an unfair advantage in attracting trading volume due to their ability to quickly meet the regulatory burdens. Congress distinguished between exchanges and SEFs, intending for competitive trade execution to be made available on both platforms. Congress also recognized the importance of SEFs as distinct from exchanges, noting that a goal of the Dodd-Frank Act is to promote the trading of swaps on SEFs. The phasing in of final rules for both exchanges and SEFs should be done concurrently to ensure that this competitive landscape remains in place under the new regulatory regime.

Not only will implementation of the final rules impact market infrastructure, but the timing in which these rules are implemented could significantly impact U.S. financial markets. As Commissioner Jill Sommers recently remarked before the House Agriculture General Farm Commodities and Risk Management Subcommittee, “a material difference in the timing of rule implementation is likely to occur, which may shift business overseas as the cost of doing business in the U.S. increases and create other opportunities for regulatory arbitrage.”⁵ If the U.S. regulations are implemented before foreign regulators have established their intended regulatory framework, it could put U.S. markets at a significant disadvantage and might result in depleted liquidity due to regulatory arbitrage opportunities.

As the rulemaking process moves forward, the WMBAA suggests the following progression of rules be completed:

- First, finalize product definitions. Providing the market with certainty related to the scope of what constitutes a “swap” and “security-based swap” will allow market participants to accurately gauge the impact of the other proposed rules and provide constructive feedback on those rules.
- Second, implement final rules related to real-time reporting for regulatory oversight purposes. The submission of information to SDRs is an activity that takes place in many OTC markets today and will not unduly burden those who must comply with the requirement. Ensuring that the Commissions receive current, accurate market data is a cost-effective method to mitigate systemic risk in the short-term.
- Next, establish block trade thresholds and finalize public reporting rules. The information gathered by SDRs since the implementation of the mandatory trade reporting requirement, along with historical data made available by trade repositories and trade execution facilities, can be used to determine the appropriate threshold levels on a product-by-product basis. At the same time, public reporting rules can be put into place, including an appropriate time delay (that is consistent with European and the other major global market rules) for block trades.
- After the reporting mechanics have been established, the clearing mandate can be implemented. During this step, the Commissions can determine what swaps are “clearable” and subject to the clearing mandate, and clearinghouses can register and begin to operate within the new framework.
- Finally, once swaps are deemed clearable, the mandatory trade execution requirement can be put into place for SEFs and DCMs for those products made available for trading. The WMBAA believes that all clearable swaps will be made available for trading by SEFs, as these trade execution platforms compete to create markets and match counterparties. With the trade execution requirement’s implementation, it is imperative that rules for SEFs and DCMs are effective at the same time, as implementing either entity’s rules prior to the other will result in an unfair advantage for capturing market share of executable trades simply because they could more quickly meet the regulatory burdens.

Flexible Approach to SEF Registration, Permitted Modes of Trade Execution, Impartial Access

The WMBAA members have long acted as intermediaries in connection with the execution of swaps in the OTC market. While a regulated OTC market is new to the swap markets, the WMBAA members are already subject to oversight by financial regulators across the globe, including the SEC and the CFTC, for services of-

⁵ Statement of Jill E. Sommers before the Subcommittee on General Farm Commodities and Risk Management, House Committee on Agriculture, May 25, 2011, available at <http://agriculture.house.gov/pdf/hearings/Sommers110525.pdf>.

ferred in a range of other products and markets. The WMBAA members have acted as OTC swap execution platforms for decades and, as a result, understand what is necessary to support and promote a regulated, competitive and liquid swaps market. Although a SEF might be a new concept originating in the Dodd-Frank Act, the effective role of existing intermediaries in the OTC swaps marketplace is not.

The WMBAA supports a flexible approach to evaluating applicant SEFs. As Congress recognized and mandated by law, to promote a competitive and liquid swaps market, trade execution “through any means of interstate commerce” establishes a broad framework that permits multiple modes of swap execution, so long as the proposed mode of execution is capable of satisfying the statutory requirements.

The WMBAA believes that any interpretation of the SEF definition must be broad, and any trading system or platform that meets the statutory requirements should be recognized and registered as a SEF. The WMBAA supports a regulatory framework that allows any SEF applicant that meets the statutory requirements set forth in the Dodd-Frank Act to be permitted to operate under each Commission’s rules in accordance with the Dodd-Frank Act.

The WMBAA strongly supports the SEC’s interpretation of the SEF definition as it applies to trade execution through any means of interstate commerce, including request for quote systems, order books, auction platforms or voice brokerage trading, because such an approach is consistent with the letter and spirit of the Dodd-Frank Act and ensures flexibility in the permitted modes of execution. The WMBAA believes that this approach should be applied consistently to all trading systems or platforms and will encourage the growth of a competitive marketplace of trade execution facilities.

Further, the WMBAA is concerned with the CFTC’s interpretation of the SEF definition, as it limits the permitted modes of trade execution, specifically restricting the use of voice-based systems to block trades. The SEF definition and corresponding requirements on the CEA, as amended by the Dodd-Frank Act, do not provide any grounds for this approach and will severely impair other markets that rely on voice-based systems (or hybrid systems, which contain a voice component) to create liquidity.

Permitted Use of Voice and Hybrid Trade Execution Platforms

The CFTC’s proposed mandate precludes the use of voice-based systems for “Required Transactions” without any explanation of why the permitted modes of execution should be more restrictive than the statute dictates. The WMBAA is concerned that such a rigid implementation of the SEF framework will devastate existing voice and “hybrid” systems (described below) that are currently relied upon for liquidity formation in global swaps markets. “Hybrid brokerage,” which integrates voice with electronic brokerage systems, should be clearly recognized as an acceptable mode of trade execution, for all swaps trade execution. The combination of traditional “voice” brokers with sophisticated electronic trading and matching systems is necessary to provide liquidity in markets for less commoditized products where liquidity is not continuous. Failure to unambiguously include such systems is not only inconsistent with the Dodd-Frank Act but will severely limit liquidity production for a wide array of transactions. The WMBAA remains concerned that such a restrictive SEF regime will lead to market disruption and, worse, liquidity constriction with adverse consequences for vital U.S. capital markets.

What determines which blend of hybrid brokerage is adopted by the markets for any given swap product is largely the market liquidity characteristic of that product, whether or not the instrument is cleared. For example, a contract to trade Henry Hub Natural Gas delivered in Summer 2017, though cleared, will generally be insufficiently liquid to trade on a central limit order book. This is true the farther out the delivery date for many cleared products, where market makers are unwilling to post executable bids and offers in instruments that trade infrequently. In markets where price spreads are wide or trading is infrequent, central limit order books are not conducive to liquidity, but rather may be disruptive to it.

Critically, what determines which blend of hybrid brokerage is adopted by the markets for any given swap product also has little to do with whether the size of a transaction is sufficient or not to be a block trade. Block trades concern the size of an order, as opposed to the degree of market liquidity or presence of tight bid-offer spreads. Depending on where block trade thresholds are set, block trades can take place in markets from very illiquid to highly liquid. Yet, central limit order book trade execution generally only works well in markets with deep liquidity, and such liquidity is not always available even within a usually liquid market. For less liquid markets, even non-block size trades depend on a range of trading methodologies distinct from central limit order book or request for quote. For these reasons,

hybrid brokerage should be clearly recognized as an acceptable mode of trade execution for all swaps whether “Required” or “Permitted.”

In addition, the regulatory framework for the swaps market must take into consideration the significant differences between the trading of futures on an existing exchange and the trading of swaps on SEF platforms. While it may be appropriate, in certain instances, to look to the futures model as instructive, over-reliance on that model will not achieve Congress’ goal. Congress explicitly incorporated a SEF alternative to the exchange-trading model, understanding that competitive execution platforms provide a valuable market function. Final rules governing SEFs should reflect Congressional intent and promote the growth of existing competitive, vibrant markets without impeding liquidity formation.

Impartial Access to SEFs

The WMBAA is concerned that the CFTC’s proposed mandate that SEFs provide impartial access to independent software vendors (“ISVs”) is beyond the legal authority in the CEA because it expands the impartial access provision beyond “market participants” to whom access is granted under the statute. Moreover, because SEFs are competitive execution platforms, a requirement to provide impartial access to market information to ISVs who lack the intent to enter into swaps on a trading system or platform will reduce the ability for market participants to benefit from the competitive landscape that provides counterparties with the best possible pricing. Further, given the lack of a definition of what constitutes an ISV and the significant technological investments made by wholesale brokers to provide premiere customer service, the ISV impartial access requirement leaves open the possibility that SEFs could qualify as ISVs in order to seek access to competitors’ trading systems or platforms. This possibility would defeat the existing structure of competitive sources of liquidity, to the detriment of market participants, including commercial end-users. The WMBAA strongly urges the CFTC to carefully consider the SEC’s impartial access proposal, which is well aligned with both the express statutory provisions and the broader goals of Title VII of the Dodd-Frank Act to promote a marketplace of competing swaps execution venues.

The WMBAA also believes the SEC should review its proposed impartial access provisions to ensure that impartial access to the SEF is different for competitor SEFs or national exchanges than for registered security-based swap dealers, major security-based swap participants, brokers or eligible contract participants. Congress clearly intended for the trade execution landscape after the implementation of the Dodd-Frank Act to include multiple competing trade execution venues, and ensuring that competitors cannot access a SEF’s trading system or platform furthers competition, to the benefit of the market and all market participants.

Interim or Temporary SEF Registration

The implementation of any interim or temporary registration relief must be in place for registered trading systems or platforms at the time that swaps are deemed “clearable” by the Commissions to allow such platforms to execute transactions at the time that trades begin to be cleared. Interim or temporary registration relief would be necessary for trading systems or platforms if sequencing of rules first addresses reporting to SDRs and mandatory clearing prior to the mandatory trade execution requirement. The WMBAA strongly encourages the Commission to provide prompt provisional registration to existing trade execution intermediaries that intend to register as a SEF and express intent to meet the regulatory requirements within a predetermined time period. To require clearing of swaps through derivatives clearing organizations without the existence of the corresponding competitive trade execution venues risks consistent implementation of the Dodd-Frank Act and could have a disruptive impact on market activity and liquidity formation, to the detriment of market participants.

At the same time, a temporary registration regime should ensure that trade execution on SEFs and exchanges is in place without benefitting one execution platform over another. Temporary registration for existing trade execution platforms should be fashioned into final rules in order to avoid disrupting market activity and provide a framework for compliance with the new rules. The failure of the Commission to provide interim or temporary relief for existing trading systems or platforms may alter the swaps markets and unfairly induce market participants to trade outside the U.S. or on already-registered and operating exchanges.

The 15 Second Rule

Finally, there does not appear to be any authority for the CFTC’s proposed requirement that, for “Required Transactions,” SEFs must require that traders with the ability to execute against a customer’s order or execute two customers against each other be subject to a 15 second timing delay between the entry of those two

orders (“15 Second Rule”). One adverse impact of the proposed 15 Second Rule is that the dealer will not know until the expiration of 15 seconds whether it will have completed both sides of the trade or whether another market participant will have taken one side. Therefore, at the time of receiving the customer order, the dealer has no way of knowing whether it will ultimately serve as its customer’s principal counterparty or merely as its executing agent. The result will be greater uncertainty for the dealer in the use of its capital and, possibly, the reduction of dealer activities leading, in turn, to diminished liquidity in and competitiveness of U.S. markets with costly implications for buy-side customers and end-users.

While this delay is intended by the Commission to ensure sufficient pre-trade transparency, under the CEA, transparency must be balanced against the liquidity needs of the market. Once a trade is completed when there is agreement between the parties on price and terms, any delay exposing the parties to that trade to further market risk will have to be reflected in the pricing of the transaction, to the detriment of all market participants.

Ensuring that Block Trade Thresholds are Appropriately Established

As noted in previous remarks submitted to each Commission, from the perspective of intermediaries who broker transactions of significant size between financial institutions it is critical that the block trade threshold levels and the reporting regimes related to those transactions are established in a manner that does not impede liquidity formation. A failure to effectively implement block trading thresholds will frustrate companies’ ability to hedge commercial risk. Participants rely on swaps to appropriately plan for the future, and any significant changes to market structure might ultimately inhibit economic growth and competitiveness.

Establishing the appropriate block trade thresholds is of particular concern for exempt SEFs because the CFTC’s proposal regarding permitted modes of execution restricts the use of voice-based systems solely to block trades. While WMBAA believes that this approach is contrary to the SEF definition (as discussed herein and in previous letters), which permits trade execution through any means of interstate commerce, this approach, if combined with block trade thresholds that are too high for the particular instrument, would have a negative impact on liquidity formation.

With respect to block trade thresholds, the liquidity of a market for a particular financial product or instrument depends on several factors, including the parameters of the particular instrument, including tenor and duration, the number of market participants and facilitators of liquidity, the degree of standardization of instrument terms and the volume of trading activity. Compared to commoditized, exchange-traded products and the more standardized OTC instruments, many swaps markets feature a broader array of less-commoditized products and larger-sized orders that are traded by fewer counterparties, almost all of which are institutional and not retail. Trading in these markets is characterized by variable or non-continuous liquidity. Such liquidity can be episodic, with liquidity peaks and troughs that can be seasonal (*e.g.*, certain energy products) or more volatile and tied to external market and economic conditions (*e.g.*, many credit, energy and interest rate products).

As a result of the episodic nature of liquidity in certain swaps markets combined with the presence of fewer participants, the WMBAA believes that the CFTC and SEC need to carefully structure a clearing, trade execution and reporting regime for block trades that is not a “one size fits all” approach, but rather takes into account the unique challenges of fostering liquidity in the broad range of swaps markets.

Such a regime would provide an approach that permits the execution of transactions of significant size in a manner that retains incentives for market participants to provide liquidity and capital without creating opportunities for front-running and market distortion.

To that end, the WMBAA supports the creation of a Swaps Standards Advisory Committee (“Advisory Committee”) for each Commission, comprised of recognized industry experts and representatives of registered SDRs and SEFs to make recommendations to the Commissions for appropriate block trade thresholds for swaps. The Advisory Committee would (i) provide the Commissions with meaningful statistics and metrics from a broad range of contract markets, SDRs and SEFs to be considered in any ongoing rulemakings in this area and (ii) work with the Commissions to establish and maintain written policies and procedures for calculating and publicizing block trade thresholds for all swaps reported to the registered SDR in accordance with the criteria and formula for determining block size specified by the Commissions.

The Advisory Committee would also undertake market studies and research at its expense as is necessary to establish such standards. This arrangement would permit SEFs, as the entities most closely related to block trade execution, to provide essen-

tial input into the Commissions' block trade determinations and work with registered SDRs to distribute the resulting threshold levels to SEFs. Further, the proposed regulatory structure would reduce the burden on SDRs, remove the possibility of miscommunication between SDRs and SEFs and ensure that SEFs do not rely upon dated or incorrect block trade thresholds in their trade execution activities. In fact, WMBAA members possess historical data for their segment of the OTC swap market which could be analyzed immediately, even before final rules are implemented, to determine appropriate introductory block trade thresholds, which could be revised after an interim period, as appropriate.

Conclusion

The WMBAA thanks the Commissions for the opportunity to comment on these very important issues. We look forward to continuing our conversations with the Commissioners and staff as the new regulatory framework is developed and implemented in a way that fosters competition and liquidity for market participants.

Please feel free to contact the undersigned with any questions you may have on our comments.

Sincerely,



STEPHEN MERKEL, *Chairman*.

The CHAIRMAN. Thank you.

And when you are ready, Ms. Boulwood, you may begin.

STATEMENT OF BRENDA L. BOULTWOOD, CHIEF RISK OFFICER AND SENIOR VICE PRESIDENT, CONSTELLATION ENERGY, BALTIMORE, MD; ON BEHALF OF COALITION FOR DERIVATIVES END-USERS

Ms. BOULTWOOD. Good morning, Chairman Lucas, Ranking Member Peterson, Members of the Committee. It is a pleasure to appear before you this morning.

My name is Brenda Boulwood and I serve as Chief Risk Officer and Senior Vice President for Constellation Energy. On behalf of Constellation, as well as the End-User Coalition, I am privileged to talk to you today about steps we believe Congress should take to fix three problems with proposed regulations implementing Dodd-Frank legislation.

First, a proper *swap dealer* definition and *de minimis* exception are needed to ensure end-users are not regulated as swap dealers. Second, end-users should be allowed to continue to transact without the threat of large margin requirements and we believe inter-affiliate swaps should not be subjected to these requirements as well. And third, the CFTC should have to follow the high standards for cost-benefit analysis.

The End-User Coalition includes a diverse group of companies that make and produce goods and services including agriculture, manufacturing, vehicles, electricity and natural gas. Let me be clear from the outset: Our coalition is not opposed to greater transparency in these markets but end-users did not create systemic risk and none in our coalition was behind the near-collapse of the economy in 2008.

I have been involved in risk management practices in a variety of capacities—academia, commercial entities, financial institutions and consulting—for more than 25 years. I serve on the boards of the Committee of Chief Risk Officers and the Global Association of Risk Professionals as well as serving as a member on the CFTC Technology Advisory Committee. Constellation Energy is a Fortune

200 company located in Baltimore, Maryland, and is the largest competitive supplier of electricity in the country with more than 36,000 commercial and industrial customers in 36 states. We are the largest competitive supplier due to a variety of risk management tools we employ for the benefit of our customers. Because physical energy markets are volatile and unpredictable, we utilize exchange trading and over-the-counter derivatives to better manage our risks. These derivatives allow us to provide our customers with a low fixed price for the products and services they demand.

Legislation will soon be introduced aimed at fixing the *swap dealer* definition. A proper definition of *swap dealer* is crucial to ensure that burdensome requirements such as mandatory margin capital and clearing are not improperly forced upon non-financial end-users. The *de minimis* exception must be set large enough to avoid capturing firms that had nothing to do with the financial crisis, that would never rise to the level of too big to fail simply because they are not and never were systemically risky. The CFTC's proposed definition includes exemptions that are too narrow and would leave energy firms and other end-users to be unintentionally caught up in a *swap dealer* definition and rules that would require onerous margin clearing, real-time reporting and capital requirements.

H.R. 2682 focuses on margin requirements for end-users. Today, an end-user decides whether to execute a derivative hedge through an exchange or over the counter. If the hedge is conducted through an exchange, initial margin is posted. If we transact over the counter, we may utilize unsecured lines of credit with counterparties and post margins when exposures exceed these limits. In other words, we navigate between liquidity risk and posting margins and counterparty credit risk. Today, this credit risk can be mitigated with all types of collateral—letters of credit, parental guarantees, asset liens, and sometimes even cash. At the time of the passage of the Dodd-Frank Act, the intent was that the end-user would be exempted from any requirements to post cash margin. Consequently, we need Congress to step in and clarify the ability of end-users to continue to manage counterparty risk without unnecessary margin requirements.

Let me briefly offer my thoughts on the Stivers-Fudge bill. Constellation Energy, like many other companies, uses the business model through which we limit the number of affiliates within our corporation that enter into derivative transactions with external counterparties in order to more effectively manage our enterprise risks and to secure better pricing on our derivative transactions. We strongly support the Stivers-Fudge bill, which recognizes that inter-affiliate swaps are internal, largely bookkeeping in nature, and do not create systemic risk.

Let me turn to H.R. 1840, which focuses on cost-benefit analysis for any proposed rules. We firmly believe that rigorous cost-benefit analysis creates better rules and helps avoid making the mistake of putting a rule in place that would create unintended effects. As we saw with the SEC's proxy access rule, which was overturned by the courts, inadequate consideration of costs, benefits and comments made during the rulemaking process does not establish a foundation that can sustain rulemaking. The Conaway-Quigley bill

would require the CFTC to undertake structured and rigorous cost-benefit analysis.

In conclusion, I want to thank you, Chairman Lucas, Ranking Member Peterson, and Members of the Committee for convening this hearing. Ensuring that Congressional intent is followed by the CFTC is critically important to the entire end-user community. However, if legislation is not passed to clarify the statute's intent, end-users risk being caught up in the unintended consequences of the Dodd-Frank implementation. It is important to remember that end-users rely on derivatives to reduce risk, bring certainty and stability to our business, and ultimately to benefit our customers. We did not contribute to the financial crisis and we don't pose a threat to the financial system.

