

**LEGISLATIVE PROPOSALS TO BRING
CERTAINTY TO THE OVER-THE-COUNTER
DERIVATIVES MARKET**

HEARING
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED TWELFTH CONGRESS
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**LEGISLATIVE PROPOSALS TO BRING
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Friday, October 14, 2011

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

The subcommittee met, pursuant to notice, at 9:05 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Lucas, Biggert, Hensarling, Neugebauer, Pearce, Posey, Fitzpatrick, Hayworth, Hurt, Grimm, Stivers, Dold; Waters, Sherman, Lynch, Miller of North Carolina, Maloney, Donnelly, Himes, Peters, Green, and Ellison.

Also present: Representative Canseco.

Chairman GARRETT. Good morning. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order.

Good morning to everyone on the panel. I think this is the first time we started a little bit late. I try to start these things right on time. I apologize to all of you.

But we do welcome the gentleman from Texas for being with us here on the committee at the very beginning. This is a rare day, too, but thank you. Thank you, everyone.

Today's hearing is entitled, "Legislative Proposals to Bring Certainty to the Over-the-Counter Derivatives Market."

We have a fairly large panel to hear testimony from, but before we do that, we will have opening statements from the Members, 10 minutes or so on each side, if we actually consume that, and then we will look to each of you for your testimony. So I will begin by yielding myself 3 minutes, and say, again, welcome.

I look forward to all of your testimony. I look forward to a good discussion on the legislation that is before us. It is my hope that at least several of these bills will have, as we have had with other bills, bipartisan support.

I am pleased that my colleagues on the other side of the aisle have joined me and others in engaging in implementation of Title VII of the Dodd-Frank Act. We have had several proposals before today; and I believe it is appropriate to make sure that Dodd-Frank is—now that it is the law—implemented by regulators in a com-

mon-sense manner that actually works. For this to happen: first, regulations must not impose overly burdensome and unjustified costs on American businesses; second, they must not drive businesses overseas; and third, they must not unnecessarily place American businesses at a competitive disadvantage vis-a-vis countries overseas.

While derivatives are often vilified, and have been at the very beginning of this process, they have served as an extremely important risk management tool for thousands of American businesses across the country and pension funds as well. Regulators must be mindful of this and must be mindful about not harming the functioning of a mature market. Instead, they should focus on a regulatory structure that allows them to understand where the risk in the system actually resides.

In an effort to provide certainty and direction to the rulemaking process, I recently introduced the Swap Execution Facility Clarification Act with Mrs. Maloney, Mr. Hurt, and Mr. Meeks. Dodd-Frank gave the SEC and the CFTC broad latitude to get the rules right. Unfortunately, after these proposals were released, virtually the entire market—from the buy side, asset managers, pension funds, and commercial end-users, to the sell side, to the dealers and even prospective swap execution facilities, told me the regulators got it wrong.

In order to respect the congressional intent reflected in the heavily negotiated language of the SEF definition, we carefully drafted the bill, H.R. 2586, to direct regulators to provide market participants with the flexibility—and this is key—that they need to obtain price discovery in the market and in the method of execution they use.

In addition to allowing voice execution on SEF trade, the bill prohibits the 15-second rule, also, and includes restrictions on the RFQ model and sweep book requirements. I feel that the specific nature of this direction is necessary to promote the conditions for a competitive marketplace in the swaps area.

Mr. Canseco here has a bill, H.R. 3045, which was also introduced, at least in part, because of concerns over regulatory interpretation of the statute. I heard from pension plans that the SEC and the CFTC rules would prohibit them from using swaps to hedge against market volatility and manage the obligations owed to their retirees. So H.R. 3045 ensures that ERISA pension plans can engage in swap transactions without their swap dealer counterparties incorrectly being labeled as fiduciaries. Of course, that would make it impossible for the transactions to take place in the first place.

We also have Mr. Stiver's bill, H.R. 2779, which seems to be another common-sense solution to address inter-affiliate trades, along with Ms. Hayworth's bill, H.R. 1838, which repeals Section 716 of Dodd-Frank, otherwise known as the swap push-out provision.

Now because there was no hearing on this issue, and as Ben Bernanke has said, it would make the U.S. financial system less resilient and more susceptible to systemic risk, I look forward to having a thoughtful discussion now about Section 716, which we have not had so far.

Once again, I thank the entire panel, and I look forward to a healthy dialogue on this issue.

And, with that, Mr. Peters is recognized for 1 minute.

Mr. PETERS. Thank you, Chairman Garrett, for holding this hearing.

I also would like to thank the witnesses for taking the time to share their testimony with us today.

I certainly understand the important role that derivatives play in our economy. They are safely used every day by companies that are managing risk. As a member of the Dodd-Frank Conference Committee, I worked to ensure that Title VII struck the appropriate balance between creating a safer, more transparent market for derivatives, and ensuring that these products were still widely available and affordable for those who choose to use them.

In the year-and-a-half since the law was enacted, I have tried to work constructively with regulatory agencies to ensure that their rules make sense and are consistent with congressional intent. The issues that are being addressed in this hearing are very important. I think that many of them could probably be addressed by better coordination between the agencies and by greater feedback from the agencies to those who have submitted comments. Unfortunately, both the SEC and the CFTC are under a great deal of pressure, both in terms of time and in terms of the volume of work they are being asked to undertake. Adding to this pressure is the fact that they have so far not been given the resources commensurate with their increased workload.

In any event, I think there are Members on both sides of the aisle who are committed to making sure the agencies get this right, and I look forward to working with my colleagues to make sure that happens.

Chairman GARRETT. The gentleman yields back. We will be turning to Mrs. Biggert next for 1 minute, but before we do that, I ask for unanimous consent that Mr. Canseco can participate in this hearing.

Without objection, we welcome you.

Mrs. Biggert, for 1 minute.

Mrs. BIGGERT. Thank you, Mr. Chairman. Good morning to all of you, and thank you for being here.

I am concerned that Title VII of the Dodd-Frank Act is shaping up to be one of the worst provisions in a bill loaded with provisions that stifle economic growth. This derivatives provision is poised to place our financial systems at a severe disadvantage with its global competitors and could actually increase risk in our system by forcing many derivatives into the unregulated shadow banking system.

Federal Reserve Board Chairman Bernanke noted, as the chairman said, that Section 716 would make the U.S. financial system less resilient and more susceptible to systemic risk because forcing hedging activities out of insured depository institutions would weaken both financial stability and strong prudential regulation.

Section 716 will also place U.S. financial institutions at a competitive disadvantage because non-U.S. jurisdictions have not implemented similar regulations. Despite being promised that U.S. regulators would coordinate with their international counterparts,

Dodd-Frank is in the final stages of implementation, while other countries have completely failed to take action.

While I support bringing better transparency to our derivatives market, it is absolutely critical that we do not inhibit the competitiveness of our U.S. institutions. With the struggling economy, we simply cannot afford it.

Thank you again for being here, and I yield back.

Chairman GARRETT. The gentlelady yields back.

The gentleman from Texas, Mr. Hensarling, for 1½ minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

A week ago, we awoke to the bad news that once again we had an unemployment rate above 9 percent. I believe it has been so for 27 of the past 29 months.

As I talk to investors, Fortune 50 CEOs, and small business owners in my district, it is evident that the lack of our job creation is resulting from, number one, a debt crisis. As one put it to me, I know one day I am going to have to pay for this. I am not going to go out and invest in a bunch of new equipment or hire people.

It has do with our level of taxation and uncertainty. People don't know what their tax rate is going to be 16 months from now, but they know it will go up as part of the President's health care plan, as part of the snapback of tax rates that have been in place since 2001 and 2003, and it certainly is derived from a regulatory onslaught.

Mr. Chairman, I thank you for calling this hearing, because it is far past time that this Congress starts to look at the jobs impact of each and every regulation. When it comes to our over-the-counter derivatives market, whether we are talking about Section 716 of Dodd-Frank, whether we are looking at the affiliate swap roles, whether we are looking at the special entity designation for ERISA plans, there is either: one, way too much uncertainty; or two, certainly bad regulations that I believe are going to harm capital formation and job creation. The legislation that we are talking about today goes to the heart of the matter, and I appreciate you calling this hearing. Hopefully, we can move these common-sense pieces of legislation.

I thank you and I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Hurt is recognized for 1 minute.

Mr. HURT. Thank you, Mr. Chairman. Thank you for holding today's hearing on these important legislative proposals. I appreciate the opportunity to work with you as well as Representatives Maloney and Meeks on the Swap Execution Facility Clarification Act.

This legislation is necessary because the Federal regulators, particularly the CFTC, strayed outside of congressional intent in their SEF rulemaking and are attempting to impose a market structure that would be detrimental to the swaps market and its participants. These proposed rules would limit market efficiency and lead to negative consequences for farmers, manufacturers, small businesses, financial institutions, and pension funds.

H.R. 2586 will ensure that Federal regulators do not implement a Washington-style market structure for SEFs. This bill will provide flexibility to the market and give prospective SEFs and SEF

participants the ability to interact without constricting liquidity or limiting price discovery.

The importance of getting the SEF rulemaking correct cannot be understated. A misstep could lead to significant increased costs for risk management and for capital formation for all Americans, and these increased costs jeopardize jobs. H.R. 2586 ensures that future rulemaking by regulators will be consistent and will help maintain a functional and liquid swaps market so that businesses can mitigate risk and uncertainty in their operations.

Thank you again, Mr. Chairman, for holding this hearing; and I want to thank each of the witnesses for being here today. I look forward to your testimony.

I yield back.

Chairman GARRETT. The gentleman yields back. Thank you very much.

Now, I will recognize the gentlelady from California for 3 minutes.

Ms. WATERS. Thank you, Mr. Chairman. I thank you for holding this hearing on these legislative proposals related to the over-the-counter derivatives market.

Last July, we passed the Wall Street Reform and Consumer Protection Act and gave the SEC and the CFTC the authority to regulate the use of derivatives. We created transparency in markets by requiring that most derivatives be traded on exchanges and that the details of these transactions, including price, be reported.

The reason for this regulation was because we saw the systemic panic caused when AIG failed. We saw that Jefferson County, Alabama, was sold derivatives with hefty fees and complex terms that they didn't even understand. And now, we are seeing the uncertainty caused by a lack of transparency as it relates to credit default swaps on European debt.

So I would like to underline just how important it is that our regulation of derivatives moves forward in a timely manner. I am very concerned by attempts to delay implementation of the derivatives provisions in Dodd-Frank, particularly the 2-year delay that passed this committee earlier this year under unanimous objection of Democrats on this committee. Given both the European crisis and the continued problems with speculation in the oil market, I think that this 2-year delay will be tremendously dangerous.

I would also like to state my concern with back-door attempts to delay regulation by restricting funding to the SEC and the CFTC. Current House Republicans' proposals would hold SEC funding flat and would cut CFTC funding by 15 percent relative to Fiscal Year 2011. Such funding restrictions are simply unacceptable, given the new responsibilities provided to these agencies after the historic financial crisis of 2008.

As for the four bills being considered today, I am, of course, open to refining what we did in Dodd-Frank to ensure that rules can be implemented effectively, but I am not certain that legislation is necessarily needed, given the tremendous flexibility we afforded to regulators.

I would also add that on the issue of H.R. 1838, which is being considered today and would repeal Section 716 of Dodd-Frank, I am very concerned about a step backwards in terms of ending the

casino-style betting that got us into the 2008 crisis. I think it makes good sense that banks with Federal backing, either through a discount window or through deposit insurance, be restricted from using that backstop to fund their derivatives business subject to some bona fide exception.

I thank you, and I yield back the balance of my time.

Chairman GARRETT. And the gentlelady yields back. Thank you for that.

Mr. Dold is recognized for 1 minute.