Thanks for your time, and I look forward to your questions.
[The prepared statement of Ms. Boulwood follows:]

PREPARED STATEMENT OF BRENDA L. BOULTWOOD, CHIEF RISK OFFICER AND SENIOR VICE PRESIDENT, CONSTELLATION ENERGY, BALTIMORE, MD; ON BEHALF OF COALITION FOR DERIVATIVES END-USERS

Good morning, Chairman Lucas, Ranking Member Peterson, Members of the Committee, it is a pleasure to appear before you this morning. My name is Brenda Boulwood and I serve as Chief Risk Officer and Senior Vice President for Constellation Energy. I am here today in my capacity as an officer with Constellation; but, I am also here representing the broader end-user coalition, which is comprised of a variety of entities from agricultural interests, to manufacturers, car companies, airlines, and energy companies. While it may seem odd to have such a diverse and broad coalition coalescing around the same set of legislative proposals, I want to assure the Committee that we appreciate your hard work in helping to address some of the unintended consequences of the Dodd-Frank Act, as well as some of the broadly interpreted proposed rules that we believe go well beyond Congressional intent. Let me be clear from the outset, our coalition is not opposed to greater transparency in these markets. In fact, we are highly supportive of greater transparency. But, you achieve transparency through reporting, not classifying end-users as swap dealers. Simply put, end-users do not create systemic risk and none in our coalition were behind the collapse of the economy in 2008. Therefore, we are here today to offer our thoughts to several legislative proposals that we believe will help resolve those unintended consequences.

Before I begin my testimony on the proposed legislation, I would like to give a brief background about myself, who Constellation is, and how and why we use derivatives to help manage our customer's risk.

I have been involved in risk management practices in a variety of capacities—academia, commercial entities, financial institutions, and consulting—for more than thirty years. I serve on the Boards of the Committee of Chief Risk Officers (CCRO) and the Global Association of Risk Professionals (GARP), as well as serving as a member of the CFTC's Technology Advisory Committee. As you may recall, the CCRO began as a result of the accounting scandals from the early part of the last decade and is comprised of CRO's across the entire energy spectrum.

Constellation Energy is a Fortune 200 company located in Baltimore, MD, and is the largest competitive supplier of electricity in the country. We serve more than 30,000 megawatts of electricity daily and own approximately 12,000 megawatts of generation that comes from a diversified fleet across the U.S. To put that in perspective, our load obligation is approximately the same amount of power consumed by all of New England on a daily basis. We serve load to approximately 36,000 commercial and industrial customers in 36 states and we provide natural gas and energy products and services for homes and businesses across the country. Finally, the company delivers electricity and natural gas through the Baltimore Gas and Electric Company (BGE), our regulated utility in central Maryland.

One of the reasons we have been so successful in growing our competitive supply business is due in large part to our ability to win load serving auctions by being the low cost provider. We are able to be the low cost provider due to a variety of risk management tools we employ to the benefit of our customers. We utilize exchange trading, clearinghouses and over-the-counter (OTC) derivatives to help manage these risks.

For example, electricity—it must be produced and consumed simultaneously; cannot be stored; and has some very volatile fuel exposure—coal, natural gas, and uranium. Furthermore, electricity gets delivered to thousands of points along the grid at a moment's notice. Physical energy markets are volatile and unpredictable, but hedging with derivatives allows Constellation to manage these risks and provide its thousands of customers with electricity and natural gas at a low fixed price.

Now, I would like to specifically address some of the proposed pieces of legislation that will help to resolve some of the unintended consequences that are emanating from the Commodity Futures Trading Commission's (CFTC) proposed rules.

For instance, H.R. 2682 is a bill that focuses on margin requirements for end-users. Today, an end-user decides whether to execute a derivative hedge through an exchange or over-the-counter (OTC). If it is conducted through an exchange, initial margin is posted and variation margin is required or returned depending on price fluctuations. If we transact OTC, we may utilize unsecured lines with counterparties and post margin when exposures exceeds the size of a credit line. In other words, we navigate between liquidity risk, or posting margin, and counterparty credit risk. Today, this credit risk can be mitigated with collateral of all kinds—Letters of Credit (LCs), Parental Guarantees (PGs), asset liens and sometimes cash. At the time of passage of the Dodd-Frank Act, we understood from the legislative language, as well as from letters and statements by the principal authors of the legislation, that end-users would be exempted from any requirement to post **cash** margin. Unfortunately, margin rules proposed by the prudential banking regulators this past summer create uncertainty by reserving to the regulators the authority to, *de facto*, impose margin on end-users by requiring that such margin be collected by our swap-dealer counterparties. While the Coalition supports the Grimm-Peters-Owens-Scott bill, we are hopeful that, as it works its way through the legislative process, the bill can be expanded to cover financial end-users such as small banks, as well as non-financial end-users.

We are also very concerned about the regulators' proposed restrictions on using non-cash collateral to satisfy margin requirements. These restrictions could force companies to either abandon effective risk-mitigation strategies or critical capital expenditures. Furthermore, based on Federal Reserve data for bank lending (drawn facilities) in the U.S. of \$550BN, additional interest charges passed on to corporations are estimated to be \$2.8BN annually as a result of the Dodd-Frank Act. And, a survey conducted by the Coalition found that companies would have to hold aside on average \$269 million of cash or immediately available bank credit to meet a 3% initial margin requirement. Though the rule proposed by banking regulators may or may not require this magnitude of collateral, in our world of finite resources and financial constraints, this is a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. The aforementioned study extrapolated the effects across the S&P 500 to predict the consequent loss of 100,000 to 130,000 direct and indirect jobs. The effect on the many thousands of end-users beyond the S&P 500 would be proportionately greater. We would also have to make a considerable investment in information systems that would replicate much of the technology in a bank's trading room for marking to market and settling derivatives transactions, thus further depleting our working capital. A potential consequence of margin rules is liquidity risks for end-users that require us to increase debt levels and funnel cash from productive investments. In fact, a June 13, 2011, an Office of the Comptroller of the Currency (OCC) study provided an estimate of incremental initial margin requirements for large banks of \$2TR, much of which we believe will be collected from their end-user counterparties. Consequently, we need Congress to step in and clarify the ability of end-users and banks to continue to manage counterparty risk without unnecessary initial and variation margin requirements.

Now, let me turn to the not yet introduced legislative proposal that seeks to clarify the swap dealer definition. A properly-tailored definition of "swap dealer" is another crucial element to ensuring that burdensome requirements such as mandatory margin, capital and clearing are not improperly forced upon non-financial end-users. The Dodd-Frank Act regulates swap dealers and major swap participants differently than end-users and appropriately so. But it is very important that the definition be tailored to capture persons that are actually in the business of providing dealer services to end-users, not the end-users themselves. Furthermore, to the extent end-users engage in only a small amount of customer-facing swap activity that is tied to their core non-financial businesses (*e.g.*, manufacturing, processing, marketing), and whose dealing does not create systemic risk, they should not be treated as swap dealers. To that end, the *de minimis* exception to the definition of "swap dealer" **must** be set in legislation at a reasonable level that protects end-users from being

regulated the same as the largest swap dealers that are potentially systemically risky. In addition, a company should not be regulated as a swap dealer simply because it makes a market for its own affiliates. Inter-affiliate trades should not be subject to regulations designed for market-facing transactions, and should not be a factor for determining whether a company is a swap dealer.

With that in mind, let me briefly offer my thoughts on H.R. 2779, also referred to as the Stivers-Fudge bill. Constellation Energy, like many other companies, uses a business model through which we limit the number of affiliates within our corporation that enters into derivatives transactions with external and other swap dealer counterparties. Rather than having each corporate subsidiary transact individually with external counterparties, a single or limited number of corporate entities face dealers and other counterparties in the market. This helps our company centralize risk taking, accountability and performance management. These entities then allocate transactions to those affiliates seeking to mitigate the underlying risk. This allocation is done by way of “inter-affiliate swaps”—or swaps between commonly controlled entities. This structure allows us to more effectively manage our corporate risk on an enterprise basis and to secure better pricing on our derivatives transactions. The transactions are largely “bookkeeping” in nature and do not create systemic risk. Using affiliates to transact has always been a healthy part of the way many companies internally centralize risk and manage overall performance. For example, small farmers and ranchers, utilities, and car manufacturers, to name a few, perform their hedging transactions in this way.

As we understand it, however, regulators are considering whether to subject inter-affiliate swaps to the same set of requirements that would apply to swaps with external dealer counterparties—possibly including margin, clearing, real-time reporting, and other requirements. In my mind, this would be a mistake, imposing substantial costs on the economy and on consumers. That is why we strongly support the Stivers-Fudge bill, which recognizes that inter-affiliate swaps do not create systemic risk and that consequently, as a category, inter-affiliate swaps should not be subject to regulation as if they were outward-facing. The Stivers-Fudge bill would exempt a *category* of swaps, not a *particular type* of entity from regulation. That is precisely what the Administration did in exempting foreign exchange swaps and forwards and it is the right approach here as well.

Finally, let me turn to H.R. 1840, which focuses on cost-benefit analysis for any proposed rules. We firmly believe that rigorous cost-benefit analysis creates better rules. By first analyzing how a regulation will affect individuals, companies, other stakeholders, and the integrity of the overall market, a regulatory agency can avoid making the mistake of putting a rule in place that has adverse and unintended effects. The CFTC is subject to a cost-benefit analysis requirement, but it does not require the regulator to consider such key factors as available alternatives to regulation, whether the regulation is tailored to impose the least burden possible while achieving its goals, and whether the regulation maximizes net benefits. These and other factors would be required to be considered under the Conaway-Quigley bill. The CFTC should conduct a rigorous cost-benefit analysis for each proposed rule’s impact on market liquidity, price discovery, as well as the potential costs to existing market participants and participants that may consider entering the market in the future.

As we saw when the SEC’s proxy access rule was overturned by the courts, inadequate consideration of costs, benefits, and comments made during the rulemaking process does not establish a foundation that can sustain a rulemaking. The Conaway-Quigley bill would require the CFTC to undertake a *structured and rigorous* cost-benefit analysis when it promulgates rules; thus, ensuring a better process more likely to achieve statutory goals while limiting substantial societal costs.

In conclusion, I want to thank Chairman Lucas, Ranking Member Peterson and Members of the Committee for convening this hearing and affording me the opportunity to testify. Ensuring that Congressional intent is followed by the CFTC is critically important to the entire end-user community. I had hoped after passage of the Dodd-Frank Act that future legislation would not be required to deal with the concerns I have outlined here today. However, if legislation is not passed to clarify the statute’s intent, end-users risk being captured as swap dealers and the end-user exemptions included in the bill would be null and void. It is important to remember that end-users rely on derivatives to reduce risk; bring certainty and stability to their businesses; and, ultimately to benefit their customers. We did not contribute to the financial crisis and we do not pose a threat to the financial system.

I would like to leave you with this final comment. As you probably know, the electricity industry is comprised of a number of types of entities, which include electric co-ops; investor owned utilities, which could be vertically integrated or merchant generators; and, public power organizations. These groups represent every electric

customer in the United States and rarely agree on any public policy. However, if these regulations are improperly implemented by the CFTC, then it could cause electricity prices to rise for every consumer in America. That is why when it comes to Title VII of the Dodd-Frank Act we are in 100% alignment that end-users must not be captured as swap dealers or forced to clear all of their transactions.

Thank you for your time and I look forward to your questions.

The CHAIRMAN. Thank you.

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

STATEMENT OF TODD THUL, RISK MANAGER, CARGILL AGHORIZONS, MINNEAPOLIS, MN; ON BEHALF OF COMMODITY MARKETS COUNCIL

Mr. THUL. Thank you. Chairman Lucas, Ranking Member Peterson, and Members of the House Committee on Agriculture, thank you for convening today's hearing. I am Todd Thul, Risk Manager for Cargill AgHorizons, which offers a wide variety of marketing alternatives for producers of all sizes. I am testifying today on behalf of the Commodity Markets Council, a trade association that represents the exchanges and the industry.

The CFTC has been implementing the regulations required under Dodd-Frank. Today, I would like to provide perspectives on a number of these issues.

Issue number one: Many firms use inter-affiliate swaps to limit the number of entities transacting with external dealer counterparties. This structure allows the company to effectively manage risk on an enterprise basis and to secure better pricing on derivative transactions. The agreements are largely bookkeeping in nature and do not create systemic risk. Inter-affiliate swaps should not be regulated in the same manner as swaps with external dealers including margin, clearing and real-time reporting. These requirements would impose substantial costs on the economy, consumers and end-users.

Issue number two: The CFTC has proposed that all members of a designated contract market capture and maintain extensive records of all communications related to commodity transactions. The proposal presents steep technology and cost challenges across the entire grain industry including country elevators who deal with producers in person and on the phone when executing cash contracts. This proposal raises anti-competitive concerns by creating a divided cash marketplace, imposing the requirement on some country elevators but not all. Dodd-Frank was intended to address concerns about systemic risks created by an unregulated over-the-counter market. The CFTC's proposed recording and recordkeeping rule would add costs to the cash market that will ultimately be shared through the entire value chain.

My final issue: Under Dodd-Frank, Congress created a statutory definition of *bona fide* hedge transactions, which enumerates various types of hedging, among them, anticipatory merchandising positions. An anticipatory hedge occurs when a commercial entity takes a position in the futures market to meet a physical need for a commodity it anticipates buying or selling in the future. Congress made clear in its *bona fide* hedge definition that companies engaged in the physical trade should receive an exemption for anticipatory merchandising positions. However, the CFTC through its proposed rules would deny companies the exemption and would re-

characterize them as speculative. This is not consistent with the law and has the potential to have negative effects in the cash commodity markets.

The Act provides that a *bona fide* hedge may be defined to permit producers, purchasers, sellers, middlemen and users of a commodity to hedge their legitimate anticipated business needs. The CFTC's proposed rule, which may be finalized as early as next week, would limit *bona fide* hedge exemptions to five specific transactions called enumerated hedges. This will greatly reduce the industry's ability to offer the same suite of marketing tools to our invaluable farmer suppliers.

Serious questions have been raised on how to provide bids for farmers overnight or through the weekend to manage risk appropriately. Merchandising of grain could be curtailed because of the inability to manage risk if the hedge is considered speculative and not *bona fide* under this rule. From a risk management perspective, a better limitation on anticipatory hedging would be annual volume. Unless revised, the CFTC's approach will severely limit the ability of grain handlers to participate in the market and impede the ability to offer competitive bids to farmers, to manage risk, to provide liquidity and to move agricultural products from origin to destination. The irony is that limiting commercial participation in the market actually introduces volatility. Clearly, this is not what Congress intended.

In summary, the proposed restriction on anticipatory hedging is not consistent with current commercial practice which did not contribute to the financial conditions that led to passage of Dodd-Frank. The modest proposals suggested to the Commission would allow farmers and the industry to maintain recognized risk management practice while remaining consistent with the statute and subject to CFTC oversight. This will allow the U.S. farmer to maintain access to risk management products, price discovery and competitive marketing options. Limiting anticipatory hedging will result in risk that must otherwise be managed, which could manifest itself in wider basis spreads, more volatile basis or limited bids, all of which run counter to the intent of Congress, the statute and the marketplace.

Thank you.

[The prepared statement of Mr. Thul follows:]

PREPARED STATEMENT OF TODD THUL, RISK MANAGER, CARGILL AGHORIZONS,
MINNEAPOLIS, MN; ON BEHALF OF COMMODITY MARKETS COUNCIL

Chairman Lucas, Ranking Member Peterson and Members of the House Committee on Agriculture: Thank you for convening this hearing on various elements of the Dodd-Frank Act. I am Todd Thul, Risk Manager for Cargill AgHorizons. AgHorizons is our business that works directly with farmers. Many of them are your constituents and all of them are constituents of this Committee. We offer a wide variety of grain marketing options for producers of all sizes. We provide many forms of risk management and price protection that meet individual producers' desired level of opportunity and control. We also offer agronomic services, seed, fertilizer, consulting services and crop input financing to help producers manage their operations. Our goal is to be the partner of choice for our farmer customers.

Today, I am testifying on behalf of the Commodity Markets Council (CMC). CMC is a trade association that brings together exchanges and their industry counterparts. The activities of CMC members include the complete spectrum of commercial end-users of all futures markets including energy and agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago

Mercantile Exchange, ICE Futures U.S., Kansas City Board of Trade, Minneapolis Grain Exchange and the New York Mercantile Exchange. CMC, in conjunction with the Coalition for Derivatives End Users, is well-positioned to provide the consensus views of commercial end-users of derivatives. Our comments represent the collective view of CMC's members.

The Commodity Futures Trading Commission (CFTC) has been working aggressively to implement the regulations required under the Dodd-Frank Act. Today, I would like to provide perspectives on a number of these issues.

Inter-Affiliate Swap Transactions

Many firms use a business model through which the number of affiliates within the corporate group that enter into derivatives transactions with dealer counterparties are limited. Rather than having each corporate subsidiary individually transact with dealer counterparties, a single or limited number of corporate entities face dealers. These entities then allocate transactions to those affiliates seeking to mitigate the underlying risk. This allocation is done by way of "inter-affiliate swaps"—swaps between commonly controlled entities. This structure allows the company to more effectively manage corporate risk on an enterprise basis and to secure better pricing on derivatives transactions. The transactions are largely "book-keeping" in nature and do not create systemic risk. Regulators are reportedly considering whether to subject inter-affiliate swaps to the same set of requirements that apply to swaps with external dealer counterparties—possibly including margin, clearing, real-time reporting, and other requirements. This would be a mistake and would impose substantial costs on the economy, on consumers and on end-users. Accordingly, the CMC strongly endorses the thrust of the Stivers-Fudge bill. It is the right thing to do. CMC understands the intent of the bill is to cover all business operating models that might be negatively affected by the inter-affiliate interpretation and therefore would like to work with the sponsors to be sure the proposed legislation accomplishes that objective.

Bona fide and Anticipatory Hedges

One area of ongoing rulemaking which has recently garnered a lot of attention by our industry is the CFTC's proposed rules on position limits and, more specifically, the proposed definition of *bona fide* hedge transactions.

Under Dodd-Frank, Congress for the first time created a statutory definition of *bona fide* hedge transactions. The statutory definition enumerates various kinds of hedging transactions, among them anticipatory merchandising positions.

An anticipatory hedge occurs when a commercial entity takes a position in the futures market to offset a position that it anticipates taking in the cash market in the future. A simple example is the buying of corn futures now in anticipation of buying physical corn at harvest from farmers, or the selling of cotton futures now in anticipation of selling physical cotton at some point in the future. In these cases, a commercial entity is taking a position in the futures market to meet a physical need for a commodity it anticipates buying or selling in the future.

While Congress made clear in its *bona fide* hedge definition that companies engaged in the physical trade should receive an exemption for anticipatory merchandising positions, the CFTC through its proposed rules would deny companies the exemption and would recharacterize them as "speculative". This is not only inconsistent with the law, but has the potential to have calamitous effects in the cash commodity markets in the physical commodity marketplace.

The CFTC is taking a narrower view of *bona fide* hedging than that defined by Congress in the Dodd-Frank law. The CFTC's proposed rules would limit *bona fide* hedge exemptions to five specific transactions called "enumerated" hedges. The Commodity Exchange Act, as amended by the Dodd-Frank Act ("Act") provides that position limits shall not apply to transactions or positions shown to be *bona fide* hedges, as defined by the CFTC consistent with the purposes of the Act. Section 4a(c)(1) of the Act also provides that a *bona fide* hedge may be defined to permit producers, purchasers, sellers, middlemen and users of a commodity to hedge their legitimate anticipated business needs. Thus the statutory language provides for hedges of legitimate business needs at each step as the commodity moves from producer to user, and recognizes that merchandiser are entitled to hedge anticipated needs.

The Act [Sec. 4a(c)(2)] also provides its own definition of *bona fide* hedge, and states that the CFTC shall define what constitutes a *bona fide* hedge. This statutory hedge definition includes an anticipatory merchandising hedge, because it permits hedges of the potential changes in value of assets that a person anticipates owning or merchandising, as long as the transactions are a substitute for physical trans-

actions to be made at a later time and they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise.

The Commodity Markets Council and the Working Group of Commercial Energy Firms filed public comments to the CFTC on June 5, 2011, urging the Commission to reconsider its proposed rules and, in particular, the proposed *bona fide* hedge definition. The CMC subsequently transmitted in a June 10, 2011 letter its concerns about these types of hedges to the respecting Chairs and Ranking Members of the House and Senate Agriculture Committees, Senate Banking Committee, and House Financial Services Committee. I would ask that copies of these letters be included in the hearing record.

Through the summer, the CMC, its member companies and other interested parties also engaged in direct meetings with the CFTC to respond to requests for additional information about the relationship between anticipatory hedges and cash market efficiencies.

We remain hopeful that the CFTC will take into account these comments and provide the commercial trade with a meaningful exemption for anticipatory hedges. However, recent press accounts suggest the final rule may disappoint in this area. We understand that the CFTC is considering limiting anticipatory merchandising hedging to unfilled storage capacities through calendar spread positions for one year. If this turns out to be the case, the CFTC's action will reduce the industry's ability to continue offering the same suite of marketing tools to farmers that they are accustomed to using because the management of the risk associated with those tools may be constrained if the hedge of that risk is deemed to be anticipatory. Serious questions have been raised about how to provide weekend bids for farmers going in to large harvest weekends, or manage risk associated with export elevators that might have limited one-time capacity but very large throughputs. Merchandising of grain could be curtailed because of the inability to manage the risk if the hedge is considered speculative and not *bona fide* under this rule. As serious as all these issues are for farmers, the implications are far broader with the potential to impact energy markets as well.

From a risk management perspective, a better limitation on anticipatory hedging would be annual throughput—or volume—actually handled on a historic basis by each company. For example, an export elevator may have 4 million bushels of physical storage capacity, but might handle 100 million bushels on an annual basis. If it is full, how will it establish a bid and manage the risk on the 96 million bushels of grain it has yet to purchase from farmers that it not only anticipates, but knows it will be exporting from that facility? Unless revised, the CFTC's approach will severely limit the ability of grain handlers to participate in the market and impede the ability to offer competitive bids to farmers, manage risk, provide liquidity and move agriculture products from origin to destination. The irony is that limiting commercial participation in the market actually introduces volatility. Clearly this is not what Congress intended.

Recording and Recordkeeping Requirements

In a proposed rule described only as conforming amendments, the CFTC has proposed imposing expensive and burdensome recording and recordkeeping requirements across a broad swath of the cash grain marketplace. The proposal would require all members of a designated contract market (DCM) such as the Chicago Board of Trade, Kansas City Board of Trade or MGEX to capture and maintain extensive records of all communications related to a commodity transaction. Even country elevators operated by those firms would be required to record telephone conversations with producers when discussing cash sales or contracts.

The proposal presents steep technology and cost challenges to small-town country elevators who deal extensively with producers on the phone when arranging cash sales and forward cash contracts. This proposal raises anti-competitive concerns because it could create a bifurcated cash marketplace by imposing the requirement on country elevators who are owned by members of DCMs but not on other companies. Who will the producer call to sell his cash grain: the elevator that has to inform him they are recording his phone calls, or the elevator a few miles down the road that is not required to do so? The CMC believes the proposal may prompt companies who are members of a DCM to reconsider their membership in order to avoid the regulatory burden. This result exposes not only the discriminatory application of the rule, but also highlights the fundamental question within the industry about the proposed rule. Dodd-Frank was intended to address concerns about systemic risks created by an unregulated over-the-counter market. The CFTC's proposed recording and recordkeeping rule does not address any of those concerns. Rather it seems targeted at the cash market and the real commercial trade, neither of which were responsible for the financial crisis and both of which suffered because of that crisis.

All this proposal will do is add cost to the real economy—costs that are ultimately shared throughout the value chain from farmer to consumer.

Swap Dealer Bill (not yet introduced)

It is important that end-users who engage in only a small amount of swap dealing relative to their non-dealing activities and whose dealing does not create systemic risk not be treated as swap dealers. As such, the *de minimis* exception to the definition of “swap dealer” must be expanded to a reasonable level that protects end-users from being regulated the same as the largest swap dealers.

Cost-Benefit Analysis Bill (H.R. 1840)

Rigorous cost-benefit analysis creates better rules. The CFTC is subject to a cost-benefit analysis requirement but it does not require the regulator to consider such key factors as available alternatives to regulation, whether the regulation is tailored to impose the least burden possible while achieving its goals, and whether the regulation maximizes net benefits. These and other factors would be required to be considered under the Conaway-Quigley bill, which CMC strongly supports.

Summary

The proposed restriction on anticipatory hedging is inconsistent with current commercial practice which did not contribute to the financial conditions that led to passage of the Act. The proposed restriction significantly narrows the hedging definition included in the Act by Congress and without question will curtail our ability to serve farmers with risk management programs. The Act states that *bona fide* hedge term shall be defined by the CFTC consistent with the purposes of the Act. The proposed restriction is not consistent with these purposes:

- (a) The express purpose of the position limits is to prevent excessive speculation which causes sudden or unreasonable fluctuations or unwarranted changes in commodity prices. [Act, sec. 4a(a)(1)]. An anticipatory merchandising hedge, done in accordance with current commercial practice, is not speculation and does not cause unreasonable or unwarranted price changes.
- (b) The Act says hedges of legitimate anticipated business needs by middlemen are permissible hedging to be the subject of CFTC rulemaking. Under current commercial practice, anticipatory merchandising hedges are for the purpose of satisfying legitimate anticipated business needs for merchandisers, and it would be contrary to the purposes of the Act to prohibit them.
- (c) Congress recognized in the statutory definition that anticipatory hedges can include those which hedge commodities that are anticipated to be owned or merchandised, and the proposed restrictions relating to dedicated unfilled capacity and calendar spreads undermine Congressional intent as reflected in the broader statutory definition.

The CMC along with the Working Group of Commercial Energy Firms has submitted specific comments and proposals for the CFTC to consider during its rulemaking. Absent the adoption of significant change, the new rules defining *bona fide* hedging and by negative inference speculation will create cash market inefficiencies. Moreover, the proposed rule would make CFTC reports on market participation meaningless because they would no longer reflect real cash market activities.

The modest proposals suggested to the Commission would allow farmers and the industry to manage risk consistent with longstanding practices while remaining consistent with the statute and subject to CFTC oversight. They will allow farmers and the grain industry to continue to have access to risk management, price discovery and marketing options that have long served the industry well. Limiting anticipatory hedging will result in risk that must somehow otherwise be managed. This risk was heretofore managed in the futures market—now the risk could manifest itself in wider basis spreads, more volatile basis, limited bids, or wider bid-ask spreads, all of which run counter to the intent of Congress, the statute, the interest of farmers, the marketplace, end-users and market participants.

ATTACHMENT

June 10, 2011

Hon. DEBBIE STABENOW,
Chairman,

Hon. PAT ROBERTS,
Ranking Member,

Hon. FRANK D. LUCAS,
Chairman,

Hon. COLIN C. PETERSON,
Ranking Minority Member,

Senate Committee on Agriculture, Nutrition & Forestry, Washington, D.C.; Hon. TIM JOHNSON, <i>Chairman</i> , Hon. RICHARD SHELBY, <i>Ranking Member</i> , Senate Committee on Banking, Housing, and Urban Affairs, Washington, D.C.;	House Committee on Agriculture, Washington, D.C.; Hon. SPENCER BACHUS, <i>Chairman</i> , Hon. BARNEY FRANK, <i>Ranking Minority Member</i> , House Committee on Financial Services, Washington, D.C.
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Re: CFTC Proposed Treatment of *Bona Fide* Hedging

Dear Chairmen Stabenow, Johnson, Lucas, Bachus and Ranking Members Roberts, Shelby, Peterson and Frank:

We are extremely concerned about the direction taken by the Commodity Trading Futures Commission (“CFTC”) in its proposed rules with respect to *bona fide* hedging. We believe the proposed regulations are unnecessarily narrow, impose onerous reporting obligations on commercial market participants, and lack the flexibility necessary to ensure that the legitimate hedging activities of corporations who carry cash market risks in physical commodities continue to receive treatment as “*bona fide*” hedges under the rules. Left unchanged, the current rules will adversely affect agriculture and energy commodity markets.

Specifically, we fear the proposed rules may result in the following:

- Reduced liquidity in physical futures markets as a significant amount of trading currently considered hedging is recharacterized as speculative, and as the daily reporting requirements mandate a prescriptive accounting of total cash transactions on a global basis for commercial concerns of any significant size;
- Increased risk held by farmers and small and medium sized energy producers because transactions currently held as hedging positions by the commercial trade would no longer qualify, thus significantly reducing commercial firms’ use of those strategies as a way to provide attractive cash forward markets to market participants;
- Increased confusion among market participants and analysts as the rules would make public reports less transparent by requiring hedgers to report hedges as speculative positions, thereby decreasing “*bona fide*” hedging open interest and increasing “speculative” open interest in a misleading manner; and
- Increased hedging costs for all end-users resulting from decreased ability to robustly manage price risks inherent in physical commodity markets.

We believe the CFTC needs to seriously consider major structural changes in its approach, both in defining what constitutes a *bona fide* hedge, the process for making *bona fide* hedge determinations, and in its proposed reporting regime. We support regulation that brings transparency and stability to the agriculture and energy commodity markets in the United States. However, the CFTC proposal in its present form seems likely to achieve neither of these objectives, and instead will reduce liquidity, hamper legitimate risk mitigation activities, and generally increase the level of risk held by farmers, producers and commercial agriculture and energy companies that today provide a valuable service in getting much-needed agricultural and energy commodities from producers into the hands of end-users. This ironic outcome would be both unfortunate and completely opposite to the goals of the Dodd-Frank legislation.

Attached you will find a comment letter jointly sent by the Commodity Markets Council and the Energy Working Group that details our specific concerns to the CFTC on the proposed rules. As CFTC’s rulemaking process continues forward, we would respectfully ask that you request from the CFTC briefings or status updates, as appropriate, with respect to this vitally-important issue. If you have any questions or need any further information, please contact me at [Redacted] or [Redacted].

Regards,



CHRISTINE M. COCHRAN,
President.

Commodity Markets Council Membership*Exchange Members*

Chicago Board of Trade
 Chicago Mercantile Exchange
 ICE Futures U.S.
 Kansas City Board of Trade
 Minneapolis Grain Exchange
 New York Mercantile Exchange

Industry Members

ABN AMRO Clearing Chicago, LLC
 Archer Daniels Midland
 Avena Nordic Grain
 BNSF Railway
 BM&F Bovespa
 Brooks Grain, LLC
 Bunge
 Cereal Food Processors
 Farms Technology, LLC
 FCStone, LLC
 Gavilon, LLC
 Gresham Investment Management, LLC
 Infinium Capital Management
 JP Morgan
 Kraft Foods
 Laymac, Inc.
 Lincoln Grain Exchange
 Louis Dreyfus Commodities
 Macquarie Bank Limited
 Mocek, Greg
 Penson Futures
 Pia Capital Management LP
 Rand Financial Services, Inc.
 Red Rock Trading, LLC
 RJ O'Brien
 Rich Investments
 Riverland Ag
 State Street Global Markets
 TENCO, Inc.
 The Scoular Co.
 Vermillion Asset Management

ATTACHMENT

June 5, 2011

Via Electronic Submission

DAVID A. STAWICK,
Secretary,
 Commodity Futures Trading Commission,
 Washington, D.C.

Re: *Position Limits for Derivatives*, RIN 3038-AD15 and 3038-AD16

Dear Secretary Stawick:

I. Introduction

On behalf of the Working Group of Commercial Energy Firms (the "Working Group")¹ and the Commodity Markets Council ("CMC")² (collectively, the "Commer-

¹The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities.

²CMC is a trade association bringing together commodity exchanges with their industry counterparts. The activities of our members represent the complete spectrum of commercial users of all futures markets including agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures U.S., Kansas City Board of Trade, Minneapolis Grain Exchange, and New York Mercantile Exchange. Please note that Hunton & Williams LLP is not counsel to CMC.

cial Alliance”),³ Hunton & Williams LLP hereby submits these comments to supplement the individually filed comments of the Working Group and the CMC submitted in response to the Commission’s Notice of Proposed Rulemaking, *Position Limits for Derivatives* (the “Proposed Position Limits Rule”).⁴ While the Working Group and the CMC individually filed comments in response to the Proposed Position Limits Rule, the Commercial Alliance is filing the comments set forth herein because further issues were discovered that had not previously been addressed. Specifically, these comments address the Commercial Alliance’s concerns with the *bona fide* hedging exemption as set forth in the Proposed Position Limits Rule.

II. Comments of the Commercial Alliance

Participants in the Commercial Alliance share a common concern that the Commission’s proposed rules implementing Title VII of the Act, while primarily designed to address problems in the financial markets, will materially and adversely affect the commercial markets through which agricultural and energy-related commodities are ultimately delivered to United States consumers. The Working Group and CMC separately filed comments in response to the Proposed Position Limits Proposed Rule, presenting arguments opposing the imposition of position limits set forth in the Proposed Position Limit Rule.⁵

In this letter, we are not addressing whether the imposition of Federal speculative position limits is appropriate as a legal or policy matter. Rather, the Commercial Alliance seeks to focus the Commission’s attention on certain flaws in the proposed definition of a *bona fide* hedging transaction set forth in proposed CFTC Rule 151.5(a), which, if adopted as proposed, will disrupt the use of commercial markets for hedging purposes.

A. Definition of *Bona Fide Hedge*

As addressed by CMC and the Working Group in their individually filed comments on the Proposed Position Limits Rule, the Commission has taken a narrower view of *bona fide* hedging than as defined by Congress in the Act. Specifically, the Commission has proposed to allow as *bona fide* hedges only transactions that fit within five specific categories of hedges, referred to as “enumerated hedges.”

In addition, while Congress permitted the Commission to exempt “any transaction or class of transactions” from any position limits that it establishes pursuant to the Act, the Proposed Position Limits Rule has eliminated the opportunity for participants transacting in exempt and agricultural commodities to apply for exemptions from position limits for what have historically been known, and permitted, as “non-enumerated hedges.” As a consequence, certain traditional risk-reducing commercial transactions executed in energy and agricultural markets would not fall within the definition of a *bona fide* hedging transaction under the Commission’s Proposed Position Limits Rule.⁶ Such transactions include, but are not limited to, the following:

- Unfixed price commitments in the same calendar month;
- Unfixed price commitments in a different commodity;
- Hedges relating to assets that a person anticipates owning or merchandising;
- Hedges of services;
- Hedges of “spread” and “arbitrage” positions;
- Hedging in the last 5 days of trading an expiring contract; and
- Hedges on assets.

The Commercial Alliance provides in *Attachment A* hereto specific examples of commercial transactions executed in energy and agricultural markets that would not fall within the definition of a *bona fide* hedging transaction under the Commission’s Proposed Position Limits Rule.

³The Commercial Alliance is a combined effort among commercial agriculture and energy companies to address significant issues under the Commission’s rulemakings to implement derivatives reform under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

⁴*Position Limits for Derivatives*, Notice of Proposed Rulemaking, 76 FED. REG. 4752 (Jan. 26, 2011).

⁵See *Position Limits for Derivatives*, Comments of the Working Group of Commercial Energy Firms (Mar. 28, 2011); *Position Limits for Derivatives*, Comments of the Commodity Markets Council (Mar. 28, 2011).

⁶See proposed CFTC Rule 151.5(a). The problems manifest themselves, in many circumstances, because cash settled swaps and DCM physically-settled futures do not offset each other in position calculations for purposes of these rules.

B. The Commission Should Incorporate All of the Activities Described in the Attached Examples Into the Final CFTC Rule 151.5(a)(2)—Enumerated Hedges

All of the examples in *Attachment A* represent commercial activities that fall within the definition of *bona fide* hedge set forth in Section 737 of the Act and CFTC Rule 151.5(a)(1) of the Proposed Position Limits Rule. Accordingly, they should be incorporated into the list of enumerated hedges to establish, beyond doubt, that such transactions would qualify as *bona fide* hedges under any final Commission rules.

C. The Commission Should Retain the Flexibility of Former CFTC Rule 1.3(z)(3)—Non-Enumerated Hedges and Related Processes

In addition to providing certainty for the types of transactions set forth in *Attachment A*, the Commission should preserve the rule and process for obtaining exemptions for non-enumerated hedges. Markets are dynamic and are subject to change. The Commercial Alliance submits that it is neither in the public interest nor in its own interest as a market regulator for the Commission to adopt a rule that effectively eliminates its discretion and flexibility to grant an exemption for a *bona fide* hedging strategy that it could not foresee today (or, for that matter, that was simply overlooked during this process). While the Commission would be permitted to amend CFTC Rule 151.5(a)(2) to accommodate any unforeseen *bona fide* hedging strategies, the Commercial Alliance submits that the process to amend such Rule would not be in the best interests of the markets or the economy, as it would effectively delay the applicant hedger from the opportunity to timely establish that legitimate hedge position. Therefore, the Commission should retain CFTC Rule 1.3(z)(3) to give it the flexibility to adapt to changing market circumstances.

D. Compliance With the Daily Reporting Requirement Will Be Unduly Burdensome

As discussed in both the CMC and Working Group individual comments on the Proposed Position Limits Rule, requiring market participants to report daily on their cash market positions will be extremely and unduly burdensome and is not justified by any corresponding benefit.⁷ In addition to the operational burdens of building and maintaining a compliance system to perform such reporting, the process, or lack thereof, for applying for an exemption in advance of exceeding any position limit creates significant uncertainty for market participants seeking to accommodate both their short-term and long-term hedging needs. Accordingly, the Commercial Alliance requests that the Commission consider these concerns and provide market participants clear guidance on the process for applying for, and complying with, exemptions from speculative position limits.

IV. Conclusion

The Commercial Alliance supports regulation that brings transparency and stability to the agriculture and energy swap markets in the United States. The Commercial Alliance appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein prior to the adoption of any final rule implementing Title VII of the Act. The Commercial Alliance expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact Christine Cochran, President, CMC, at [Redacted], or R. Michael Sweeney, Jr., counsel to the Working Group, at [Redacted].

Respectfully submitted,

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CC:

Hon. GARY GENSLER, *Chairman*;
Hon. MICHAEL DUNN, *Commissioner*;
Hon. BART CHILTON, *Commissioner*;
Hon. JILL SOMMERS, *Commissioner*;
Hon. SCOTT O'MALIA, *Commissioner*;
DAN BERKOVITZ, *General Counsel*, Office of General Counsel;
BRUCE FEKRAT, *Special Counsel*, Division of Market Oversight.

⁷ See *Position Limits for Derivatives*, Comments of the Working Group of Commercial Energy Firms at Part III.C (Mar. 28, 2011); *Position Limits for Derivatives*, Comments of the Commodity Markets Council at Part 4 (Mar. 28, 2011).

ATTACHMENT A

Examples of Transactions That Do Not Qualify as Bona Fide Hedging Under the Proposed Position Limits Rule

The following provides examples of hedging transactions commonly entered into by commercial firms in agricultural and exempt commodity markets that will be effectively excluded from the definition of *bona fide* hedge as set forth under the Commission's Proposed Position Limits Rule.

I. Unfixed Price Commitments**A. In the Same Calendar Month**

Proposed CFTC Rule 151.5(a)(2)(iii) would permit a hedge of offsetting unfixed price purchase and sale commitments only if they were based on different delivery months. The following example demonstrates the potential need to hedge basis risk in the same delivery month, but at a different delivery location. If one used a cash-settled swap in one location and a physical delivery futures contract at the other, these positions would not offset, and would not qualify as *bona fide* hedge positions.

Example: A natural gas (“NG”) wholesaler buys gas at (Point 1) and sells it at another point on the same pipeline (Point 2) to a different counterparty. Both contracts are at an index price plus or minus a differential. In order to lock in the current spread relationship between the prices at the two delivery locations, NG wholesaler sells a NYMEX Henry Hub futures contract and enters into a “long” swap on the price at Point 2, hedging the risk that the price at Point 2 will decline relative to the price at Point 1. Since the purchase and sale will occur during the same delivery month, this hedge would not constitute a **bona fide** hedge under proposed CFTC Rule 151.5(a)(2).

B. In a Different Commodity

Proposed CFTC Rule 151.5(a)(2)(iii) would permit a hedge of offsetting unfixed price purchase and sale commitments only if they were in the same commodity. The following example demonstrates the potential need to hedge basis risk between two different commodities.

Example 1: Power plant operator buys natural gas from which it generates and sells power. It buys gas from one party at an index plus or minus a differential and it sells power to a different party at an index plus or minus a differential. In order to lock in the basis between gas and power prices, it enters into a swap on the power price and Henry Hub futures contracts in natural gas, effectively hedging the risk that the price of power will decline relative to the price of gas. Since the two prices are referencing different commodities, this hedge would not constitute a **bona fide** hedge under proposed CFTC Rule 151.5(a)(2).

II. “Anticipated” Transactions

Although hedges of “anticipated ownership” and “anticipated merchandising” transactions would be *bona fide* hedges under the language in the Dodd-Frank Act and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for them as “enumerated hedges” under proposed CFTC Rule 151.5(a)(2).

Example 1: Commercial entity X, a wholesale marketer of crude oil, has purchased a cargo of oil currently transiting the Atlantic from Europe to the U.S. at the price of ICE Brent futures plus or minus a differential. It is negotiating to sell that cargo in the U.S. gulf coast at a price of NYMEX WTI plus or minus a differential. Although it has not concluded negotiations on the sale, it believes that it will do so in the next several days. Believing that prices may fall over the next several days, it places a hedge in NYMEX WTI futures. Under proposed CFTC Rule 151.5(a)(2), this would not constitute a **bona fide** hedge.