Mr. DOLD. Thank you, Mr. Chairman. I certainly want to thank you for holding the hearing, and I want to thank our witnesses for your time and for being here today.

We do have an unemployment rate of 9.1 percent, and it has been extraordinarily high. It is the number one issue I think we face in this Congress, to try to jump-start the economy and put people back to work. It is going to be done, I think, in the private sector, and when I talk to people about uncertainty, that seems to be one of the major things people have in this.

Whenever Congress passes legislation, especially a 2,000-page bill like Dodd-Frank, I think we have an obligation to continually review and reevaluate the real-world results of the legislation. We must identify and correct unintended negative consequences that apply to a general cost-benefit analysis of the legislation's effects. Whether or not we voted for Dodd-Frank, we are not eternally bound to support every single provision regardless of whether we were for the original bill itself. Instead, we are here to do the best we can for our constituents and for our country; and sometimes that means making corrections to bills that were previously supported when circumstances change or when new information arises.

Today, we are here to consider doing that with respect to some of Dodd-Frank's derivatives provisions. Derivatives are very important for our international competitiveness, for American jobs, and for our economic prosperity. We can't afford to persist with these mistakes on these issues. So I look forward to hearing from each and every one of you and to working with my colleagues on the other side of the aisle for some common-sense reform.

Chairman GARRETT. That is what we are always looking for, the common-sense reform, thank you.

And now, we look to the gentleman from New York, Mr. Grimm, for 1 minute.

Mr. GRIMM. Thank you, Mr. Chairman.

First of all, I want to thank the witnesses for being here today. I appreciate your time.

And the timing of this hearing could not be more appropriate. Just this week, the New York State Comptroller announced that New York City, the best portion of which I represent, stands to lose another 10,000 financial services jobs by the end of 2012. I believe it is clear that many of the regulations put into place by Dodd-Frank and Title VII in particular are playing a part in these job losses.

In order to maintain the competitiveness of the U.S. financial markets, we must ensure that our regulatory structure does not put us at a disadvantage relative to the rest of the world. Therefore, I am encouraged by this committee considering these four

pieces of legislation, two of which, I might add, were put together on a bipartisan basis. I look forward to our witnesses' views on these bills and how they can further ensure that our burdensome regulation does not put U.S. financial sector jobs needlessly at risk.

I thank you, and I yield back the balance of my time.

Chairman GARRETT. I thank the gentleman.

Did the gentleman wish to be recognized for 1 minute?

Mr. DONNELLY. Thank you, Mr. Chairman.

I think we forget that hundreds of thousands of jobs in Indiana, Ohio, Pennsylvania, and other places were all lost due to the extraordinary destruction caused on Wall Street, due to the extraordinary destruction caused by derivatives and their failures.

And, Mr. Grimm, I sympathize with the loss of those jobs, as I know you do, of the hundreds of thousands of jobs that went before that caused by the destruction from the derivatives and the conduct that occurred on Wall Street and with a number of these actions. And I look forward to getting these derivatives right as well, but I also want everyone to understand why we are here today, because of the actions that took place before.

Thank you.

Chairman GARRETT. The gentleman yields back.

Mr. Canseco for 1½ minutes and the final word.

Mr. CANSECO. Thank you, Mr. Chairman; and thank you for having me here in your subcommittee.

Millions of Americans rely on income from employer pension plans during retirement, and managers of pension plans have a duty to prudently manage their portfolios in order to meet their long-term obligations to employees and retirees. A crucial part of managing investment risk, especially in a large and diversified pension portfolio, is having the ability to use swaps in order to hedge risk, notably interest rate risks. However, a provision included in the Dodd-Frank bill, and proposed rules from regulatory agencies, could seriously curtail the ability of pension plans to hedge these risks.

On the proposed rules from the SEC, the CFTC, and the Department of Labor, a swap dealer that seeks to enter into a transaction with a pension plan could trigger a fiduciary obligation under ERISA, thereby precluding the dealer from engaging in such transactions. However, neither swap dealers nor pension plans have ever considered the dealer to be acting as a fiduciary in such a scenario.

H.R. 3045, which I have introduced along with Chairman Garrett, would remove pension plans from the special-entity status conferred upon them in Dodd-Frank and allow them to continue to be able to use swap dealers in order to manage risk responsibly in their portfolios, regardless of how regulators implement the rules. This bill is an important step towards protecting the retirement income of millions of Americans, and I look forward to hearing from witnesses today on this matter.

Thank you, and I yield back.

Chairman GARRETT. The gentleman yields back.

Since there are no other opening statements, we look then to the panel.

Again, we welcome the panel here today; and we thank you very much for the testimony you are about to give us. As always, your full written statements will be made a part of the record. You will each be recognized for 5 minutes.

So, we will begin with Mr. Bailey. You are recognized.

STATEMENT OF KEITH BAILEY, MANAGING DIRECTOR, FIXED INCOME, CURRENCIES AND COMMODITIES DIVISION, BARCLAYS CAPITAL, ON BEHALF OF THE INSTITUTE OF INTERNATIONAL BANKERS

Mr. BAILEY. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, my name is Keith Bailey. I am managing director in the Fixed Income, Currencies and Commodities division of Barclays Capital.

I am pleased to be here to testify on behalf of the Institute of International Bankers (IIB) regarding four discrete legislative proposals to amend Title VII. Many of these issues sought to be addressed by these bills are very important to the members of the IIB. The IIB represents internationally headquartered financial institutions from over 35 countries around the world that have operations in the United States.

International banks provide an important source of credit for U.S. borrowers and enhance the depth and liquidity of U.S. financial markets. Our U.S. operations contribute billions of dollars each year to the economies of major cities across the country by employing over 250,000 U.S. citizens and permanent residents.

The IIB members support Title VII's objectives of reducing systemic risk and increasing transparency, and many of our home countries are working to implement similar reforms.

As Title VII is implemented, it is important to note that foreign banks and U.S. banks alike seek to minimize the number of legal entities through which they conduct swap dealing business. This benefits both the banks and their customers by increasing efficiencies and decreasing risk through netting and offsetting of exposures. It also allows customers to transact with a more credit-worthy entity.

It is equally important to recognize that, as the swap market is a global one, it is imperative that derivatives reforms maintain a level global playing field.

We believe that these two objectives will be better achieved if the legislative proposals before the subcommittee today are enacted into law. In particular, I would like to focus on H.R. 1838 and H.R. 2779.

H.R. 1838, sponsored by Representative Hayworth, would repeal Section 716 of Dodd-Frank, also known as the swaps push-out provision. Section 716's exclusions, grandfathering, and transition provisions apply only to insured depository institutions. Thus, our principal concern with Section 716 is its impact on uninsured U.S. branches and agencies of foreign banks which will not benefit from these exclusions.

When Section 716 was enacted, Members of Congress acknowledged that the lack of parity between foreign bank branches and U.S.-insured depository institutions was unintended and inconsistent with the U.S. policy of national treatment. These same

members acknowledge the need to ensure that foreign bank branches are treated the same as insured depository institutions. However, in the rush to complete the conference and finalize Section 716, there was no opportunity to rectify this significant oversight.

Less than 2 years remain before the foreign bank branches will be forced to push out all of their swaps dealing business. In some cases, even existing positions will need to be pushed out. The implications of this impending deadline are serious.

Swap dealing is typically conducted as an integrated part of a bank's overall business. Swap positions often hedge loans and other non-swap positions. Winding down or restructuring swap-dealing activities could have a material impact on foreign bank lending in this country. Customer agreements will be required to be modified, possibly resulting in significant tax consequences and possibly in litigation. These renegotiations of agreements will lead to delays in affording customers access to liquidity that is offered by foreign banks. The customers will lose their ability to net and set off collateral and payment obligations.

The IIB strongly supports H.R. 1838 as it would effectively accord equal treatment to foreign banks. It also would eliminate the significant negative impacts on capital, netting, and risk management which would result from conducting derivative trading through multiple U.S. entities. In its current form, Section 716 will result in higher execution costs for our customers.

The IIB also supports H.R. 2779 cosponsored by Representatives Stivers and Fudge. H.R. 2779 makes clear that many burdensome Title VII requirements do not apply to inter-affiliate swaps. This is important because inter-affiliate swaps promote execution flexibility for clients and superior risk management by swap dealers.

At the same time, H.R. 2779 preserves necessary regulatory oversight. Prudential regulators would continue through their supervisory role to have oversight of these transactions and to impose capital and other requirements as appropriate, both at the holding company and the subsidiary levels.

The CFTC and the SEC as market regulators will continue to have access to inter-affiliate transaction data. To the extent that the Commissions uncover specific evasive conduct involving inter-affiliate transactions, they would retain their authority to address that conduct.

We believe that H.R. 2779 strikes the right balance by: first, ensuring that the prudential supervisors and the market regulators have the requisite tools to perform their regulatory responsibilities; and second, ensuring that Dodd-Frank objectives of reducing systemic risk and increasing transparency are not undermined.

I thank you for the opportunity to testify today on behalf of the Institute of International Bankers. I would be happy to answer any questions you might have.

Thank you.

[The prepared statement of Mr. Bailey can be found on page 44 of the appendix.]

Chairman GARRETT. And I thank you.

Mr. Bernardo, welcome to the panel and to the committee. You are recognized for 5 minutes.

STATEMENT OF SHAWN BERNARDO, SENIOR MANAGING DIRECTOR, TULLETT PREBON, ON BEHALF OF THE WHOLESALE MARKET BROKERS ASSOCIATION, AMERICAS

Mr. BERNARDO. Thank you.

My name is Shawn Bernardo. I am a senior managing director for Tullett Prebon, a leading global inter-dealer broker of over-the-counter financial products. I am also the chairman of the Wholesale Market Brokers Association, Americas (WMBAA), an independent industry body whose membership includes the largest North American inter-dealer brokers.

I am testifying today on behalf of the WMBAA. Our trading systems are the prototypes for swap execution facilities under Dodd-Frank.

Mr. Chairman, we thank you and your colleagues, Representatives Maloney, Meeks, and Hurt, for your leadership in introducing H.R. 2586, the SEF Clarification Act. The WMBAA supports the bipartisan effort to ensure the congressional intent is followed in the SEF rulemaking process.

For example, before John Deere enters into a contract to sell tractors to an Argentinean farm 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 risk knowing it can offset that exposure on one of the hybrid platforms we operate.

So how is this done? Imagine a large room filled with long desks not just in New York City but also in Kentucky, New Jersey, and Texas. Each desk has a group of professionals with several computer screens and telephone squawk boxes that transmit prices to our customers. There are thousands of these professionals in the United States who use a wide array of trading technologies to meet the demands of the marketplace and their customers.

It is what CFTC Commissioner Bart Chilton described in a press interview as "big dynamic operations, not just a couple of guys in a back room with a phone." Each method we use is geared to the specific dynamics of financial products we broker. We call this range of training methods hybrid brokerage.

Swap markets have unique characteristics. They are full of institutional and not retail participants. There is a much larger number of complex products compared to the highly commoditized futures markets. And while the product range is wider, the trading volume is quite variable. The most active single-name credit default swap contracts trade a little over 20 times per day, and the majority trade once per day.

It is because of these unique trading and liquidity characteristics of swaps that our firms develop the hybrid brokerage methods I have described. In my 15 years in the industry, I have seen many products transition from voice or hybrid to electronic platforms as the liquidity increases. For others, however, hybrid trading systems are necessary to create the liquidity needed for businesses to adequately hedge risk. Developing and operating hoses hybrid systems creates thousands of American jobs.

The SEF provision of Dodd-Frank requires post-trade reporting and promotes pre-trade transparency as an aspirational goal. In

fact, Dodd-Frank requires reporting to be balanced against the impact on liquidity.