Example 2: In the example above, the parties have concluded their negotiations and, as is standard in the industry, agreed to the transactions subject to credit terms and legal review of documentation. Again, the NYMEX WTI hedge placed by Commercial entity X would not constitute a **bona fide** hedge under the proposed CFC Rule 151.5(a)(2).

Example 3: Farmers Elevator, a grain merchandiser, owns a 3 million bushel storage facility in Farmville, a town surrounded by thousands of acres of growing corn, soybeans, and wheat. As part of its normal business practices, Farmers Elevator expects in the future to enter into forward contracts with area farmers under which Farmers Elevator agrees to pay farmers a fixed price for their grain at harvest. In order to hedge this risk, Farmers Elevator “goes short” on CME

by selling futures contracts. Under the proposed rule, this would not constitute a **bona fide** hedge since at the time of the futures position by Farmers Elevator there in fact is no underlying physical contract. The result would be that Farmers Elevator may no longer be able to provide attractive forward cash market contracts to its farm customers.

Example 4: In February of 2011, prior to spring wheat planting, Elevator X, which has storage capacity that is currently sitting completely empty, locks in a spread of \$1.40 on a portion of its expected throughput for the crop year by buying July 2011 Wheat futures and selling July 2012 Wheat futures. Regardless of whether Elevator X actually buys wheat in 2011, this transaction represents a hedge by Elevator X of its capacity (i.e., the value of its grain storage assets). If there is a crop failure during the 2011 harvest resulting in little to no wheat deliveries at Elevator X, the spread position hedge will perform by providing Elevator X the economic value of the position hedging against such an event. Alternatively if Elevator X (as expected) buys wheat, it will hedge these specific price risks by taking appropriate futures positions and reducing the July/July Wheat spread. This “hedging of capacity” strategy would not be a **bona fide** hedge under the proposed CFTC proposed Rule 151.5(a)(2).

III. Hedging of Services

Although hedges on the value of “services that a person provides or purchases, or anticipates providing or purchasing” would be **bona fide** hedges under the language in the Dodd-Frank Act and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for them as “enumerated hedges” under proposed CFTC Rule 151.5(a)(2).

Example 1: Commercial energy firm Z is a wholesale marketer of natural gas. It has an opportunity to acquire one year of firm transportation on Natural Gas Pipeline (“NGPL”) from the Texok receipt point to the Henry Hub delivery point for an all-in cost of \$.30/mmbtu. The “value” of that service at that time is \$.33/mmbtu, measured as the difference between the price at which one can sell the natural gas at the delivery point minus the price at which one can purchase the gas at the receipt point. At that time, commercial energy firm Z can enter into a swap locking in the calendar 2012 strip at Texok at a price of \$.40/mmbtu and sell a calendar strip of NYMEX Henry Hub natural gas futures contracts locking in a sale price at a weighted average of \$.433/mmbtu. Entering into those two separate transactions without having actually purchased or sold natural gas to transport has allowed commercial energy firm Z to hedge the value of the firm transportation service that it holds or can acquire.⁸ However, under the Commission’s proposal, the transactions would not qualify as **bona fide** hedge transactions.

Example 2: Natural Gas Producer X has new production coming on line over the next few years in the Gulf of Mexico. The production is located near Point A on Pipeline Y’s interstate natural gas pipeline system. Producer X has the desire to sell gas to customers in Region B as the price for natural gas in Region B is significantly higher than at Point A, where natural gas would currently be delivered into Pipeline Y’s system. Producer X contacts Pipeline Y and negotiates a Precedent Agreement with the pipeline under which Pipeline Y will build new transportation capacity from Point A to Region B. Under the Precedent Agreement, Producer A is obligated to pay demand charges to the pipeline for a term of 5 years from the date the pipeline goes into commercial operation, if Pipeline Y is able to complete a successful open season and obtains the necessary permits to construct and operate the new section or expansion of its pipeline system from Point A to Region B. The open season is designed to attract commitments from other potential shippers to help support the cost of building and operating the pipeline expansion. The schedule calls for a completion of construction and commercial operation of the pipeline expansion on March 31, 2013.

Producer X is concerned that the natural gas price differential between Point A and Region B could collapse and is fairly confident the expansion project will be completed. In order to manage the risk associated with the 5 year financial commitment to Pipeline Y, i.e., pipeline demand charges, Producer X enters into swaps at Point B for a term of April 1, 2013 to March 31, 2018, to lock-in the price spread between Point A and Region B. Under the Commission’s Proposed

⁸Note that this “value” exists whether commercial energy firm Z ever owns or intends to own the physical commodity. In some circumstances, the firm might choose to release the capacity to a third-party and realize the value of the transportation service from the capacity release transaction.

Rule, the swap transactions would not qualify as **bona fide** hedges. In this case, the expansion of the pipeline system that would afford customers in Region B more access to lower priced gas might not occur without the ability to count the swaps associated with this transaction as a **bona fide** hedge.

Example 3: Commercial energy firm A is an electric utility that owns coal-fired generation facilities. Firm A enters into contracts with major railroads to transport coal from producing regions to its various generating facilities. One or more of these contracts are subject to a fuel surcharge, whereby rates paid by firm A to transport coal are indexed to the price of diesel fuel. As prices for the diesel fuel rise, the rate paid by firm A to transport coal also rises. To mitigate this risk, firm A could enter into a long position in futures contracts or swaps for the diesel fuel, whereby gains realized on these instruments should prices rise would off-set any increase in the rate paid by firm A to transport coal. Under the Proposed Rule, however, these transactions would not qualify as **bona fide** hedge transactions since they would be entered into as a hedge of services—in this case, coal transportation services.

IV. Hedges of “Spread” Or “Arbitrage” Positions

Although hedges on the value of spread or arbitrage positions would be **bona fide** hedges under the language in the Act and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for them as “enumerated hedges” under proposed CFTC Rule 151.5(a)(2).

Example 1: The business model of Company X is to import crude oil from Europe to the United States. On an average year it imports 48 million barrels of crude oil. Its purchases in Europe are generally priced against Brent oil and its sales in the United States are priced against WTI. Those prices are readily available across the price curve, more than a year in advance. There are times when Company X believes the differential for a particular month is favorable and it seeks to lock in that differential by buying Brent swaps and selling NYMEX WTI futures, knowing that it will ultimately buy the oil priced in Brent and sell the oil priced in WTI. Under the proposed rule, even though this transaction allows Company X to hedge the risk of its business strategy and expected transactions, this would not be a **bona fide** hedge under proposed CFTC Rule 151.5(a)(1).

Example 2: Grain Merchandiser X is in the business of buying wheat in, among other places, North Dakota, using a Minneapolis Grain Exchange (MGEX) reference price. Grain Merchandiser X is also in the business of selling wheat to Italian flour mills, using a Euronext France (MATIF) price. These prices are readily available across the price curve, more than a year in advance. As such, there are times when Grain Merchandiser X believes the differential for a particular month is favorable and it seeks to lock in the differential by selling MATIF futures (or swaps) and buying MGEX futures, even though it will ultimately buy North Dakota wheat priced in MGEX futures. This transaction, which allows Grain Merchandiser X to hedge the risk of the expected transactions in its business strategy, would not be a **bona fide** hedge since it is not enumerated under proposed CFTC Rule 151.5(a)(2).

V. Hedging in the Last Five Days of Trading an Expiring Contract

The following examples illustrate the uneconomic consequences of prohibiting a **bona fide** hedge positions from being held in the last 5 days of trading.

A. Unsold Anticipated Production—Proposed CFTC Rule 151.5(a)(2)(i)(B)

Example 1: Company A anticipates producing 2000 barrels of crude oil in July. That production is currently unsold. To hedge its risk that the value of those barrels may decline prior to their sale, Company A will sell two July NYMEX WTI crude oil futures contracts, which represent delivery ratably during the month of July. The last trading day of the July futures contract is June 21st. The last day that Company A could hold the position as a **bona fide** hedge under the proposal is June 14th. This means that if Company A holds the contract from June 15th through June 21st and delivers its oil under the July futures contract, it could not treat those positions as a **bona fide** hedge during that period. Alternatively, in order to maintain **bona fide** hedge status, it would be required to roll its hedge into the August contract on June 14th, taking basis risk on the July/August spread for the additional 5 days.

B. *Unfixed Price Contracts*—Proposed CFTC Rule 151.5(a)(2)(iii)

Example 1: *Company B has a contract to buy natural gas at the Henry Hub in July at NYMEX + \$.10 and a contract to resell it at the Henry Hub in August at NYMEX + \$.15. To hedge the basis risk, it sells NYMEX July futures and buys NYMEX August futures. Under the Commission’s proposal, this position would not be a **bona fide** hedge if it was carried into the last 5 days of trading of the NYMEX July futures contract. Company B would be forced to roll its position to a less efficient hedge.*

C. *Cross-Commodity Hedges*—Proposed CFTC Rule 151.5(a)(2)(v)

Example 1: *Commercial energy firm J supplies jet fuel to airlines at a variety of airports in the United States, including Houston Intercontinental Airport. It has a fixed-price contract to purchase jet fuel from a refinery on the gulf coast during early June. Because there is no liquid jet fuel futures contract, commercial energy firm J uses the June NYMEX physically-delivered WTI crude oil futures contract to hedge its price risk. Under the Proposed Rule, commercial energy firm J would be required to liquidate its hedge during the last 5 trading days of the June contract and either remain unhedged or replace its June hedge with a contract that represents a different delivery period and, therefore, a different supply/demand and pricing profile.*

Example 2: *AgriCorp, a grain warehouse, grain merchandiser and feed ingredient wholesaler, buys wheat from farmers. At the same time, Agricorn enters into a fixed price agreement with a feedyard to supply feed (the exact components of which could be satisfied using wheat, corn, DDGs, or other ingredients). In order to hedge its risk, AgriCorp enters into a swap, hedging the risk that the price of wheat will decline relative to the price of corn (the corn futures price better correlates to feed prices, thereby providing a more effective hedge). Since the two prices are referencing different commodities, this hedge would not constitute a **bona fide** hedge if held in the last 5 days of trading.*

VI. *Hedges on Assets*

Example: *XYZ Corp. is planning on buying a liquefied natural gas (“LNG”) vessel. The value of that asset is based upon the spread between natural gas prices between and among various continents. XYZ will need financing in order to make the purchase. The lenders will only make a loan if XYZ can demonstrate a level of certainty as to its future revenue stream. As it negotiates with the ship-builder and as it negotiates with lenders, the current differentials are favorable for robust demand for LNG. XYZ wants to enter into separate swaps and/or futures positions in the U.S., Europe and Asia to lock in the potential purchase prices in producing regions and the potential sales prices in consuming regions at current differentials. This will allow it to lock in the value of LNG transportation and satisfy lenders that this is a good credit risk for them to take on. Those swaps and/or futures positions would not be **bona fide** hedges under the Proposed Position Limit Rule because the ship-owner does not own or anticipate owning the underlying commodities.*

The CHAIRMAN. Thank you, and the chair would like to remind Members that they will be recognized for questioning in order of seniority for Members who were here at the start of the hearing, and after that, Members will be recognized in order of arrival. I do appreciate the Members’ understanding, and just to provide a little clarity, on the majority side, the first three or so will be myself, Mr. Johnson, Mr. Conaway. On the minority side, it will be Mr. Holden, Mr. Peterson and Mr. Boswell. And with that, I turn to myself.

Throughout this process, I have argued that regulation and a healthy economy can go together. A robust regulation, yes, and a healthy economy can go hand in hand. Unfortunately, we have not seen that balance, I believe, in many of the proposed rules. Certain regulatory proposals will impose costs to the real economy that may very well exceed the benefits achieved in Dodd-Frank’s objectives, and that is what we are here today to address. That is our job.

Yesterday, the Chairman of the CFTC gave a speech before the Futures Industry Association in which he said, “It has been just

over a year since Dodd-Frank reforms became law. There are those who might like to roll them back and put us back in the regulatory environment that preceded the crisis 3 years ago." So I ask this first couple of questions to the panel, and anyone can answer that chooses to. Do you believe that if the proposals considered today were enacted, that they would roll back Dodd-Frank reforms, number one, and if the proposed changes were made, will your regulatory environment be the same as it was 3 years ago? Fair question. Do you believe what we are discussing today would roll back Dodd-Frank's reforms, and if these bills were indeed to be signed into law, do you believe that the regulatory environment would be where it was 3 years ago? Whoever would care to step into that? Please.

Ms. SANEVICH. Certainly, speaking for the ERISA plans, the regulatory requirement would indeed change even if the proposals that are presented today, at least as they related to ERISA plans were enacted, what these proposals would do in our view is really reflect better what the Congressional intent was. In some of the cases that particularly affect ERISA plans, the regulations that have been proposed currently are not within the spirit of what Congress intended and in some cases would essential eliminate the ability of ERISA plans to use swaps, which is clearly what Congress did not intend in enacting Dodd-Frank. So things would not be business as usual as they were 3 years ago but they would certainly clarify and move us closer to what we think Congress had intended with enacting certain provisions of the Dodd-Frank.

The CHAIRMAN. Thank you.

Anyone else wish to comment? Yes, Mr. Williams.

Mr. WILLIAMS. Mr. Chairman, it appears to us that the implementation of the legislation considered today would only allow the practical implementation of Dodd-Frank as envisioned, and the regulatory environment compared to 3 years ago would be substantially different.

The CHAIRMAN. Thank you.

Mr. GIANCARLO. Mr. Chairman, these proposals are not meant to roll back Dodd-Frank, and I could say for the record, we are not in favor of rolling back Dodd-Frank. Dodd-Frank imposes substantial changes on the wholesale swaps industry, many of which in fact we were advocating for before Dodd-Frank, such things as moving to more of a cleared market structure. We wholly support that major accomplishment of Dodd-Frank and think that will improve transparency and access to the markets for many participants.

The mandatory execution provision is also one that we are very supportive of but we are supportive of it if it is in accord with Congress's clear intent that execution facilities could use any means of interstate commerce. So we see the Swap Clarification Act and these other bills as purely clarification and not a rollback of the operative provisions of Dodd-Frank.

Ms. BOULTWOOD. So I will add to that answer. You know, Dodd-Frank was put in place as a statute to protect and control the economy against systemic risk and also create greater transparency with respect to Title VII and our world of derivatives. So neither of those would be lessened, if you will, by the rules that we are con-

sidering or the legislation that we are considering today. This legislation in fact ensures that those that created the systemic risk are treated under the rules from the SEC and CFTC and would exclude, for example, end-users who are well known through history of having not created, or are sources, of systemic risk. There are reporting provisions, even for end-users, that are a part of the rule-making under Title VII which would be in place that really further that goal of transparency in the derivatives markets. I think the provision of clearing maintains a very new aspect of transparency that would be preserved even when these proposed legislative bills are approved.

The CHAIRMAN. One last question, and I understand the answers to these from your comments but just for the record, do you think it is important for Congress to legislate in the areas proposed today or should we wait until the agencies finalize the rules? Yes, ma'am.

Ms. SANEVICH. We definitely think Congress should act because, frankly, if the rules are adopted and finalized, by then at least for the ERISA plans, it would be too late. They will not be able to engage in swaps as of the time the rules are set for implementation and that would be a disastrous result for the millions of Americans that depend on defined benefit plans for their retirement security.

The CHAIRMAN. Yes, Mr. Cordes?

Mr. CORDES. Mr. Chairman, I would agree with that. The bills need to be enacted today. We need to get some clarification on some of these things. We have cooperatives today that are putting their businesses on hold from going forward, and part of that is the uncertainty. We need this clarification. Our concern is down the road if we don't have that clarification, will we have the proper risk management tools to put through the cooperative network that ultimately get down to the farmer level? I don't think it is any surprise today with the volatility in the markets out there, farmers are faced with greater challenges about protecting and managing their margins and their operations that will be subject to risk.

Mr. GIANCARLO. Mr. Chairman, we operate global marketplaces in addition to Louisville, Kentucky, and Sugarland, Texas, that I mentioned earlier. We also operate marketplaces in London, in Geneva, in Dubai and Singapore and places like that, and with the restrictions placed on modes of execution proposed by the CFTC, the operators of markets in those jurisdictions are licking their chops as they are waiting for markets to migrate offshore. In the modern world of swaps, markets move at a flick of a mouse. It is not as if they have to move buildings or bridges. They can move to foreign marketplaces. If we set restrictions on the methods of execution that are unsuitable for the nature of the instruments, we will see those instruments trade in foreign markets almost overnight. It is very, very important that Congress's intent that the mode of execution be suitable for the instrument and any means of interstate commerce be interpreted as it is meant to be, be enacted as soon as possible.

The CHAIRMAN. Thank you. One last comment, and my time will have expired.

Mr. THUL. Just to add on, Mr. Chairman, I would say that the comment that you made at the beginning of your questioning was just adding real cost to the economy and if this goes through as it

is today, we have lack of clarity around what many of the definitions are and then also the potential to introduce a lot of added incremental costs to the commercial businesses that we are dealing with that are not in place today and could hurt the competitiveness of the United States.

The CHAIRMAN. Thank you. My time has expired. I now recognize the gentleman from Pennsylvania, Mr. Holden, for 5 minutes.

Mr. HOLDEN. Thank you, Mr. Chairman.

Mr. Williams, to which Prudential Regulators does your bank answer to?

Mr. WILLIAMS. To what regulators do we answer?

Mr. HOLDEN. Yes.

Mr. WILLIAMS. We have at least three regulators: the Georgia Department of Banking and Finance, the FDIC and the Federal Reserve System.

Mr. HOLDEN. Now, if Dodd-Frank had never been enacted into law, would your regulators have the authority to require you to collect margin from your swap counterparties whether they be financial or commercial using their preexisting statutory authority to oversee your bank's safety and soundness?

Mr. WILLIAMS. They have the authority to oversee our safety and soundness. I don't believe they have the statutory authority to specify specific margin requirements or collateral requirements on specific transactions.

Mr. HOLDEN. Well, it is my understanding that the regulators do have that authority, so Mr. Chairman, I suggest maybe we can get the Prudential Regulators in here and get clarification on this.

For other members of the panel, if we do discover the Prudential Regulators, as I understand it, can still require margin despite H.R. 2682, how do we address your concerns? In other words, I believe they can have you impose margins, if we find out that that is correct as they are telling me, what does this legislation do and how do we address your concerns?

Mr. WILLIAMS. I am not familiar with the specific legislation you mentioned, and I don't know about the Prudential Regulators' specific authority to regulate specific transactions. I will be happy to get back to you on that.

Mr. HOLDEN. Does anyone else care to comment? Because it is my clear understanding that they believe that they can have margins imposed.

Ms. BOULTWOOD. Yes, that is correct, so they can either impose margin on counterparties, and that is initial margin and variation margin, and if they choose not to impose that margin, then they will be required to hold additional capital. So either presents a cost because this capital, if it is held by the bank, will be passed through as a charge, which would be reflected in the bid ask spread. That is the price of the derivative that is transacted. And if it is a margin requirement, initial margin and variation margin, then it is a direct capital cost to the counterparty.

Mr. HOLDEN. Okay. Well, help me—this is complicated stuff, so you said they do have the authority, so if they do have the authority, how would H.R. 2682 if enacted into law affect the concern? They can do it anyway, correct?

Ms. BOULTWOOD. That is a good question. I think it would require cooperation in kind of this unprecedented environment of regulatory change between authorities like the CFTC, the SEC and Prudential Regulators which, honestly, we haven't seen before. How does that get legislated? I leave it to more experienced minds than mine, but I do think that there has to be a way to force the cooperation across Prudential Regulators and independent Commissions.

Ms. SANEVICH. I guess I have a couple of observations. Obviously, I don't know the jurisdictional lines between Prudential Regulators and Congress but the Prudential Regulators came out with these margin rules as a direct result of the Dodd-Frank Act. Something in the Act must have made them stop and think and go ahead and start regulating margin requirements. Moreover, the CFTC also has tacked onto the Prudential Regulators with respect to margin requirements for anyone who will not be caught by the Prudential Regulators. So certainly the CFTC since it is empowered under the Dodd-Frank Act to do what it is doing, there has to be some sort of cross-jurisdictional issue.

And last, I believe the Chairman had mentioned and maybe the Ranking Member as well the cost-benefit analysis issue, and perhaps that is where some solution can be found, because with respect to the ERISA pension plans, they are called high-risk end-users by default. It is not like the regulators had thought about what pension plans do, how they manage their risk or what they use interest rate swaps for, they just said if you are not this and you are not this, you must be a high-risk financial end-user, and that is clearly a ludicrous result with respect to pension plans. Maybe that is a way to force the issue and make folks think about exactly how these margin requirements will be implemented and how they will affect the various end-users that will be affected.