Today, the members of the WMBAA create active price discovery by providing their platforms prepaid transparency regardless of the method of trade execution. As registered SEFs, WMBAA members will provide fully electronic reporting of the transaction to the regulators and the swap data repositories.

While my written testimony addresses the SEF rulemaking in more detail, I would like to discuss one key issue this morning.

Congress made clear in Dodd-Frank that SEFs may conduct business using “any means of interstate commerce.” Congress’ words are clear: “Any means of interstate commerce.” And that includes the full range of hybrid brokerage methods I have described.

We are concerned with the CFTC’s proposed SEF rules restricting trading methods to only electronic central limit order book or RFQ systems for non-block clear trades. This approach is inconsistent with a plain reading of the statute and its legislative history. Imagine if Apple were told by Congress that they could sell their products through any means of interstate commerce, but then a regulator told them that they had to fire their sales associates, close their retail stores, shut down their toll-free sales line, and customers could only purchase Apple products online without human interaction at apple.com. That would obviously be an overreaching restriction on the clear statutory language.

Here, the CFTC is interpreting Dodd-Frank to say that for many trades, SEFs can use any means of interstate consumers as long as it is only purely electronic systems.

Getting the rules wrong will impact American businesses 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 don’t mess up platforms that are currently working well.” This is a delicate balancing act.

Mr. Chairman, consideration and passage of the bipartisan SEF Clarification Act will provide regulators with a clear expression of Congress’ intent to permit SEFs to use any means of interstate commerce to execute swap transactions.

Thank you for your time today.

[The prepared statement of Mr. Bernardo can be found on page 55 of the appendix.]

Chairman GARRETT. I thank you and thank you for drawing that picture for us of what the market actually looks like.

Ms. Boulwood is recognized for 5 minutes. Welcome.

**STATEMENT OF BRENDA BOULTWOOD, CHIEF RISK OFFICER
AND SENIOR VICE PRESIDENT, CONSTELLATION ENERGY,
ON BEHALF OF THE END-USER COALITION**

Ms. BOULTWOOD. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. 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 of Constellation Energy.

On behalf of Constellation, and the Coalition of End-Users, I am privileged to talk to you today about steps Congress should take to

fix three problems with the proposed regulations implementing Dodd-Frank legislation: first, inter-affiliate swaps should not be subjected to margin requirements in order to transact; second, swap execution facility (SEF) rules should not place end-users at a competitive disadvantage by limiting our choice of counterparty options and modes of execution; and third, we need a proper swap dealer definition and a de minimis exception to ensure that end-users are not regulated as swap dealers.

The End-User Coalition includes a diverse group of companies that provide goods and services, including agriculture, manufacturing, vehicles, electricity, and natural gas. From the outset, our Coalition has supported greater transparency, but we think end-users like us create jobs, not systemic risk, and should not be further burdened by regulations that Congress intended for financial dealers who caused the crisis.

I have been involved in risk management for more than 25 years in a variety of settings from academia to financial institutions to commercial entities and as a consultant. I serve on the boards of the Committee of Chief Risk Officers, and the Global Association of Risk Professionals, and I am a member of the CFTC's 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 44 States. We are the largest due to a variety of risk-management tools we employ to the benefit of our customers. Physical energy markets are volatile and unpredictable, but derivatives allow us to stabilize this volatility. We pass these benefits on to our customers in the form of low fixed prices for the energy they need to run their businesses and power their homes.

Now, I would like to specifically address some of the proposed pieces of legislation. First, we strongly support H.R. 2779, the Stivers-Fudge bill, because it recognizes that inter-affiliate swaps do not create systemic risks and should not be subject to burdensome margin costs. Like many other companies, Constellation uses inter-affiliate swaps because it is more efficient to manage our corporate risk in total, rather than on an affiliate-by-affiliate basis. And we can get better prices by buying our derivatives in bulk through one part of our organization. Inter-affiliate swaps are used to allocate these derivatives and are largely bookkeeping in nature and do not create systemic risk.

I would also like to speak briefly in support of H.R. 2586, the Swap Execution Facility Clarification Act. This measure provides clarity for existing voice broker markets so that they can qualify as SEFs. Preserving these markets is important as voice brokers are often the primary means to facilitate transactions for many illiquid products. Limiting the methods market participants may use to execute trades may result in unintended consequences, a reduced market liquidity, price discovery, and access to markets that are simply not developed enough to justify the cost of mandatory screen-based trading.

Congress intended for swap trading on SEFs to develop over time in a transparent way that maximizes competition through multiple methods of interstate commerce and consistent regulation. That is

why we support the goals of H.R. 2586, which seek to ensure that end-users will continue to have a variety of options for hedging their risks.

Finally, legislation will soon be introduced to fix 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 large enough that it does not capture firms like ours that had nothing to do with the financial crisis. We would never rise to the level of too-big-to-fail and are not interconnected to the broader market in a way that would create systemic risk.

The CFTC's proposed exemptions are too narrow and would catch many other end-users in swap dealer rules, like margin, clearing, real-time reporting, and capital requirements. Even the Administration's proposal and the testimony of regulatory officials during the Dodd-Frank legislative process spoke of regulating financial institutions, not energy providers or end-users like ourselves.

In conclusion, I want to thank Chairman Garrett, Ranking Member Waters, and members of the subcommittee for convening this hearing. Ensuring the CFTC follows congressional intent 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 captured as swap dealers, and the end-user exemptions included in the bill will be null and void. It is important to remember that end-users rely on derivatives to reduce risk, bring certainty and stability to our businesses, and ultimately to benefit our customers. We create jobs, not systemic risk, and we should not be further burdened by regulations Congress intended for financial dealers. Thank for your time, and I look forward to your questions.

[The prepared statement of Ms. Boulton can be found on page 78 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Mr. Cawley, you are recognized and welcome to the committee.

**STATEMENT OF JAMES CAWLEY, CEO, JAVELIN CAPITAL
MARKETS, LLC**

Mr. CAWLEY. Thank you. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, my name is James Cawley. I am chief executive officer of Javelin Capital Markets, an electronic execution venue of OTC derivatives that will register as a swaps execution facility under the Dodd-Frank Act.

I am also here today to represent the interest of the Swaps Derivatives Market Association (SDMA), which is comprised of several independent derivatives dealers and clearing brokers, some of whom are the largest in the world.

Thank you for inviting me here today to testify. Let me first address H.R. 1838, that calls for repeal of Section 716 of the Dodd-Frank Act. Section 716 requires that the U.S. Government can no longer bail out swap dealers that do not hold deposits from the American public.

The SDMA respectfully opposes H.R. 1838 because it would allow for future bailouts of Wall Street by Main Street. We oppose 1838

because it is not the role of government to intervene in private business by picking winners or losers.

Government bailouts of private business run contrary to the fundamental tenants of free enterprise in this country. Swap dealers, like all other private businesses, must be allowed to succeed or fail on their own merits. Swap dealers serve no prudential role to the economy. To be sure, as we have seen from the financial crisis of 2008, systemic risk borne at the bilateral construct of an uncleared swap increases the systemic risk of these firms. But the swap-clearing mandate under Dodd-Frank substantially mitigates such risk, and thus, in the future, these firms will be allowed to fail without threatening our economy.

We oppose 1838 because of the moral hazard implications. For swap traders to know that somehow their firms and their jobs would be protected by the U.S. taxpayer would only encourage further high-risk behavior and drastically increase the likelihood of another bailout.

Lastly, the SDMA opposes such a bill because even if the U.S. taxpayer wanted to bail out Wall Street it simply can't afford it. With budget deficits running close to 100 percent of GDP, the U.S. taxpayer doesn't have the funds. Moreover, one need only look to the paralyzed economies of Ireland, Portugal, and Greece to appreciate the ills of taking bailouts a bridge too far. As unfortunate as it is, bad actors in finance should be rewarded as bad actors in other industries, not with bailouts but with bankruptcy.

With regard to the Swap Execution Clarification Act that calls for an override of various pre-trade transparency provisions under the Dodd-Frank Act, the SDMA respectfully opposes that, too. To not require SEFs to show live firm bids and offers to the entire market so that participants can transact on them would dangerously limit fair dealing, restrict competition, and increase systemic risk.

As empirical evidence and academic research show, the dissemination of live actionable prices to all market participants simultaneously increases market integrity, promotes a level playing field, and increases liquidity. Fair and open markets attract more dealers and buy-side participants, which, in turn, foster even greater liquidity. As evidenced by the financial crisis of 2008, the credit default swap and interest rate swap markets can never have enough liquidity.

The SDMA opposes H.R. 2586 because it would increase transaction costs. With regard to transaction costs in the swap markets today, it is estimated that market participants pay \$50 billion annually. By fostering greater pre- and post-trade transparency, it is estimated that such transaction costs would fall by 30 percent, or \$15 billion, annually in the first few years after Dodd-Frank. That is \$15 billion that corporations can use on their own balance sheets to invest in research and development or hire more American workers. That is \$15 billion that loan portfolios can pass back to consumers in the form of cheaper small business loans or mortgages for American families. To be clear, the current SEF rules promote transparency fair dealing and lower transaction costs. The SEC and the CFTC have mindfully permitted different execution meth-

ods, such as exchange-like anonymous central limit order books and requests for quote methodologies.

Moreover the Commissions do not restrict voice hybrid broking methodologies; they merely require that they operate with certain pre-trade transparency precepts. The Commissions have wisely allowed the markets to decide which method works best in each market context. The SDMA, too, has several voice brokering constituent firms, with many hundreds, if not thousands, of voice brokers. And after our careful review, we support the Dodd-Frank Act as passed.

To be sure, to change the rules now would be expensive to roll back. Clearinghouses dealers, buy-side, and trading venues have already invested hundreds of millions of dollars in anticipation of such rules. To reverse these rules now would be costly, inhibit capital formation, cost jobs, and sacrifice economic growth.

To conclude, the SDMA calls on the members of this subcommittee to forego proposed bills H.R. 1838 and 2586 and instead request an immediate finalization of clearing, execution, and trade reporting rules by the regulators. As we enter now our second global financial crisis in 3 years, we should be mindful that the swap markets are no better protected today than they were back in 2008. The sooner we implement Dodd-Frank, the safer the American economy will be. I thank you for your time. And I am glad to answer any of your questions.

[The prepared statement of Mr. Cawley can be found on page 83 of the appendix.]

Chairman GARRETT. Thank you, Mr. Cawley.

Mr. Mason, you are recognized for 5 minutes, and welcome to the panel.

STATEMENT OF KENT MASON, DAVIS & HARMAN LLP, ON BEHALF OF THE AMERICAN BENEFITS COUNCIL AND THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

Mr. MASON. Thank you.

My name is Kent Mason. I am a partner in the law firm of Davis & Harman. I have been working in the pension area for almost 30 years. And I can assure you that time flies in the pension area.

I am testifying today on behalf of the American Benefits Council and the Committee on Investment of Employee Benefit Assets. Those two organizations together represent the vast majority of this country's private retirement plans. I want to thank you very much for holding this hearing and for inviting us to testify.

ERISA pension plans use swaps to manage investment risk and liability risk. Without swaps, pension funding obligations for companies would become much more volatile. That volatility would have two main effects: one, it would undermine the security of employees retirement benefits; and two, it would cause the company sponsoring these plans to have to reserve in the aggregate billions of additional dollars to hold for funding obligations. Those reserves would divert assets away from job creation and investments in the economy.

I am going to focus today on three issues: one, the business conduct standards, which are our highest priority; two, the SEF rules; and three, the margin rules. I am going to start with the business

conduct rules. In the business conduct issue, we have three issues there. The first is the fiduciary issue, as Mr. Canseco explained better than I am going to here. Under the business conduct rule, proposed business conduct rules, a swap dealer has the obligation to review the qualifications of a plan's advisor. That review, under current ERISA law would make the swap dealer a fiduciary. As a fiduciary, the swap dealer could not enter into a swap with a plan; it would be a prohibited transaction, and thus, all swaps with plans would have to cease. The answer here is actually very straightforward. We need a simple rule that says no action required by the business conduct standards will make a swap dealer a fiduciary. That is exactly what H.R. 3045 would do, and we support it.