Mr. HOLDEN. Thank you.

Mr. Chairman, based on the answer, it is just more apparent that we need to have the regulators come before us so we can have some clarity, and I yield back.

Mr. CONAWAY [presiding.] One clarification. Ms. Boulwood, were you talking in your answer about the current regulations or the proposed regulations?

Ms. BOULTWOOD. As Ms. Sanevich indicated, it is the regulations that have come about for banks as a result of Dodd-Frank.

Mr. CONAWAY. Okay. So the proposed regulations?

Ms. BOULTWOOD. Correct, and whether they are in—I don't know the timeline for when they go into effect but they are proposed.

Mr. CONAWAY. Mr. Tim Johnson for 5 minutes.

Mr. JOHNSON. Thank you, Mr. Chairman.

Let me address this to all the panelists, and I don't need *ad seriatim* but maybe a select response. You are all in some form or another an integral part of the agricultural sector in the United States. How do you feel that the CFTC regulations as proposed without any guiding legislation will impact American agriculture?

Mr. CORDES. I would say without some clarification on the rules as things are proposed, you are going to have agriculture not knowing exactly where they stand. They will be hesitant to offer some of the risk management tools that they do in the industry today.

I would say if you get these volatile markets like we saw in 2008, which we are very close at today, some of the impact you will see in rural America, you will probably find that as farmers want to sell grain into the future, say 6 months to a year out or maybe a year and a half, won't have that opportunity because there won't be buyers there to post those bids because without these tools, they can't manage that. So they need clarification so we can offer the proper tools.

Mr. JOHNSON. So would the whole panel basically have a sense that a lack of certainty causes some degree of instability and lack of predictability in the process? Is that a fair statement?

Let me ask Mr. Thul from Cargill, you are a major player in my district and the agricultural sector around the country. Your company is facing a significant number of new regulatory requirements that could greatly change—I think that is an understatement—your risk management practices. What would be, in your judgment, the cumulative effect of those regulations, or these regulations, for Cargill, and more particularly for its customers?

Mr. THUL. Thank you. I think it would be a drastic change for us. You know, if you look at the anticipatory hedging piece of this and even the *bona fide* hedge definition, it could greatly reduce our ability to be able to handle the grain crops and service our customers, and at its worst case, that could translate into not being able to accept nearby delivery in times when the marketplace absolutely needs it. So I think it could be—

Mr. JOHNSON. That is good. I appreciate that.

The Ranking Member, my good friend, Mr. Peterson, has expressed some concerns about this series of three bills and three discussion drafts that they might be premature and that they not be geared in at least time-wise to what we need to do. Do any of you have any thoughts or response to that? Don't all speak at once.

Ms. BOULTWOOD. Also, it is in part related to the last question, just in terms of the costs we are already seeing. So behavior is changing. We have observed in the energy markets already decreases in liquidity in those markets. There could be a number of reasons to explain that, but certainly the uncertainty and potential for regulations, costly regulations, is one large reason. When we look at our costs internally, there will be significant costs of implementation if we don't properly as proposed under this proposed legislation define the end-user and the appropriate size of its *de minimis* exception to the *swap dealer* definition. We will also have technology costs as well as those costs we see in the market.

Mr. JOHNSON. I guess my last question is in the form of a comment. Ranking Member Costa and I recently held a field hearing in central Illinois with respect to rural development, broadband services and so forth, which really raises the larger issue of where rural America, where small-town America is going. I am presuming that the members of the panel here like most of the Members of the Committee would agree that there is going to be an impact on small-town America, rural America, particularly during an era when there is at best a decline and at worst a rapid decline in terms of the infrastructure and economic future of that area. Would you say that is a fair summation of the impact of the rules without any guiding legislation?

Mr. THUL. I absolutely would agree with that, and I think that it is going to put unnecessary costs in an already low margin-type environment that we have in our agricultural system.

Mr. JOHNSON. My time has expired. Let me just make a concluding remark. I think this has been a very instructive hearing so far, and a lot of good input, good witnesses and actually good proposals for change, but I would suggest that when we deal in a mega cosmic sense, we oftentimes have a microcosmic effect in terms of people's real lives in the Central Valley of California or in Decatur, Illinois, and I am hopeful we as Members of Congress, the CFTC and you all are mindful of what the impact could be.

Mr. CONAWAY. The gentleman yields back.

Mr. Peterson for 5 minutes.

Mr. PETERSON. Thank you, Mr. Chairman.

Does anybody here remember Enron? You know, we had an energy company that became a financial trading company, and like a swap dealer, it served as a counterparty to a wide range of energy swaps with a wide range of customers and operated in the dark without oversight, without regulation, created separate entities and moved risk to those entities to hide it from its own balance sheet and again with little oversight. Out of that fiasco, that is part of the reason we got the Sarbanes-Oxley legislation, which typically overreacted and put costs on people that weren't the problem, and some of the issues that you are raising here today, but as part of the cost of getting that done, we got rid of Glass-Steagall, which caused part of this problem. And then we in this Committee passed the CFMA in 2000, which further caused this problem, and I have to admit as a junior Member of the Committee, and for those of you that are new here, this might be instructive—I bought into this. The argument was, these guys are a bunch of rich guys that are gambling their own money and so it is none of our business what they do, and they almost took down the whole damn world economy.

And the other thing that happened in the CFMA is that a lot of this swap business was gambling, especially these naked CDS's, and so there was a question about whether there was legal backing of these contracts, and so in the CFMA, we gave legal certainty to these swaps, and at the time we had \$80 billion in the swap market, and from 2000 to 2008, it went to \$600 or \$700 trillion with no regulation, nobody knowing who was doing what, and that is what we are trying to get at here.

So today you come before us with one proposed bill that would give energy companies the ability to make markets and engage in dealing activities and energy swap with little or no chance of being designated as a swap dealer regardless of how much dealing businesses you do, and we know that some of you do a significant amount of dealing.

Another bill would exempt even from the definition of *swap* those swaps conducted between affiliates of your company, and so there are Members who see what you are asking for and point their fingers and say Enron. Clearly, none of you are Enron, I understand that, I am not accusing you of that, but what do you say? What can I say to those that fear that these bills are going to reinstate

the condition for the rise and subsequent collapse of another Enron kind of situation?

Ms. BOULTWOOD. I can start the response. We all remember Enron. It is a great thing to discuss as we think about this proposed legislation, but Enron as well as certain telecom companies in that era, there were large accounting scandals and Enron had a lot to do with financing off balance sheet in entities that weren't legitimate and didn't have legitimate assets backing them. Now, Enron, at the same time they were perpetrating an accounting fraud were also transacting in derivative markets. That is true. They were dealing, they were market making often without physical assets to support that activity.

Mr. PETERSON. Well, and so was AIG.

Ms. BOULTWOOD. Well—

Mr. PETERSON. I mean, there were a number of people that were doing these swaps—

Ms. BOULTWOOD. And so—

Mr. PETERSON.—and not putting any money up, and that is part of what we are trying to get at here. I mean, you keep saying that this is going to add cost. Well, yes, it is going to add cost in some places that should add cost because people were operating and doing these deals and pretending that there wasn't any risk and any potential problem, and the government ended up picking up the bill. And then Goldman goes over and makes this deal in Greece and now the taxpayers in Europe are going to pick up the bill for that, and we are still allowing people to do this stuff, and these are the major folks that are involved in this. So I said from the start that the legitimate end-users did not cause the problem and should not be swept up in this, but some of these bills create loopholes that are going to allow this stuff to go on, and I am just not going to stand for that. Maybe there will be some collateral damage in this but I am not going to be one that is going to sit here and have another collapse happen and happen the second time on my watch. I made a big enough mistake the first time by supporting the CFMA, so some of us that have been around want to err on the side of caution here.

Ms. BOULTWOOD. Just on Enron, since we started there, I would just like to remind the Committee that never did any power or natural gas cease to flow. The end-using customers continued to receive their commodities and the collapse of Enron was a failure of a corporate strategy and, we can look back rightfully so, and so businesses take risks, they fail.

Mr. PETERSON. The collapse of Lehman was a failure of a corporate strategy, and there would have been a lot more collapses if the government wouldn't have come in and bailed them out, and so now we have just put in law the ability to have the government bail these people out no matter how stupid they are. That is part of what we did in Dodd-Frank. So that is my concern. We are letting people go out and do this stuff and then at the end of the day we are going to bail them out? I mean, the taxpayers are tired of this, and you see what is going on on Wall Street, and I don't know that they are focused on the right things necessarily but I understand their frustration. I have the people in my district that feel

the same way, and if we don't respond to this, that Wall Street protest is going to get bigger, not smaller.

Mr. GIANCARLO. Congressman, the basic reforms of Dodd-Frank, of clearing, central counterparty clearing of greater transparency, of regulated execution, stands unchallenged by certainly my organization, myself and most of my fellow members of this panel. What these reforms that we are talking about today are about clarifications of issues, not about repeal, not about going back. And in fact, in some ways Enron was a very good model, what happened in Enron for the drafters of Dodd-Frank. I think a number of lessons were learned. The U.S. energy market as it exists today has very much risen out of the ashes of Enron. Following Enron, we went to a cleared environment where market participants have a choice of clearing entity. We went to a multiple execution environment where market participants have a choice of execution venue and they are not limited to a single silo as we have in a number of futures markets. And that is really the model for Dodd-Frank where market participants will be required to clear but they will have a choice of clearing venue. They will be required to execute through a SEF or an exchange, but they will have a choice of execution facility, and in the language I noted in my opening testimony, through any means of interstate commerce, market participants should have a choice of how to execute the trade. In the SEF Clarification Act, all that is being asked is that Congress's intent be stated clearly so that regulators fulfill the intent of Dodd-Frank, which in a number of ways picked up on a number of the mistakes that were made in the Enron situation and are trying to get it right, and we are very supportive of that.

Mr. PETERSON. Thank you.

Thank you, Mr. Chairman.

Mr. CONAWAY. I thank the gentleman.

Turning back to the cost-benefit analysis rules and the procedure that were used with this current set, just for a point of clarification, my good friend from Minnesota bragged ever so briefly on the bill to clarify the rules on behalf of the CFTC. That is a prospective change to their cost-benefit analysis and would not affect anything that is going on right now, so it would just require the agency in the future to abide by the rules that even the President in his January letter set out.

I would like each panelist to briefly talk about if the cost-benefit analysis that was done, how it would have changed perhaps the rules that you are interested as relates to each of your entities, so we will just come down the list and kind of briefly talk on how that might have impacted what you are worried about, what you are not worried about.

Mr. CORDES. Yes, the cost-benefit analysis, if you get a good weighting about how disruptive to commerce and liquidity in the industry, in the cooperative world, what we are thinking about, and more importantly, closer to home I am thinking for my own company, CHS, where do these become and where you weight that out. We are not swap dealers yet we feel there is enough wiggle room in this language and that is what we are asking for clarification today: let us set that aside so we don't get labeled into that category because there are costs along with being that. If you are

in that category, that is going to inhibit some things we can do, activities with our members through the local cooperative network down to the farmer network. What does that do for commerce in rural America? If you can get that balance right between there, I think that would make a big difference.

Mr. CONAWAY. Mr. Williams, you mentioned \$100,000 charge or fee for a clearing member for a small bank. Was that reflected anywhere in the CFTC's analysis?

Mr. WILLIAMS. That is not reflected in the CFTC's analysis. That is the feedback we get from potential clearinghouse partners that we would work with.

Mr. CONAWAY. The broader question is still for anybody.

Mr. WILLIAMS. It is clear that small banks have a minuscule participation in the derivatives market. These costs that would be a result of the legislation would significantly increase the cost of participating in the market and probably make it prohibitive for us to participate.

Ms. SANEVICH. Certainly with respect to the ERISA plans, the fact that there is an overarching regulatory scheme already in place certainly fits in within the President's January letter as well as this cost-benefit issue in that the ERISA plans' case, not only is there no benefit, there is a lot of cost, I mean, the cost is huge. In some cases, ERISA pension plans will be unable to in the future engage in these very important risk mitigation strategies. To take that authority away from those that manage the pension assets would be a grave mistake, and you can also easily see the lack of a thorough cost-benefit analysis. Back to this margin issue, I mean, anyone who would actually put an ERISA pension plan in the same bucket as a hedge fund and call an ERISA pension plan a high-risk financial end-user, I mean, clearly the uniqueness of an ERISA pension plan has not been taken into account.

Mr. GIANCARLO. If I can use an analogy to describe global markets for swaps, it would be sort of like a balloon. If you squeeze it here, it pops out there. Markets can move around the globe, overnight, if they become too restrictive. The goal is not to find the lowest level of restrictions but in fact it is the right balance of restrictions and regulations for any given marketplace. The jurisdiction that has the right balance, the right balance of transparency and liquidity as Congress in Dodd-Frank said, liquidity must be balanced against transparency. The jurisdiction of the right balance are where markets move. Our concern with some of the restrictions coming out of the CFTC whether it is restrictions on mode of access, modes of execution, whether it is on something that has become known as the 15 second rule, which I won't go into but it is addressed in my testimony—

Mr. CONAWAY.—in order to be respectful of the other panelists' time. The point, though is—

Mr. GIANCARLO. The point is that there has not been a cost-benefit analysis for some of the restrictions, and my worry is that we don't know what will be the effect. The effect could very well be to force markets offshore, which would be detrimental for American business interests, which would either not be able to source their hedging needs here or have to go offshore to find them.

Ms. BOULTWOOD. Can I add to that? Just in terms of the *swap dealer* definition if left as is will have an overly broad reach, and this will, to earlier points, limit market participation, increase the cost of hedging as market liquidity falls, and we will see those that can transact in other jurisdictions, other markets with certainty. You know, these contracts, whether it is when we are hedging oil or we are hedging gas, we can transact internationally, and if an entity has a capitalized sub in a foreign country, it is not a major issue to move to that other jurisdiction that has regulatory certainty. So the costs to the company, to the market as well as to the taxpayer just haven't been assessed and set off against the benefits to society of all these controls to help mitigate systemic risk or the fear of a future bailout.

Mr. CONAWAY. Quickly, Mr. Thul.

Mr. THUL. One last comment. So in addition to the costs, which I don't think we know what the true effect will be today, it is going to have the unintended consequence of pushing risk on to the actual end-users with more volatility in the markets and unduly creating speculation by default in a lot of these cash markets if we can't get clarity around these issues.

Mr. CONAWAY. I would like to ask unanimous consent to submit a statement from the National Rural Electric Cooperative Association. Hearing no objections.

[The document referred to is located on p. 111.]

Mr. CONAWAY. Mr. Courtney for 5 minutes.

Mr. COURTNEY. Thank you, Mr. Chairman. I want to thank the witnesses for being here today. As the Member of Congress who represents Senator Chris Dodd, who last night former Speaker Gingrich said should be arrested for his work on this, I want to thank Mr. Giancarlo for at least acknowledging that this legislation was intended to deal with a problem which Mr. Peterson said almost brought the whole world down. When I listen to the complaints here today about the speculative ideas about where costs are going to be, Mr. Thul, you have customers in eastern Connecticut, farmers who buy Cargill products, and when I talked to them last spring and summer about their challenges that they face right now, it was the outrageous spike in energy costs which was completely indecipherable to them in terms of why it was happening. I just say to you, the notion that the *status quo* is something that end-users, real end-users like dairy farmers can count on in terms of having any kind of predictability or confidence in their own costs looking out on the horizon, I mean, it does not exist right now. You cannot find an oil dealer in Connecticut that will hedge for this winter's fuel for their customers because they have totally lost confidence in energy markets. It is gone. They are totally hostile to it, let alone suspicious of it. And one of the rules that Dodd-Frank included was to try and put some position limits in terms of the traders that deal with this market. Chairman Gentzler has been here four times talking about the fact that they are trying to move this rule forward. They have had over 20,000 comments. I am sure every single group here has had an opportunity to wade in just as administrative law allows for the public and for interested parties to have their opportunity to be heard. What I am hearing at home is, what is taking so long in terms of

trying to stabilize a market that again people just have absolutely no confidence in right now and it is just killing them with real costs and real lives, which we have heard a lot of talk about here today.

So I guess the question I want to ask is that the cost-benefit measure that is being proposed here, I mean, do you see that bill as basically restarting the regulatory process for the position limits rule, just to take one item out of Dodd-Frank that the Commission has been working assiduously on and some would say far too slowly on? I mean, is it your hope that if we pass that bill that we go back to square one and just start this process all over again? Again, if someone could help me in terms of their legislative interpretation of that measure.

Mr. CONAWAY. If the gentleman will suspend, the proposed law is prospective. It would have nothing to do with anything that has been proposed so far.

Mr. COURTNEY. So the bill that we have before us—

Mr. CONAWAY. It is not a restart.

Mr. COURTNEY. Okay. Then I will change my question then and just ask whether or not any of you think that what has happened last spring when the price of oil per barrel went up to \$115 a barrel had anything to do with over-speculation, and maybe our friend here from the energy association can answer that question.

Ms. BOULTWOOD. It used to be that many commodity prices were set in the United States. We were the marginal buyer and it was our supply and demand that drove the price of a commodity whether it was oil, gas or copper. You know, the market has globalized and now the marginal buyers are often not in the United States, and you can have supply-and-demand factors in China and the Middle East and so on impacting the way those market curves shift, and it can seem inexplicable to Americans, rural Americans, Americans in big cities, but we are going through a globalization of these markets. We will not be able to explain based on domestic activity all changes in oil prices or all changes in gas prices.

And to try to use a tool, in my view, to use a tool like position limits, that will limit activity in the United States and ultimately growth within our own country, but to think that it will limit activity in futures markets and in physical markets around the world is unlikely.

Mr. COURTNEY. You know, it is sort of funny because you hear a lot of people in this town talk about American exceptionalism and how we should be a leader, but when we talk about, again, just trying to have, in my opinion, some commonsense regulation, then suddenly there is this feeling that we have to fear to sort of stake out a position. I mean, the fact is, as I am sure you know, G20 conferences, governments now are talking about trying to sort of harmonize regulation in this, and at some point, somebody has to move here in terms of trying to at least show the way that we are just not going to be powerless and helpless in terms of forces that—again, small businesses and farmers are getting killed in terms of trying to keep up with costs that again just have nothing to do with real supply and demand, as you said.

Mr. Giancarlo?

Mr. GIANCARLO. Yes. On the subject of harmonization, that is a great concern to us. The Europeans are not taking the approach that the CFTC is taking, that the modes of execution of swaps needs to be limited to electronic systems, and in fact, what we are concerned about is that they will allow these multiple modes of execution to be used and that may actually attract trading to go from U.S. markets to European markets where it may be a more natural form of executing these less liquid swaps products. So it is a great concern to us.

Mr. COURTNEY. So when President Sarkozy and others have really publicly talked about the fact that they want to try and get some coherence internationally, I mean, how do we make that happen? Do we just do nothing here and go to meeting after meeting?

Mr. GIANCARLO. Harmonization would be great, and some leaders talk about it, but at the underlying administrative level, it is not happening in a number of key areas.

Mr. COURTNEY. Well, it is kind of a sad message to have to take back to real end-users who basically are looking to us to try and get some rationality in terms of these markets.

Mr. CONAWAY. The gentleman yields back.

Mr. Scott, 5 minutes.

Mr. AUSTIN SCOTT of Georgia. Yes, sir. Thank you, Mr. Chairman.

If you look at the CFTC website, it says that swaps were the center of the 2008 financial crisis, and I would think that maybe an improper use of swaps or abuse of swaps might be a better description of what happened there, but I have a couple of questions, and part of it gets back to the 15 second rule that has been discussed. Mr. Giancarlo, if you only trade one to 20 times a day, why does the 15 second rule cause a problem? I get calls from people all the time where just in the fraction of a second that a trade is executed on the stock exchange, you may see a 3½, 4½, 5 percent change in value just during the fraction of a second it takes to execute. So why does the 15 second rule cause problems?

Mr. GIANCARLO. Let me try to just paint a little example. I used in my opening remarks an example of John Deere wanting to expand and calling a dealer to provide them with a hedge against foreign exchange risk. That dealer takes the call or receives the message or maybe electronic message from their customer, maybe through an RFQ system, and wants to serve their customer's interest, wants to actually take on that hedge, but in so doing, they are taking balance sheet risks themselves.

Mr. AUSTIN SCOTT of Georgia. Sure.

Mr. GIANCARLO. So they are actually looking to the wholesale market to find a counterparty that they may be able to trade directly to, and they may actually find it, or maybe not a full hedge but a partial hedge. The 15 second rule says that when that dealer calls us in the wholesale market to take both sides of the trade, we are going to buy our customer's need, we are going to sell it to another customer, we have to actually delay that. We can put one order in and wait 15 seconds during which time a competitor to that dealer may step in front and take the other side. So at the time of taking the customer order from John Deere, the dealer doesn't know because of this 15 second rule whether at the end of

15 seconds he is going to actually have fully hedged the risk he is taking on. So when you have more uncertainty, you always have more cost, and that cost is going to get passed down the chain to the corporate end-user. So our concern with the 15 second rule is——

Mr. AUSTIN SCOTT of Georgia. Let me stop you. I am getting short on time. Would 5 seconds make a difference?

Mr. GIANCARLO. You are adding risk. The markets in this regard work well today. There was nothing in the 15 second rule that addressed that was in the financial crisis that——

Mr. AUSTIN SCOTT of Georgia. All right. Let me stop you there because I am sorry but I am limited to 5 minutes.

I want to go back to what we were talking about with the banking, Mr. Williams, and one of the things that I don't—when we talk about exempting the smaller banks, I guess one of my questions would be some banks, the trading is as much as 60 percent of their revenue.

Mr. WILLIAMS. That is right.

Mr. AUSTIN SCOTT of Georgia. For your bank, as a percentage of revenue, what is it?

Mr. WILLIAMS. It would be less than three percent or so, and we are not trading like the participants that you mentioned where 60 percent may be a much more significant portion of their revenue.

Mr. AUSTIN SCOTT of Georgia. Yes, sir, it truly is a hedging of risk.

Mr. WILLIAMS. It is a hedging of risk related to specific loan transactions.

Mr. AUSTIN SCOTT of Georgia. And I guess the question I have is, on average, as I understand it, it is less than five percent of revenue, but the rules are being drafted so that if it is 60 percent of your bank's revenue, or of it is three percent of your bank's revenue, you are going to have to abide by the same rules.

Mr. WILLIAMS. That is right.

Mr. AUSTIN SCOTT of Georgia. And so would we be better serving the public if we base the exemption on a percentage of revenue instead of on any individual dollar figure?

Mr. WILLIAMS. I wouldn't advocate a rule based on percentage of revenue because that would be a relative measure, and while the percentage of revenue for a given institution may be relatively high, that particular institution's participation in the market may be very insignificant. So you would capture them despite the fact that they are not posing any particular systemic risk.

I think the *de minimis* exemptions as proposed in the Small Business Credit Availability Act are good ones, and would create exemptions for institutions that are fairly insignificant players in the market overall and don't pose a systemic risk.

Mr. AUSTIN SCOTT of Georgia. If a small bank, though, say 50 percent of that small bank's revenue were from the trading, would you still think that they should get the same exemption that your bank does?

Mr. WILLIAMS. I would think so. I don't think there are any small banks that get 50 percent of their revenue from trading derivatives.

Mr. AUSTIN SCOTT of Georgia. Thank you, Mr. Chairman. I just once again would like to point out that end-users didn't cause this problem, and I hope that we are able to work in a bipartisan fashion to get the exemptions for the end-users.

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

Ms. Fudge for 5 minutes.

Ms. FUDGE. Thank you, Mr. Chairman.

Mr. Cordes, help me understand how if cooperatives are owned by local members and farmers, how can a cooperative be considered a swap dealer?

Mr. CORDES. Some of the concern we have within that being owned where a swap dealer is, we don't have common control all the way down, so the local level is owned by its farmers. That local cooperative then would have ownership in the higher structure up through the affiliated cooperative, so it would have some common ownership but doesn't have control of it. When you do transactions with that affiliate to help them manage their risk, you need to write up a transaction, a contract, a swap. By doing that, you now put that—and some people look at it and say okay, are you dealing swaps or what are you doing. We would maintain that we are helping that local cooperative mitigate risk that they are passing on to help manage risk with their farmers.

Ms. FUDGE. Okay, and just a question for the entire panel. You know, I am a cosponsor of H.R. 2779, which would exempt inter-affiliate swaps from some, not all, some regulatory requirements instituted under Dodd-Frank. Given the diversity of the panel, I would like to hear from each of you about how internal risk management procedures would be affected, particularly can you discuss the differences between the different sectors that are seeking to hedge risks, for example, a manufacturing company *versus* a bank? Each one, wherever you would like to start

Mr. THUL. Thank you. Within our organization, we are centralizing that activity and so we have businesses operating across multiple geographies and across multiple industries and so we are taking advantage looking at it as an enterprise, centralizing it so we can take advantage of a center of expertise in the marketplace and to try to leverage our costs of executing the transaction. So our argument, and we are in favor of the intent of the bill because we do think it captures the fact that we are going to protect what is truly something that is not individual and that can be looked at on an enterprise approach.

Ms. FUDGE. Thank you. I am going to ask to kind of go a little quickly if you can so I can get an answer from everybody. Thank you.

Ms. BOULTWOOD. At Constellation, we have a power plant in Canada, and when we hedge the output of that plant, we create exposure in Canadian dollars. We also, in different areas, have retail businesses and generate earnings in foreign currencies, mostly Canadian dollars, and what we do is, we need to pull that exposure from different entities to centralize the foreign exchange exposure because we are a commodities company and our expertise is in the commodities market, and we don't want our exposures to be dispersed across the company. So this is one example of the risk management benefit of that centralization across affiliates so we can

centralize risk-taking and bring the expertise in that foreign exchange hedging to one spot, but it also applies even in commodities. You know, we have transactors in different parts of the country transacting power and gas. We are not letting them face to the market in each of those regions. We centralize that activity so that we can get the best centralized risk management across the different commodities to execute most efficiently.

Ms. FUDGE. Thank you.

Mr. GIANCARLO. Congresswoman, we are an intermediary, a broker of swaps products, but we really don't use swap products in our business themselves. The analogy would be to real estate agents, we match buyers and sellers of homes but we actually don't own underlying homes ourselves. We are not in the business so we really don't use swaps products.

The bill that you are cosponsoring seems like a very sensible bill for those that have that area but it is not an area that we have taken a position on or that I can really sensibly comment to you.

Ms. FUDGE. Thank you.

Ms. SANEVICH. ERISA plans, as I mentioned, are already so heavily regulated that they are already prohibited and restricted in so many ways from doing anything with any affiliates. The affiliate issue is not an issue for ERISA plans because they have a whole body of regulations and laws preventing them from doing that kind of stuff.

Ms. FUDGE. Thank you.

Mr. WILLIAMS. Atlantic Capital Bank is the operating subsidiary of a one-bank holding company, Atlantic Capital Bank Shares, and we don't conduct inter-affiliate transactions, swap transactions, and I think that would be true of most small banks.

Ms. FUDGE. Thank you.

Mr. CORDES. I can speak for the cooperative network. Most local cooperatives, their boards would have policies and procedures around position limits and risks that they can take. As they roll that up on a daily basis, they would look to lay off that risk. They would then look through the federated system to maybe aggregate that risk and then put on a swap or some transaction to manage that risk, so we would need to be able to handle that from inter-affiliates as you go along that risk mitigation curve.

Ms. FUDGE. Thank you, Mr. Chairman.

Mr. CONAWAY. The gentlelady yields back. Mr. Crawford for 5 minutes.

Mr. CRAWFORD. Thank you, Mr. Chairman. I want to thank the panelists for being here today.

I am going to start off real quick with Mr. Thul. Can you provide some examples of the types of hedges that would be restricted under CFTC's position limits proposal?

Mr. THUL. Yes. The best example of that, I mean, this comes down to the definition of what is a *bona fide* hedge and anticipatory hedges and so at the simplest level, it would be grain purchases over a weekend when the exchange is not open. We need to pre-position for that and put on a futures position in anticipation of handling the cash commodity; not being able to do that is how we are reading this as a potential limitation.

Mr. CRAWFORD. How would you recommend the CFTC draw a line between hedging and spec trading for the position limits proposal?

Mr. THUL. I think it comes down to just truly what is the definition of a *bona fide hedger* and are you involved in the commercial business or not. We are all for transparency as long as we are protecting the needs of the legitimate business, the commercial business. And so if you are tied to commercial operations and the underlying cash businesses, we feel that that should be exempted underneath the *bona fide* hedge.

Mr. CRAWFORD. I am going to switch gears and go to Mr. Williams. My constituents in the 1st District of Arkansas almost exclusively use community banks to access credit, whether it be families, small business owners, farmers. In your testimony you note that absent changes to the legislation we are discussing today, you would have difficulty remaining competitive against larger financial institutions. Can you explain the impact on your ability to compete?

Mr. WILLIAMS. Well, first of all, it would be the cost associated with being a clearinghouse member or affiliating with a clearinghouse member, and as I indicated, we think that cost may be north of \$100,000 per year. If we compare that to the revenue we receive from doing interest rate swap transactions for our borrowers, it would impair the profitability of those activities significantly.

Second, the current, the proposed *de minimis* exemption limits from the CFTC would even eliminate—the activity that my institution has conducted within the last 18 months—would be above those *de minimis* limitations. So we would be classified as a swap dealer or financial under the proposed regulations and would add significantly to our costs.

Mr. CRAWFORD. Let me ask Mr. Cordes, what is the difference between the swap activities that your companies engage in and those engaged by swap dealers?

Mr. CORDES. Yes, typically one would hold out a swap dealer makes a market. They are out there, they have a bid and offer-type thing. What our organization is doing is, we would be looking at our membership, we would be looking at, internally we would be looking at our customers, looking at how can we mitigate that risk, what risk do they have that they want to mitigate. Then, we would go find a product to manage that risk, so we would put that transaction together. So it is really mitigating risk *versus* making a market.

Mr. CRAWFORD. Okay. And then I have this question for both you and Ms. Boulwood. Why does the broad definition of *swap dealer* have a disproportionate impact on the energy and ag industries as opposed to other sectors? We will start with Mr. Cordes.

Mr. CORDES. Yes, I would say for us in the cooperative world, I mean, we are in the business around agriculture of whether it is buying grain, processing grain products, whether it is on the energy side, distribution and fuel. It has a lot of bricks and mortar to it. It has got a lot of hard assets to it so a lot of your investment capital is tied up to run those operations. It also takes a lot out of working capital to run those operations. And now if you start throwing in a swap dealer portion of it with margin requirements

and other capital requirements, it is just another burden on top of a big hurdle to get over that is already taking place around working capital and investment.

Mr. CRAWFORD. Ms. Boulthwood?

Ms. BOULTWOOD. I think the story is similar. We have a lot of assets that generate revenues that are volatile because of changing commodity prices but also energy is subject to natural hazards like weather risks. It is through swap products that we are able to even when we have volatile commodity prices, you have unknown weather patterns, you are able to create stability in the pricing that you are able to offer your customers.

Mr. CRAWFORD. Thank you.

Mr. Thul, just a final thought from your perspective. Does lower liquidity increase volatility and *vice versa*?

Mr. THUL. Yes, we would agree with that, and part of what we are shooting for is to have liquidity in markets along with transparency.

Mr. CRAWFORD. Great. Thank you. I yield back.

Mr. CONAWAY. I thank the gentleman.

The gentleman from New York, Mr. Owens, for 5 minutes.

Mr. OWENS. Thank you, Mr. Chairman.

I assume that most of you have the opportunity to interact with the CFTC on a fairly regular basis as you go through this process. Do you have any sense relative to the legislation that we are discussing today that those proposals will be ultimately included in the final regulations that will be issued by the CFTC?

Ms. BOULTWOOD. I will just start. I would say, none of us has a crystal ball but I described the CFTC Commissioners as deeply divided on many of the topics that we are discussing today in terms of proposed legislation. For example, the *swap dealer* definition, there are Commissioners on record as saying it is overly broad, we need to better understand a *de minimis* exception in order to ensure that those that didn't cause systemic risk in the past and really aren't capable of it in the future are not subject to the same rules as the swap dealers that do hold themselves out for customers making markets and so on. So I would say that there are great divisions, and based on all the interactions, they seem to be headed down a path that will have rulemaking that will look very much like the drafts that we have all reviewed and commented on. To date, we haven't seen the comments and all the interactions have much of an effect over the idea that there are fears of potential future bailouts or there are fears of loopholes, and this desire to create regulation and rulemaking to close any loophole, and then think about what does that cost in terms of business activities, and not only the markets themselves, but real costs to end-users in our economy.

Mr. GIANCARLO. Congressman, a concern that we have in our conversations with the CFTC is their orientation is toward the futures markets, which they know well through their experience, which are markets that are very different than the swap markets. They are markets that have a single silo, monopolistic structure over the products they handle and they are markets that are not open to multiple execution venues or multiple clearing venues. There are also markets that have a retail component which is a

great concern to the regulators and ones that have highly commoditized instruments that trade in those markets. Those are very different characteristics to the swaps markets and so our concern is that this institution, which is very knowledgeable in the areas that it has historically regulated, is struggling to understand these aspects of the swaps markets that are very different, aspects of the swaps markets that Congress made very clear in Dodd-Frank that had to be handled separately than what was done in the futures market. They have to be more competitive for execution, more competitive for clearing and have to take account of liquidity while balancing that with transparency.

Mr. OWENS. Thank you. I just wanted to make sure that as we move forward, we did it on the basis that you had some underlying belief that in fact these were not going to be addressed, because I think that that is important as a baseline for moving forward.

The second question I have really is maybe more conceptual, but is there any risk associated with the end-user marketplace or do you completely discount end-user risk and its impact on the system?

Mr. CORDES. I would say from our perspective, looking as an end-user that uses some swaps, the risk you need to understand as an end-user, yes, you are mitigating your risk. You have some other side of the ledger but you also need to be concerned with your counterparty risk that you are entering into, and lots of times we will use credit annexes to perform around those functions to make sure that we have security behind that, but it is not a margin, *per se*.

Mr. OWENS. But that is really what you are doing is you are netting your risk in that process?

Mr. CORDES. As an end-user, yes, you would have some physical exposure that you are looking to mitigate. You would use a swap to offset that.

Mr. OWENS. To go back to something that Mr. Peterson said before, is there any threat systemically that you could have someone who initially is not regulated growing in a fashion that would not bring them under the regulatory scheme?

Ms. BOULTWOOD. I would say that to Mr. Peterson's, to address his concerns, we remind ourselves that there was no bailout for Enron and the energy continued to flow. Everything was normal. A company did fail as did a few others in that period because of the broader accounting scandals. But, there are risks in an end-user and how you think about what is systemically important in the economy that could cause the broader marketplace to be at risk is really important as we consider here what a *de minimis* exception means to a *swap dealer* definition. When you think about the \$3 billion proposal for initial derivative size in that proposed legislation, that is $\frac{1}{1000}$ of the total size of the notional value of U.S. derivatives marketplace. We are talking \$600 trillion globally—\$3 billion is really nothing in the scheme of that. So is it $\frac{1}{1000}$ that isn't systemic or $\frac{3}{1000}$ or $\frac{10}{1000}$? You know, there is probably room to move upwards because the risk to us right now is that you define a *de minimis* exception that is too narrow and you include so many firms and they have all the costs of implementing them, the Dodd-Frank swap dealer requirements, and then we find out they

are really not systemically risky and the costs in terms of the market liquidity that disappears, maybe a lot of activity moves offshore. The costs are much more significant than any benefit we get from capturing that entity.

So it seems that the \$3 billion, it can seem like a big number but relative to the overall size of the swap market, it is small and maybe it is a better approach to start higher and then if we find that there are those companies that grow, we can always reduce it.

Mr. OWENS. Thank you. I appreciate that.

I yield back.

Mr. CONAWAY. The gentleman's time has expired.

Mr. Randy Hultgren for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here and thank you for your input on this very important discussion today. I have been hearing from many of the co-ops in my district, heard from River Valley Cooperative in Geneseo and Patriot Renewable Fuels in Annawan, who are holding back with their business plans because of uncertainty while at the same time farmers are asking for ways to manage risk, so this is so important for us to be discussing this today.

The first question I want to address to Mr. Cordes, if I could. I wonder if you would fall under the current threshold of \$100 million, and if you know who else might?

Mr. CORDES. Fall under \$100 million?

Mr. HULTGREN. Yes, under the current level of the \$100 million.

Mr. CORDES. I have to preface the answer a little bit. It partly depends. There is clarification of rules, what you are counting, what you are not. If it gets pretty broadly defined like it looks today, we would easily fall beyond the \$100 million, and quite a few cooperatives in the network would as well.

Mr. HULTGREN. So even at that level, there is still a large amount of uncertainty of actually what is counted and what isn't?

Mr. CORDES. That is correct.

Mr. HULTGREN. I wondered if I could have others of you, Mr. Cordes and others, have just your thoughts, and if you could discuss why you think the *swap dealer* definition discussion draft proposal to increase the *de minimis* threshold to \$3 billion is an appropriate threshold. So I wondered if you could maybe talk about that briefly.

Mr. CORDES. I will take a first run at it a little bit. I think partly you need to look at the volatility in the marketplace, and we are not only talking about what should that threshold be today, we are looking at some legislation that is going to be talking for the future. You look at commodity levels today, I mean, it wasn't that many years ago corn was at \$2, \$3. We are sitting at \$6, \$7, \$8 at times. So even if you look at the \$100 million threshold, it only takes about 14 million bushels of corn to get to that level, which is a pretty small percentage in the big marketplace. It needs to have a discussion around size and scale.

Mr. THUL. And I would just add to that that I think there are two other objectives that you can hit on on the *de minimis* ruling, and one of them is number of counterparties, and that would be extremely limiting for many people because it is either 15 or 25 counterparties, which when you are dealing at a country facility op-

eration, you are going to have many more participants than that. And more important, our objective is to just not be defined as a swap dealer and avoid *de minimis* altogether.

Ms. BOULTWOOD. So I will go back to an earlier point. It is really important that we, in thinking about dealing, decide what do we mean by dealing, who is the dealer, and I joke sometimes that on the streets of Baltimore it is easy to know who is the dealer and who is the user for certain commodities, you could call them. But, when you are talking about a company, there are legitimate hedging activities. There might be some speculation. There might be markets we exist in where we have to be out there finding counterparties to transact with us, but both hedging and speculation we do with our own capital. We do that to preserve our own earnings or take the risks we want to take, and it is that third category of holding yourself out to a customer and saying look, we want to be your middleman, we want to earn the spread on a trade that will perform for you and we will go offset that risk potentially somewhere else, and so it is that customer trading that we are really focused on or transactions. And here then the question is, is \$3 billion large enough, and, earlier I was saying that that is $\frac{1}{1000}$ of the total size of the U.S. notional swap market. Is $\frac{1}{1000}$ systemic to the economy? I would offer no. Is the right fraction $\frac{10}{1000}$, $\frac{100}{1000}$? You know, we have to draw a line somewhere. You would rather start higher, and if you find that there are firms that are doing things that should be considered dealing and they are finding a way out of that, we can always reduce it, but why start small and create the risk that so many companies get drawn in and either decide not to hedge, not to participate in markets, which would drive down liquidity, and find ourselves in a very different marketplace for our basic food, agriculture and energy commodities in America.

Mr. HULTGREN. I wonder quickly if someone could address, what does aggregate gross notional measure?

Ms. BOULTWOOD. Price times quantity. So if you have a contract that is covering 100 barrels of oil, there is the price of oil at the time you enter into that contract and then there is a quantity of oil, right, and that creates a value and that is your gross notional, and then someone mentioned earlier, commodity prices are highly volatile, you think about oil prices. There are risks in setting a static *de minimis* exception amount in that, if price levels doubled, for example, you could have firms that in one instance aren't considered a swap dealer but then when price levels change, they are then a swap dealer and you see this idea of firms flipping in and out of this dealing definition which really would make no sense at all.

Mr. HULTGREN. Thank you all again for being here. Thank you, Mr. Chairman. I yield back.

Mr. CONAWAY. The gentleman yields back.

Mr. Costa for 5 minutes.

Mr. COSTA. Thank you very much, Mr. Chairman.

I want to kind of revisit some of the points that a number of my colleagues have raised here because there is an underlying theme here about the concerns of having the sort of regulatory framework that calls balls and strikes fairly and allows the economy to com-

pete in this global market that we all talk about, but at the same time doesn't create circumstances as we all know that are still fresh in many of our minds in 2008, or going further back with Enron, and trying to get it right as we have all discussed here this morning is the challenge at hand.

For me, you keep talking about systemic risk, but a former Secretary of the Treasury also commented at great length about the moral hazard, and I am not so sure where you folks think the moral hazard lies in terms of the responsibility, in terms of the conditions we create. Certainly we proved that we are willing to pick winners and losers if recent history demonstrates that, and I would like you to comment, but if I have a couple of specific questions that relate to the wild speculation and radical price swings that we have seen.

Mr. Cordes, you talk about trading in the corn market a great deal, I believe, right?