The second issue, the advisor issue, under Dodd-Frank, if a swap dealer acts as an advisor to a special entity, such as a retirement plan, the swap dealer must act in the best interest of that special entity. Unfortunately, the CFTC's proposed regulations would define advisors so broadly that all swap dealers would be required to be advisors. This sets up an unworkable conflict of interest. That would mean that swap dealers would be required to act in the best interest of themselves, do their fiduciary duty to their shareholders, and in the best interest of their counterpart. That is unworkable. If that were to hold, again, all swaps with plans would cease.

Again, H.R. 3045 addresses this very well by removing ERISA plans from the definition of a special entity.

The third issue under the business conduct rules is what I call the dealer veto issue. Under the proposed regulations, the swap dealer would have the ability to veto the advisor of a special entity, such as a pension plan, based on the swap dealers opinion of the advisor's qualifications. This would give the swap dealer enormous leverage over the plan and over the advisor.

Again, H.R. 3045 would deal with this very effectively by removing ERISA plans from the definition of a special entity and remove this counterproductive veto power, which hurts plans rather than products them.

The SEF bill, the CFTC's proposed rules would raise costs very substantially for all counterparties, including ERISA plans. For example, by requiring that plans and other counterparties expose at least five RFQs to other market participants—this would cause the market to know too much about a trade before it happens and sort of mean that the ultimate counterparty would have much more trouble hedging that trade after it happens. That will obviously—the ultimate counterparty will pass on that cost to the plan or other end-user, raising costs significantly.

H.R. 2586 would solve this problem and the other issues arising under the SEF rules.

Lastly, very quickly, I just want to mention the margin requirements. The proposed margin requirements issued by the CFTC and the prudential regulators would treat ERISA plans as high-risk financial end-users and would classify them in the same category as hedge funds, imposing very onerous margin requirements. This is simply a mistake and a very costly one. ERISA plans are among the safest counterparties. We need corrective legislation. I thank you for your time, and I would be happy to answer any questions.

[The prepared statement of Mr. Mason can be found on page 86 of the appendix.]

Chairman GARRETT. Thank you, Mr. Mason.

Mr. Voldstad, you are recognized for 5 minutes, and welcome to the committee.

STATEMENT OF CONRAD VOLDSTAD, CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

Mr. VOLDSTAD. Thank you, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. Thank you for the opportunity to testify today.

My name is Conrad Voldstad. I am CEO of the International Swaps and Derivatives Association, a 25-year old institution that has over 800 members in over 50 countries, including in our membership over 60 government and supranational bodies.

I myself started in the derivatives business back in 1983 before ISDA was around. I managed global swaps and fixed-income operations for two large American firms, helped unwind long-term capital, and later managed my own hedge fund.

In my brief testimony today, I will briefly comment on H.R. 3045. We agreed both with Congressman Canseco's statement and Mr. Mason's testimony. We support this bill because it would correct an unintended consequence of the Dodd-Frank Act, one that would preclude retirement plans from using derivatives to manage their assets and liabilities.

Regarding the other bills, H.R. 2586 would rectify a number of the serious issues related in particular to the CFTC's proposals for how swap execution facilities, or SEFs, must operate. We strongly support its passage.

OTC interest rate and credit default swaps, the products that will be the first to be executed on SEFs, are the most common and liquid products with very competitive pricing. However, while they are common and liquid, they trade very infrequently, and they trade in very large size. The interest rate swap market in particular is similar to the U.S. Government bond market, where many investors rely on dealer prices for certain types of trades. U.S. Government bond investors have the ability to execute electronically or through market makers. They have a choice of venues in which to trade.

It appears the CFTC would like to reduce the choice of end-users. They would do so by specifying that SEFs require the requests-for-quotes process to include at least five market participants. What dealer will put capital at risk in very large size if at least four others see the trade? The result will be reduced liquidity and higher prices for end-users.

We also believe that end-users would have to execute large trades in a piecemeal fashion, taking execution risks they do not have to take today.

It is interesting to see that the SEC does not require RFQs to be sent to more than one participant and has not reduced choice of execution to the extent the CFTC has.

It is very important to note that unlike the requirements for clearing and trade repositories, SEF execution is not an element of

Dodd-Frank that reduces systemic risk. It does not touch the AIG-type issues that cause losses in the financial markets. It is a structural change that should, in my opinion, be subject to a more careful cost-benefit analysis and safety and soundness provisions. This, of course, has not been done.

With respect to H.R. 2779, ISDA also believes that inter-affiliate swaps play an important part in the risk-management practices of end-users and dealer firms. For a variety of reasons, they may choose to book transactions in a centralized risk-management subsidiary and then book that risk internally to another subsidiary via inter-affiliate transactions. Dealer firms of course might do the opposite, have a local entity be the booking firm and manage the risk centrally.

We do not believe that transactions within a corporate family should be subject to Dodd-Frank clearing and execution requirements. Treating inter-affiliate transactions as if they are third-party swaps will not reduce risk to the financial system. They will not increase transparency in a meaningful way, nor will they improve market integrity.

My last subject will be H.R. 1838, which would repeal Section 716 of the Dodd-Frank Act. We see four issues associated with Section 716. First, dealers will deal through one entity for one set of products and through a second entity for another set of products. As a result, netting benefits could be lost and risk would increase throughout the system.

Second, dealers in jurisdictions without a 716 requirement will have an advantage relative to their U.S. peers that may result in a loss of jobs and business in the United States.

Third, the non-bank subsidiary required by Section 716 will need to be separately capitalized. These capital requirements will be greater than the capital savings at the bank that will result from the 716 pushout. This extra capital and the capital needed to offset lost netting benefits would be far better used to create jobs and economic growth in the United States.