Mr. CORDES. That is correct.

Mr. COSTA. We have been discussing here in the last several weeks about the whole use of ethanol from corn-based fuel *versus* other alternatives, and a lot of the ethanol producers—and of course, I deal with my feed producers, the dairy folks, the cattle operations, the poultry, the pork, and they are very concerned that they think that ethanol from corn has had a factor. The ethanol producers tell me no, that is not really the case, that really the price has really been a result of speculators. Would you care to comment on whether or not you think that has been a factor?

Mr. CORDES. I think to get to the correct answer, you need to look at the whole situation that is going on. The corn market is affected by many factors.

Mr. COSTA. Of course, but how do you gauge those wild price swings based upon speculators *versus* the other factors?

Mr. CORDES. Yes, the other factors we would look at, we look at the tight carryouts in this country that we have on corn, we do not have a lot of stock so we carry over from crop to the next. I think the other thing I would point out is, we have a robust livestock industry that has decent margins, that has an appetite for corn and probably has an appetite for DDGs that comes from the ethanol industry. We also have a world market. In the last few days we had have China looking to purchase corn as their economy continues to move along.

Mr. COSTA. No, I know that, but I mean, I don't—still, we can't quantify, and to Mr. Courtney's comments to the dairymen and to the other people, our constituents, they don't get it. They see that a lot of folks are making money and they are not making anything except profits for themselves, and I don't want to belabor that point.

Mr. Giancarlo, you talked about, and all of you talked about the global markets, and some of us have spent some time with our European colleagues in Frankfurt and in London with clearinghouses. I am not so sure that your description of what is taking place there is the final word. They are still going through the vetting of their own efforts to develop a regulatory structure, as I understand it, and you talk about leadership. I think both sides are trying to figure out where that happy medium is. You seem to say that we

have already preordained this to lose these markets. I don't think that is the case.

Mr. GIANCARLO. Thank you for the question. We follow the developments in the European market very closely, and clearly, we don't have a crystal ball. In key areas, you are quite right. We are quite aligned with the Europeans. They are moving to a clearing environment as we are in the United States. They are moving to greater regulatory transparency and reporting as we are in the United States. They are recognizing in the regulation their version of swap execution facilities, what they call organized trading facilities, or OTFs, but where they are different, and at least everything I have seen in the regulations and we stay pretty close to it is, they are not mandating how those OTFs must execute swaps transactions. They are not requiring that it be done electronically only, and quite frankly, Congress did not require that they be done electronically only in Dodd-Frank. It says, "by any means of interstate commerce." Our concern, and the reason we support the SEF Clarification Act, is to make Congress's intent clear to the CFTC which alone, not the SEC, but alone the CFTC has taken the view that for cleared non-block swaps, they must be executed electronically only and that is not the direction the Europeans are going. We are truly concerned that if certain instruments need to be traded in other mechanisms other than purely electronic, they will migrate to Europe, which has not taken the same approach as the CFTC in that one regard.

Mr. COSTA. Okay.

Mr. CONAWAY. The gentleman's time has expired.

Mr. COSTA. My time has expired, but I will submit further questions for the record.

Mr. CONAWAY. Thank you.

Mrs. Hartzler for 5 minutes.

Mrs. HARTZLER. Thank you, Mr. Chairman.

I would like to thank you for coming to discussed the proposed bills for today. I think the overriding principles of Dodd-Frank was supposed to reign in the big banks, risky derivative trading activities and reduce the concentration and consolidation for a financial system. My concern, however, is that the law imposes so many burdens on financial entities that they will not have the resources to comply and that therefore they will get out of the business of all but most vanilla loans. This would push any larger or more complex business up to the gigantic banks, thereby increasing concentration and consolidation even more.

I don't think there is a sole Democratic or Republican who believes that the 2,300 page bill can be drafted with no mistakes, no oversights and no tweaks or corrections needed, and I feel that these changes utilize common sense and do not put the system at risk, and specifically, I am going to be the sponsor of the Small Business Credit Availability Act. I wanted to ask you, Mr. Williams—and I apologize for missing your opening comments. I was at a House Armed Services Committee meeting at the same time. But I am reading your testimony and some of the questions I have I would just like to get on the record. How do you think this draft of the bill that we are going to put forth facilitates the availability of credit for businesses?

Mr. WILLIAMS. Well, as you know, small banks are the primary lenders to small- mid-sized businesses across the country, and our ability to offer interest rate swaps, to offer fixed-rate financing or floating-rate financing as our borrowers may require is essential to our role as a financial intermediary and financing these small businesses. The Small Business Credit Availability Act raises the *de minimis* exemptions, changes the *financial entity* definition in a favorable way to us that allows us to continue to participate in the derivatives market and offer these important services to our borrowers.

Mrs. HARTZLER. And that is important. I represent a very rural part of Missouri, and small banks are the backbone of most of the lending, and they are the ones that are doing a good job. They know the individuals who come in. They have a relationship with them. They know if they would be a good credit risk or not. They had the collateral required and yet they are being impacted by the Dodd-Frank bills. So I appreciate that.

Let me continue, though. If small banks are provided the exemption proposed in the discussion draft, does that mean that they would be able to engage in speculative trading and still not be subjected to the clearing requirement?

Mr. WILLIAMS. No, the intent of Title VII under Dodd-Frank is clear in limiting these exemptions to financing transactions, to credit transactions, and those are loan-level hedges. They are very specific to those transactions and I don't think that would allow the opportunity for speculation.

Mrs. HARTZLER. I think that is important to make clear and have that on the record because we are just trying to allow the small and regional banks to be able to continue to help the small businesses in their area and provide the services that they need in order to help their businesses expand and grow. How expensive would it be for you to comply with the swap dealer and clearinghouse regulations? I believe you said something about \$100,000 for the clearinghouse.

Mr. WILLIAMS. As we talked to potential clearinghouse partners, we think that \$100,000 number is representative of the type of costs we would incur if we were not exempted from the *swap dealer* definition.

Mrs. HARTZLER. How would you recoup those costs if you were to have to participate in that?

Mr. WILLIAMS. We would look for more profit from the spread income that we get from swap transactions to offset that cost, which would result in higher costs to the end-user.

Mrs. HARTZLER. Very good. And just one more time, I believe you addressed this perhaps with Mr. Scott's question, but could you explain the impact of the current regulations on your business if we don't make these changes? How would it impact your ability to compete and to provide credit to small businesses?

Mr. WILLIAMS. Under the CFTC's *de minimis* rules as currently proposed, we would not be exempt and would incur the higher cost associated with being part of a clearinghouse. We would have the same regulatory burden and cost burden that a Wall Street dealer would have, and we are anything but a Wall Street dealer. We are a Main Street financier.

Mrs. HARTZLER. Absolutely. Thank you very much, ladies and gentlemen.

Mr. CONAWAY. The gentlelady yields back.

Mr. Stutzman for 5 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman, and thank you to the panelists for being here. I would like to follow up just a little bit on Mr. Costa's comments with you, Mr. Cordes, about speculation being built in the market in ethanol. There is global demand and there obviously has to be supply, and we have had some rough yields this year and last year. I guess when we have these huge swings in commodity prices, it does create volatility. At \$6, 25¢ is a big deal because we are used to \$2, \$3 corn and when 25¢ swung back then, that was a big, big deal. I guess I would just make this statement and ask if you would agree. I think it is easy to point the finger at the private sector and say there is speculation in the private sector but there is also speculation over at USDA in crop reports. Huge swings can happen in commodity prices just on USDA crop reports. Would you agree with that? We are all speculators to some extent.

Mr. CORDES. Yes, I would say that the marketplace uses USDA reports as the benchmarks, so when those reports come out, they are going to react one way or the other, is it more or less than what we thought. The market participants in the marketplace will have their own opinion but ultimately they are going to go back and use it as the guidepost. I think if you want to look at past history, and it is pretty clear if you look back in the last 10 years, yes, we are living in much more volatile times today, but you can also go back, and I don't have a chart with me today, you can go back and look at carryouts of the principal commodity in the crops—corn, soybeans, wheat—and you will see volatility goes up when carryouts go down. There is a very strong correlation over time of what is driving that.

Now, there are many factors going into what those carryouts are. You know, we can talk about speculation, we can talk about demand, we can talk about supply, but there is an interrelationship there as it goes on.

Mr. STUTZMAN. I just think it is easy to point the finger at certain entities when in the big picture of everything, agriculture has changed, and in positive ways that we are trying to adjust. I know for us in our operation back in Indiana, these tools are important to us to cover our risk as we manage through some volatile times but there are some great opportunities at the same time.

I would like to ask this question just of the entire panel. If we aren't successful in changing the proposed Dodd-Frank regulations, how many of you will stop or at least greatly curtail your current risk management activities or the services that you provide to facilitate the risk management practices of other market participants?

Mr. CORDES. Our concern here would be if it is not narrowly defined where it is, do we get caught up as a swap dealer, which we believe we are not. We are hedging; we are mitigating risk. If that becomes the case, as you mentioned rural America, they are looking for tools. There is more volatility out there. You have more at

risk. We would have to curtail those offerings that we can give to rural America.

Mr. THUL. And the other outcome from that could be just a cost going up dramatically, so if you decide to stay in the business, you could either increase your costs, as somebody else mentioned here earlier, or you are just going to transfer risk down the chain to the end-user.

Mr. STUTZMAN. Could you just touch on that real quick, Mr. Thul? How does that impact the farmer? I mean, if you can't have these tools, what does that do to the farmer?

Mr. THUL. It exposes them completely to the volatility that you were talking about, that you were alluding to earlier, so they are not going to have any form of protection over what they are looking at. We are in a cyclical business to begin with and it is going to remove any opportunity to protect themselves from the risk.

Mr. STUTZMAN. One last question, Mr. Chairman, and again, this is for any of you, but Mr. Thul maybe particularly. CFTC may finalize the position limits proposal before the EU even proposes theirs. Any comments?

Mr. THUL. Yes, we feel very strongly that we need to have a good definition of—these things all work together—*bona fide* hedge, anticipatory hedge and the position limit, and so in order to have a firm ruling on what a position limit might be, we need to have definitions around *bona fide* hedge, swap dealer and anticipatory hedging, and it feels too early.

Mr. STUTZMAN. Anyone else?

Ms. BOULTWOOD. Well, while we are focused on Europe, there is a whole other marketplace in Asia and there are many jurisdictions in Asia that have been very public and said, "We are offering regulatory certainty today, we have no plan to change our rules, we are fine with the current regime." Europe is potentially one area, but I would be more concerned about Asia and public announcements that have already been made there, and this is probably not an area where the United States necessarily needs to lead.

Mr. STUTZMAN. Thank you, Mr. Chairman. I will yield back.

Thank you to the panelists as well.

Mr. CONAWAY. I want to thank our six panelists today. You guys did a great job.

All actions have future consequences, and you can divide those consequences into those that are unforeseen and we don't have a clue what might happen, and those that you can foresee. You six today have given us a good, clear understanding of the foreseeable consequences to the current regulatory scheme being proposed by the CFTC that is negative to a good swath of folks that had nothing to do with the circumstances that related to either the Enron wreck or the wreck in 2008. The most graphic example today is that the disruption caused by Dodd-Frank and the relationships between merchants and banks with respect to debit cards that was caused by that, we now see the hue and cry among the folks out there because banks are looking for another way to try to figure out how to make up for the costs, the differential in that revenue with debit card fees. So when the government steps into things, they should have known ahead of time, all of us could have predicted that if you disrupt that commercial relationship, and I am

not picking sides between either one of them, there will be consequences that are foreseeable in this instance with a debit card. The consumer takes it in the pocketbook over and over when we don't get this correct, and we are encouraging CFTC to take a look at these foreseeable consequences and the impacts they have on consumers as they finalize these rules.

Again, I want to thank our panelists for coming today. Thank you for the prep work, clear answers and the travel that you did.

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 to any questions posed by a Member.

This hearing of the Committee on Agriculture is adjourned.
[Whereupon, at 12:18 p.m., the Committee was adjourned.]
[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS; ON BEHALF OF HON. GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman, Mr. Peterson, and Members of the Committee, thank you for holding this hearing to review legislative proposals amending Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including legislation to clarify the “swap dealer” definition. We appreciate the opportunity to again discuss how the implementation of the Dodd-Frank Act negatively impacts the rural electric cooperatives. Cooperatives use derivatives to help keep electric bills affordable for our consumer-members on Main St., and on the farm. Any costs for the rural electric cooperatives through the Commodity Futures Trading Commission’s (CFTC) regulatory overreach 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 $\frac{3}{4}$ 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 17.5 million member-owners in the states 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 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 the House Agriculture 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 members, need predictability in the price for power, fuel, transmission, financing, and other supply resources if they are to provide stable, affordable rates to their members, including farmers in your state. As not-for-profit entities, we are not in the business of making money. Rural electric cooperatives use derivatives to keep costs down by reducing the risks associated with the necessary inputs for our operations. 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 derivatives for speculation or other non-hedging purposes. We do not “deal” in derivatives, buying and selling derivatives to make a profit. We are in a difficult economic environment, and we support additional regulation of the financial markets to protect against systemic risk, but over-the-counter (OTC) derivatives are an important tool for managing 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 an 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 is financially strong and secure.

Even though the financial stakes are serious for us, rural electric co-ops are not big participants in the global derivatives markets, 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 this burden becomes 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 an affordable way.

The Definition of “Swap Dealer”

The National Rural Electric Cooperative Association is concerned that the CFTC may interpret the statutory term “swap dealer” broadly enough to sweep in our electric cooperative members, which we believe could be one of the more damaging unintended consequences of the Dodd-Frank Act. Therefore, we appreciate the Committee and Representative Randy Hultgren’s (IL-14) work on legislation that would eliminate the rural electric cooperatives’ concerns with the CFTC’s interpretation of the Dodd-Frank Act.

The definition of “swap dealer” is a relatively recent concern for the rural electric cooperatives. We have heard from CFTC staff over the past several months that they believe some of our members may be considered “swap dealers.” If this is the case, those cooperatives would be subject to a slew of new capital-draining registration and business practices requirements 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. Cooperatives are not-for-profit end-users hedging commercial risk and protecting 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. Our members keep the lights on on Main Street, and on the farm. 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 will also continue to urge the CFTC to keep a clear focus on legislative intent.

Given the uncertainty of how broadly the CFTC may interpret the term “swap dealer” under Dodd-Frank, NRECA supports draft legislation authored by Representative Randy Hultgren that is under discussion today. The legislation as drafted states clearly the intent of Congress that commercial end-users, who use derivatives to hedge or mitigate the commercial risks that arise from their electric operations, are not “swap dealers.” Further, the legislation also unambiguously clarifies that all trading or transacting in swaps “for your own account” is not “dealing.”

Importantly, the legislation also provides an increase to the *de minimis* exception to further protect energy end-users and maintain liquidity in the swaps markets. Even if the CFTC counted all swaps, not just swaps that are part of a “dealing business,” our members’ transactions would likely not reach the \$3 billion *de minimis* level. But energy end-users like electric cooperatives support this higher *de minimis* notional level to encourage non-financial market participants, like natural gas producers, to continue to participate actively in regional electricity and natural gas markets.

The initial CFTC registration as a “swap dealer” brings with it enormous and costly regulatory burdens like capital, margin, clearing, business conduct and documentation requirements. Energy end-users cannot allow the new CFTC regulatory costs to drive non-bank counterparties out of our markets, or deter others from starting to “deal” in these important regional markets.

Given the illiquidity of regional power and natural gas markets, and the volatility of prices for long-term swaps on such commodities, the \$3 billion notional amount is appropriate for long-term power or natural gas “swaps” in illiquid regional markets.

The Definition of “Swap”

While the purpose of our testimony is to express support for the Hultgren draft legislation clarifying the definition of “swap dealer”, we would like to take the opportunity to discuss the most important term in the Dodd-Frank Act—“swap.” As this Committee knows, the term “swap” defines the scope of the CFTC’s authority, impacts nearly every rule the CFTC has proposed to date, yet has not yet been finalized under the Dodd-Frank Act. In fact, the rule defining “swap dealer” is expected to be finalized before the CFTC even defines “swap.”

NRECA is concerned that if the CFTC defines that term too broadly, it could bring under the CFTC’s jurisdiction numerous 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 acknowledge in its rules that a “swap” does not include

physical forward commodity contracts, “commercial” options on non-financial commodities, or physical commodity contracts that contain option provisions, including full requirement contracts that even the smallest cooperatives use to hedge their need for physical power and natural gas. Further, CFTC should acknowledge in its rules that “swap” does not include power supply and generation capacity contracts, reserve sharing agreements, transmission contracts, emissions allowances, renewable energy credits or other transactions that are subject to FERC, EPA, or state energy or environmental regulation.

These instruments are non-financial transactions between non-financial entities that have never been considered “products” or “derivatives.” 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 global financial system. Yet, if they 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 if the costs forced utilities to abandon these long-term arrangements.

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—and insist that the CFTC draft clear rules to exclude from regulation these kinds of normal course transactions which utilities use to hedge commercial risks and meet the needs of electric consumers.

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 transactions which allow cooperatives to hedge risk and 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. The CFTC must not consider commercial end-users who hedge or mitigate commercial risks as “swap dealers.” And the CFTC must give real meaning to Dodd-Frank’s end-user exemption; limit unnecessary recordkeeping and reporting costs for end-users; and 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 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.

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 legislative proposals amending Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. 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 of this Committee to ensure that implementation of the derivatives title of the Dodd-Frank Act agrees with the intent of the Congress. ABA has consistently supported the objective of increasing transparency and appropriate supervision of credit default swaps and other financial products of systemic importance. Several pieces of legislation being reviewed by the Committee today achieves that goal and also preserves the ability of banks to serve as engines for economic growth and job creation.

The Committee is considering today multiple pieces of legislation that would further define and clarify elements of Title VII of the Dodd-Frank Act including the following:

- The Discussion Draft would clarify the definition of a swap dealer and the clearing exemption for certain banks, savings associations, farm credit system institutions, and credit unions. Among other things, it would mandate a clear-

ing exemption for institutions with an asset threshold of \$30 billion or less. It would also include an alternative clearing exemption for institutions with an aggregate uncollateralized outward swaps exposure plus aggregate potential outward swaps exposure that does not exceed \$1 billion. Moreover, the legislation would modify the language for swaps made in connection with loans. ***ABA believes that the Discussion Draft's small institution exclusion is a significant improvement, as is the clarity the legislation would provide for the existing exclusion from the swap dealer definition for transactions in connection with originating loans. We remain opposed to excluding the \$230 billion Federal Farm Credit System from any provisions of Title VII of the Dodd-Frank Act because it is a Government Sponsored Enterprise.***

- H.R. 2682, the Business Risk Mitigation and Price Stabilization Act of 2011, would clarify that end-users would not be subject to margin requirements for uncleared swaps. However, the legislation would limit the margin exemption to end-users that are not financial entities. ***ABA supports an end-user exemption from margin requirements for uncleared swaps and believes that all end-users—including banks that use swaps to hedge or mitigate risk—should be exempt.***
- A second Discussion Draft amends the Commodity Exchange Act to clarify the definition of a swap dealer would include additional criteria for determining which persons may be characterized accurately as swap dealers. Specifically, the legislation would exclude from the definition of a swap dealer those persons engaging in swaps transactions for the purpose of hedging or mitigating commercial risk or that are ancillary to a person's regular business as a producer, processor, handler, or commercial user of certain products. The Discussion Draft also adds a specific gross notional amount threshold test to the existing Dodd-Frank Act *de minimis* exception from the definition of a swap dealer. ***ABA supports establishing clearly defined criteria for the de minimis exception and stands ready to work with the Committee to develop appropriate standards for this exception.***
- H.R. 2779 would exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Act. H.R. 1840 would improve consideration by the Commodity Futures Trading Commission (CFTC) of the costs and benefits of its regulations and orders. ***ABA supports exempting inter-affiliate swaps from many of the anticipated swap regulations, as failing to do so would undermine bank internal risk management procedures and distort market information. ABA also supports a stronger requirement for full assessment of the costs and benefits of CFTC regulations.***

The remainder of this statement provides more detail on ABA's position on these bills.

Banks With Limited Swap Activities Should Be Exempt From Clearing Requirements

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. Such requirements would increase the risk in the system, not reduce it, and reducing risk is the primary purpose of hedging.

The vast majority of banks use derivatives as part of the delivery of fixed-rate loans or long-term financing to customers, ***not*** as a means for speculation. For example, a bank will use swaps to hedge the interest rate risk on its own balance sheet, thus lowering the bank's risk in providing customer loans. Moreover, interest-rate swaps help to provide long-term fixed-rate financing to manufacturers, small businesses, universities, not-for-profit organizations and other bank customers, thus helping ***customers*** safely manage their interest rate risk and focus on their core business rather than the prospect of rising interest rates.

Many banks cannot afford the expense of establishing and maintaining a clearing relationship for the limited amount of swaps transactions that they undertake in the service of their customers. A costly clearing requirement imposed on these institutions would adversely affect them and their business customers as they try to weather an uncertain economy. Without passage of several pieces of legislation before the Committee today, or proper implementation of the Dodd-Frank Act by the regulatory agencies, the result will be reduced credit options for many businesses and organizations across the country that are working to create jobs.

As we have stated in previous testimony to this Committee, ABA believes that:

- ***Banks with limited swaps activities should be exempt from the new clearing requirements in the same way as other “end-users”***
- ***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***

The ABA believes that the Discussion Draft regarding the small institutions exclusion from clearing is a significant improvement to underlying law. The Discussion Draft recognizes that many banks use swaps in the same way as other end-users, to hedge or mitigate commercial risk. Moreover, banks using swaps to hedge or mitigate commercial risk have standard risk management practices that are subject to regulatory oversight (including on-site examinations every 12 to 18 months) and they have explicit legal limits on the overall credit exposure that they can have to any individual or entity. 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 or the safety and soundness of the banks. In fact, banks and savings associations below the Discussion Draft’s \$30 billion asset threshold for a clearing exemption account for **only 0.09 percent** of the notional value of the bank swaps market as of June 2011.

The Discussion Draft provides needed certainty to the underlying law for banks that enter into swaps transactions in connection with originating loans for customers. Banks commonly enter into swaps with customers so that customers can hedge their interest rate or 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. The Discussion Draft ensures that these essential risk-mitigating services conducted as part of the loan making process are not brought into the swap dealer definition. In this way, the Discussion Draft will protect a variety of credit options for businesses of all sizes working to create jobs and grow the economy.

The ABA is concerned that the swaps exposure measurement alternative proposed in the legislation would constitute an undue administrative burden for banks. Although we agree that a risk-based measurement is appropriate for determining which institutions may qualify for the exclusion, we are concerned that the proposed measurement would be extremely cumbersome for banks to undertake. Banks with limited swaps activities are least able to afford additional regulatory or administrative burdens related to their swaps transactions and are likely to stop using swaps altogether if costs or complexities are significantly increased. As a result, they would lose an important risk management tool. The ABA will continue to work with the Committee on alternative risk-based measurements as the legislative process moves forward.

The \$230 Billion Federal Farm Credit System Should Not Be Given Special Treatment

The ABA would like to reiterate that it strongly disagrees that the \$230 billion Federal Farm Credit System (FCS) should be exempted from an asset test regarding their derivatives activities. We urge this Committee to reject its request for special treatment. 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 proposes that the joint and several liability requirement be overlooked so that it may be considered a collection of small entities, when in fact this is not the case.

The Federal Farm Credit System presents the same kind of potential liability to the American taxpayer as other GSEs. Taxpayers are the ultimate backstop in the event that the Federal Farm Credit System experiences financial problems. In fact, this has already happened. The near collapse of the Federal Farm Credit System in the late 1980s—which was a result of irresponsible farm lending by Federal Farm Credit System institutions—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 argu-**

ments for exemptions from the derivatives title of the Dodd-Frank Act and ensure that the implementation of these requirements by regulators does not permit such a look-through.

End-Users Should Not Be Subject to Margin Requirements for Uncleared Swaps

The Dodd-Frank Act does not require regulators to impose margin requirements on end-users and the legislative history makes it clear that Congress did not intend to impose margin requirements on end-users. Nonetheless, end-users currently face uncertainty about whether they will be subject to margin requirements and this legislation would provide much-needed clarity.

The margin requirements are intended to offset the greater risk to swap entities and the financial system from uncleared swaps. However, imposing margin requirements on end-users would discourage the use of swaps to hedge or mitigate risk, so it would both increase risk in the system and vitiate the end-user clearing exemption.

Furthermore, the vast majority of banks use swaps to hedge and mitigate the risks of their ordinary business activities, just as other end-users do. Banks are also subject to comprehensive regulation and use swaps to meet regulatory expectations for asset-liability management. Adding initial and variation margin requirements and imposing 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. The result would increase risk in the system, not reduce risk, which is the primary purpose of hedging.

If the Committee wants to make a distinction between the margin requirements for bank end-users and other end-users, then we urge the Committee to consider imposing only variation margin for end-user banks rather than both initial and variation margin requirements. Current market practice is for swap counterparties to negotiate whether any collateral or margin requirements should be required and banks are already required to periodically reassess changes in the value of their assets and liabilities. Accordingly, at most end-user banks should be subject to market-to-market variation margin requirements as they reassess the value of any negotiated collateral. The ABA stands ready to assist the Committee if it decides to distinguish between margin requirements for bank end-users and other end-users.

ABA Supports Clearly Defined Criteria for the De Minimis Exception

The ABA believes that the Discussion Draft clarifying the definition of a swap dealer is an important step forward. The legislation proposes clearly defined criteria for the *de minimis* exception, a goal which ABA fully supports. It is important for Congress to give clear guidance to the regulators on this point to ensure that institutions presenting nominal risk to the system are not saddled with undue costs and complications. ABA will continue to work with the Committee on the criteria for an appropriate *de minimis* exception.

ABA Supports Full Assessment of the Costs and Benefits of CFTC Regulations

The ABA supports H.R. 1840, legislation providing for a full assessment of the costs and benefits of the Commodity Futures Trading Commission (CFTC) regulations. Regulatory burden on the banking industry has grown dramatically as a result of the Dodd-Frank Act and is stretching the resources of banks across the country. The median-size bank has just 37 employees and is struggling to pay for new auditing, legal, and compliance costs resulting from a mountain of new regulations. H.R. 1840 would ensure that the best possible assessment is made of the costs and impacts of new regulations so that regulated entities are not subject to unnecessary costs that outweigh any potential regulatory benefit.

ABA Supports Exempting Inter-Affiliate Swaps From Certain Regulatory Requirements

The ABA believes that H.R. 2779, legislation exempting inter-affiliate swaps from certain regulatory requirements, significantly improves underlying law. For certain financial institutions, inter-affiliate swaps are an important tool for accommodating customer preferences and managing interest rate, currency exchange, or other balance sheet risks that arise from the normal course of business. Inter-affiliate swaps do not create additional counterparty exposure and should not be subject to the same rules intended for swaps entered into with a third party. In addition, H.R. 2779 would require reporting of inter-affiliate transactions. This requirement would not add relevant market information. ***Rather, it would be duplicative and would distort market information.*** ABA would like to continue to work with the Committee on this reporting provision going forward.

Conclusion

ABA thanks the Committee for its strong leadership in this area. The Committee's efforts will facilitate better functioning of credit markets and maximize credit options for businesses large and small that are critical to job growth. ABA believes that treating end-user banks the same way as other end-users is an essential component of this effort. ABA member banks, like commercial end-users, use swaps to mitigate the risks of ordinary business activities and should be exempted from mandatory clearing and margin requirements.

SUBMITTED STATEMENT BY INDEPENDENT COMMUNITY BANKERS OF AMERICA

Derivatives Concerns of Community Banks

Mr. Chairman and distinguished Members of the House Committee on Agriculture, ICBA is presenting this testimony for the hearing record to highlight important issues regarding title VII of the Dodd-Frank Act (DFA). As proposed by Federal regulators, these issues could have a significant impact on whether or not the 1,000 community banks that currently utilize the swaps market will be able to do so. As regulators have previously stated, access to the derivatives marketplace is important to banks desiring to hedge their own interest rate risks or provide long-term, fixed-rate products to their customers.

The Dodd-Frank Act includes provisions designed to create greater transparency and reduce conflicts of interests and systemic risks in the derivatives marketplace. ICBA agrees with these objectives but believes that proposed regulations by the SEC, the CFTC and the so called "prudential" regulators should not disadvantage community bankers' participation in the use of derivatives, either in working with their borrowers or in hedging their interest rate risks. We will seek to work with regulators to address these issues and like-minded Members of Congress.

Two specific proposals may profoundly impact whether our members can access these markets: (1) the prohibition against rehypothecation or transferring of margin to complete swap transactions; and (2) the potential to count all swaps used by commercial banks except those swaps completed only at the time of *origination* of a loan as counting toward the swap dealer definition, thus causing community banks to be classified as "swap dealers." These and other issues are reflected in a comment letter to Federal regulators submitted by ICBA on July 11, 2011.

Rehypothecation

Community banks use low-risk interest rate swaps designed to hedge the underlying risk exposure associated with their balance sheets and/or to convert variable rate loans into fixed rate loans on behalf of their customers. These interest rate swaps are "customized" to meet the underlying characteristics of their customers' individual loans in order to be an effective hedge and to meet GAAP accounting requirements.

For example, these swaps are often much smaller than standardized swap agreements; or have repayment frequencies or other characteristics that differ from cleared swaps. Their risk levels are small. They are essentially the same as the plain vanilla interest rate swaps that are cleared by clearing houses but due to their customized nature are not at this time accepted for clearing.

Therefore, the customization required for these swaps transactions means they are relegated to the over the counter (OTC) market.

In their capital and margin regulations, regulators have proposed to prohibit rehypothecation of initial margin. The margin that many community banks now hypothecate to middle market swap dealers typically is rehypothecated upstream into a separate account, identified as belonging to the community bank that put up the initial margin, but available to their counterparties in the swap transaction to cover any losses.

By prohibiting the rehypothecation of margin by the handful of middle market dealers that serve community banks, the regulators would be requiring these dealers to put their own capital into swaps transactions. This prohibition on rehypothecation will substantially and unnecessarily increase the amount of capital needed to complete these swap transactions. This will either result in making the cost of the swap transaction uneconomical or will cause the middle market dealers that community banks utilize to exit the market, thus denying access to the swaps market for community banks.

We note that the Farm Credit Council (FCC) expressed very similar concerns in their July 11 letter to Federal regulators regarding the impact if rehypothecation restrictions are applied, in this case to Farm Credit System (FCS) institutions. FCS institutions, due to their status as a Government Sponsored Enterprises (GSE) are

granted the same credit rating as the U.S. Government. Due to this rating, FCS institutions apparently do not have to put up initial margin because their swap dealers are willing to have credit exposure to such highly rated, government-backed, entities. However, the FCC notes that having to now post initial margin will cause the swap dealers to, “in turn, be forced to recover those costs by raising prices” on FCS entities. By contrast, many community banks do post initial margin and do indeed face these higher costs in their swaps transactions. Community banks are already at a disadvantage in terms of the pricing they receive on swaps transactions, and by having to compete with a GSE with tax and funding advantages at the retail level in the agricultural marketplace.

The FCC goes on to state that “Because swap entities often offset their own transactions with other swaps, they typically rehypothecate variation margin to other counterparties to satisfy their own variation margin requirements . . . prohibiting rehypothecation would therefore force swap entities to bear much higher costs and to pass those costs on . . . in the form of higher prices.”

The prohibition on the reuse of the capital of community banks, whether initial or variation margin, to complete the swaps transaction would likewise raise the costs of those transactions for community banks. This outcome will force middle market swap dealers to come up with costly capital—hard earned, scarce resources set aside to cover potential exposure on the swaps transactions in addition to the margin already put in place by the community bank for the same swap transaction. This will dramatically increase the costs of swap transactions for those serving the community banking market. Either the cost of utilizing these swaps will be economically prohibitive or middle market swap dealers will be forced out of the business of facilitating swaps for community banks.

One result is that risks to the community bank sector would increase as banks would have greater interest rate risks as they use short term deposits to fund long term, fixed-rate loans. The Savings and Loan crisis occurred because S&Ls borrowed short to lend long. Therefore, the ability of community banks to offer important fixed-rate products with longer maturities to their customers would also be placed in jeopardy. The amount of actual derivatives risk reduction in the OTC market would be insignificant if it occurred at all.

Keep in mind that community banks use low risk interest rate swaps and do not and did not utilize the risky credit default swaps used by AIG and Lehman that resulted in causing panic in financial markets due to potential systemic risks. Moreover, the statute does not prohibit rehypothecation of initial margin as is being proposed by regulators.

Contrary to the broad brush painted by some Federal regulators, not all swaps utilized in the OTC market pose greater risks than cleared swaps. Certainly, low risk interest rate swaps used by community banks do not put swap dealers at risk nor do they pose systemic risks. Therefore, regulators should make distinctions between products within the OTC market instead of assuming that all swaps in the OTC market are risky simply because they are not accepted for clearing by clearing houses..

For example, proposed regulations have noted the problems of AIG in the OTC market as a reason to generally assert that swaps traded in the OTC market are supposedly riskier than those traded in clearing houses. However, AIG’s problems resulted from using credit default swaps (CDS), an insurance-like product, not from the low-risk interest rate swaps used by community banks.

These are important distinctions since the Dodd-Frank Act requires that margin requirements be based on the risks posed by the non-cleared derivatives.

Therefore, if implemented as proposed, regulations designed to address the problems caused by a few very large financial institutions would have the perverse and unintended consequence of penalizing community banks, much smaller institutions which did not cause the financial crisis and which were not the intended target of title VII.

Regulators have asked whether certain types of rehypothecation should be allowed. We believe that one option would be to provide an exemption to the prohibition on rehypothecation of margin associated with interest rate swaps entered into by a community bank with a swap dealer, where the swap is related to hedging the community bank’s interest rate risks or providing long-term, fixed-rate products to their customers. This would be appropriate since the capital or margin being rehypothecated will be used for the same swaps transactions. We have drafted narrow legislative language to accomplish this.

Avoid a One-Size-Fits-All Approach

We believe it is important to understand what is occurring through title VII and related regulations. Congress adopted title VII to address the risky activities of the

very large Wall Street investment firms and of the nation's largest banks. It has been reported that only a handful of these mega institutions control roughly 95 percent of the derivatives marketplace. Therefore, Congress imposed title VII in an effort to force many swaps into clearinghouses where there will be little if any unsecured risk. However, due to the extremely large amount of capital and market resources required to become a clearinghouse member, several of the very large institutions (the member/owners) that were intimately involved in causing the financial meltdown and systemic risk issues in the first place will now also be the very institutions that reportedly will be the primary owners who control and profit most from the clearinghouses.

The Federal regulators, not wanting these large entities to "game the system" by also placing risky swaps into the OTC market, are now attempting to overlay the clearing model onto the OTC marketplace *and* onto all or many of the minor and peripheral players involved in the OTC market. The proposed requirements and/or restrictions regarding margin, clearing requirements and rehypothecation are intertwined and driven by this attempt to impose the clearing model, with its high costs, onto the OTC marketplace.

As noted above, many community banks post initial margin. However, whether or not initial margin is posted is often negotiated between counterparties within the ISDA master agreement. Regulators should not require initial margin, but rather allow for it to be negotiated between parties as needed. Likewise, whether rehypothecation is allowed is also an option within the ISDA master agreement. Further, requirements to clear would impose significant costs on community banks, even though their swaps are not clearable due to their customized nature, resulting in another example of why community banks would lose access to the swaps market for the limited number of swaps they engage in.

These terms should not be dictated by Federal regulators who are proposing to impose the clearinghouse model onto the OTC market with few, if any, distinctions. By requiring initial margin, by requiring clearing and by prohibiting rehypothecation, either separately or in combinations, regulators are increasing costs upon all parties at every stage of OTC transactions. This will increase the costs of doing swaps, most likely making them uneconomical and unavailable. The end-users, whether farmers or small or large businesses and community banks will suffer the unintended consequences if the final regulations are not carefully and skillfully written. Otherwise, the result will be greater risks throughout various sectors of the economy—NOT—greater safety and soundness as intended.

Swap Dealer Definition

A second major concern rises from Dodd-Frank's exemption of commercial banks being classified as swap dealers to the extent they enter into a swap with a customer in connection with originating a loan with that customer. Federal regulators have requested comments as to whether this exclusion should apply only to swaps entered into contemporaneously with the bank's origination of the loan and how "contemporaneously" should be defined for this purpose.

Regulators and/or Congress need to ensure that this exemption applies to swaps entered into before, during or after origination of loans to provide enough flexibility to serve their customers' timing and needs for swaps to facilitate fixed rate financings. Otherwise, community banks will be considered swap dealers and will stop using swaps.

We appreciate legislation before the Committee that would help ensure this objective and look forward to working with Congress on this matter.

Other Legislative Goals

Prudential Regulators asked in their proposed regulations on margin and capital requirements for covered swap entities whether non-financial end-users should be exempt from mandatory clearing requirements. ICBA responded that they should. Prudential regulators then asked whether counterparties that are small financial institutions using derivatives to hedge their risks should be treated in the same manner as non-financial end-users for the purposes of the margin requirements. ICBA indicated that small financial institutions should receive the same exemption as non-financial end-users since community banks are basically end-users as well. ICBA supports legislation to ensure these goals are met.

In addition, Congressman Conaway and several other cosponsors have introduced H.R. 1840, bipartisan legislation that requires a thorough cost-benefit analysis of CFTC regulations. ICBA supports such efforts and has indicated support for even broader legislation (*e.g.*, S. 1615) as we believe that regulations must not be onerous or imposed on a one-size-fits-all basis.

Community banks contend with costly, unwieldy regulatory burdens that often jeopardize their capacity to raise capital, lend to small businesses and consumers, and support job creation. Similar to H.R. 1840, S. 1615 would require agencies to subject proposed new rules to a more rigorous, 12 point analysis to ensure that they are truly needed, are designed to pose as little burden and cost as possible, and pass a basic cost-benefit test. Importantly, the legislation would also require a retrospective 'look-back' every 5 years so that regulators could evaluate rules after they've been put in place. This concept may also be useful to incorporate into H.R. 1840 due to the complexity and omnibus nature of title VII rulemaking. In this case, a 2 or 3 year 'look-back' would be even more appropriate.

In our current difficult economic environment, it is important to ensure a reasonable check on new regulations, ensuring that they do not jeopardize community banks' viability by imposing costs that outweigh any benefit. This includes requiring Federal agencies to more fully analyze alternative approaches to new regulations and to determine ways to streamline existing regulations.

Farm Credit System Exemptions

The FCS has suggested that it be treated as small financial institutions although it is collectively over \$200 billion in assets. The FCS has suggested that regulators "look through" to their individual associations. This would be like looking at the individual branches of a large national bank and determining that the branches themselves are not swap dealers. However, FCS institutions have joint and several liability, making their institutions responsible for each other's losses.

CFTC Chairman Gensler stated in his statement on CFTC's margin proposal: "The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Interconnectedness among financial entities allows one entity's failures to cause uncertainties and possible runs on the funding of other financial entities, which can spread risk and economic harm throughout the economy."

While the FCS does not share the blame of the nation's largest banks and Wall Street firms in causing this recent financial crisis, their institutions were engaged in reckless lending that led to the 1980's farm credit crisis and its resulting misery. As a GSE, the System is indeed interconnected and Congress would be tempted to step in and bail out the System if it were to once again fail as it did in the 1980s when the System was a much smaller entity. By contrast to the recent bailout of the nation's largest banks and the FCS's 1980's bailout, hundreds of independent community banks—institutions that are not interconnected—have been allowed to fail during these different times of crisis.

Therefore, the FCS should not be granted special exemptions or advantages over other financial institutions in the swaps marketplace. The System has tax; funding and other advantages as a privileged GSE that competes against private sector lenders in the retail marketplace and it receives lax oversight of its mission area by its charitable regulator, the Farm Credit Administration (FCA).

Conclusion

The low risk interest rate swaps being utilized by community banks pose no systemic risks to the financial markets. Due to the low risks involved, community banks' customized swaps should not be subject to higher capital and margin requirements particularly compared to the plain-vanilla swaps that will be cleared. Banks, who utilize swaps to hedge their own interest rate risks and to serve the needs of their customers, should not be considered swap dealers.

There should not be a prohibition on rehypothecation of margin when used to complete swap transactions.

Otherwise, capital costs would become too great and the use of low risk interest rate swaps by community banks would be uneconomical. Farmers and small businesses would suffer. Risks within the banking sector would increase.

A June 20 letter from the House and Senate Chairmen of the respective Agriculture Committees to Federal regulators states: "Lastly, we urge regulators to ensure that any new capital requirements are carefully linked to the risk associated with the uncleared transactions, and not used as a means to deter over-the-counter derivatives trading." This would indeed be the unfortunate outcome if the prohibition on rehypothecation is allowed to occur.

We urge Congress to ensure that rehypothecation of margin is allowed when necessary to complete swaps transactions and we urge careful consideration of legislative initiatives that would address the other issues referenced in our testimony. ICBA stands ready to assist Congress and regulators in these efforts.
Thank you.