Finally, the non-bank companies set up as a result of 716 will have to duplicate functions that are also carried out in the bank. This, of course, will create costs that will be passed on to derivative users. What Section 716 will ultimately do is put risk into an entity that is owned by the same parent that owns the bank that would otherwise house the business. Is risk in the financial system reduced at all? Will the risk be as transparent if it is moved from a bank to a bank affiliate? And more importantly, might it move to entirely different non-bank entities?

This concludes my testimony. ISDA appreciates the opportunity to testify on these important bills. And I look forward to answering any questions you may have. Thank you.

[The prepared statement of Mr. Voldstad can be found on page 99 of the appendix.]

Chairman GARRETT. And likewise, Mr. Voldstad, thank you for your testimony.

Since everyone here said they look forward to our questioning, let's go to some questioning.

I will begin with my questioning.

I will throw this out, I guess, to Mr. Cawley for a brief answer, and then maybe I will throw it out to Ms. Boulwood to follow up on an answer, same sort of thing.

Mr. Cawley, your testimony was it might be a little different with regard to how things would play out as far as whether everything would be forced onto a central order book or not. And even if it was not all forced on there, whether or not—since your testimony seemed to indicate that there would be some flexibility out there whether—the question that comes up in my mind is whether, even if there is some flexibility there, whether you still would have to first go to a central order book to check that, so to speak, for the pricing over there. If it were the case that everything had to go there, then some of us would disagree that that was the intention of Congress, that Congress was not intending to micromanage the operation of the markets in that place. And even if it is not, the effect of the rules, that everything goes there per se, but things have to go there indirectly as far as to having to at least check the central order book, still I would say that is not the intention of Congress. I would like your comments on that.

And Ms. Boulwood, I would like your comments on that as well.

Before that, though, I will just share with you what some other folks who are not on the panel, from the ICI in general, wrote in support of the legislation, the SEF legislation. I am not going to read all of it, but they say, the appropriate regulation of SEFs will be of critical importance to the success of Title VII of regulation rulemaking. ICI believes that the proposed trading restrictions and the Commission SEFs related proposals—the current rules, which you say, let go into affect—do not strike the right balance of proposed restrictions, enhance transparency at the expense of liquidity and efficient pricing, which could discourage the use of SEFs. It jumps down and says to another piece of it, the fund is required to go to five swap dealers prior to executing swap transactions; to that point, it would likely suffer from information leakage and signaling, so they have concerns there.

Just two other ones really quick, from Chatham Financial. These are advisors to the end-user folks, right? Again, they speak in general support of the legislation that we are talking about, the Swap Execution Facility Clarification Act. Here is the interesting—in a comment letter to regulators, the Coalition for Derivatives End-Users highlighted the communicating of the details of these language transactions to more than one or two parties could adversely affect end-users' ability to execute trade efficiency. The Coalition further emphasized that this would frustrate rather than fulfill the goals of promoting SEF usage; it could work against the goals of price transparency and price efficiency, right?

Then they go on, interesting also; it says the New Democrat Coalition expressed similar concerns in its letter to regulators. They noted that Congress also recognized, however, that there is not always sufficient liquidity in exchanges in support of all types of swaps. So you have those people who sort of side with where we are standing on this.

And then last would be, well, last but not least, BlackRock—and we are all familiar with them—Asset Management fully supports the objectives of the legislation. We believe the Swap Execution Fa-

cility Clarification Act is consistent with these objectives as put in Dodd-Frank but not as—I am paraphrasing them—as being implemented.

So I will give you just quick time, Mr. Cawley, because my time is limited, and then Ms. Boulton on this.

Mr. CAWLEY. So by our read, Mr. Chairman, of the rules as proposed, we see two or three different methods, so central limit order books, as you probably know, allow customers to see live real-time prices, bids and orders, bids and offers, exchange like.

Chairman GARRETT. But would it have to go—my time is limited.

Mr. CAWLEY. No, it would not.

Chairman GARRETT. But would it have to go there first for a check?

Mr. CAWLEY. By our read, the rules offer either the choice of going to a central limit order book or to go to an RFQ. Now, voice hybrid brokering works today, as Shawn Bernardo talked about, very well in the interdealer markets today. But one thing that also works well today in those voice hybrid markets is the fact that it itself is a central limit order book. Dealers today trade with each other using a wholesale central limit order book. They do so with the assistance of voice when the market is not as liquid as it might be. With interest rate swaps, they are highly liquid.

Chairman GARRETT. That I understand. Ms. Boulton, then?

Ms. BOULTON. I will respond in two ways: one is just practical concerns; and the other is, I guess, more conceptual. In our business, hedging output from generation plants as well as supply that we provide around the country, there are many locations and types of products that we transact in for hedging purposes that either you have a very limited number of market participants, you may not get to five, for example, or the volumes are very low in those transactions. So the point is, for physical transactions where you are hedging financially, your mode of communication with parties on the other side of the transaction is very critical. You can't—you don't want to restrict those modes of communication.

And then second, and more conceptual I think, aligned with ICI and Chatham is that this is about interstate commerce and the importance of not having rules and having legislation that would prohibit certain types of interstate commerce just is very important. And that is why your legislation is critical and provides clarity that isn't being provided by the current set of rules.

Chairman GARRETT. Okay. I appreciate both of your testimonies. The ranking member is recognized.

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

Mr. Cawley, section 716 of Dodd-Frank requires banks that have access to Federal assistance, such as deposit insurance and access to the discount window, to push out their derivatives business subject to some exceptions. Many of the witnesses here likely think that this proposal is unworkable or impossible to implement. I guess I can conclude from your testimony that you don't believe that it is necessary to repeal section 716, or do you think that the industry can collaborate with regulators to make it workable?

And in answering that—and this may be a little bit unfair—our first witness, Mr. Bailey, comes from a company that received about a billion dollars in bailout from the discount window. Are you

saying that the American taxpayers should not be responsible for bailing out under the same kind of circumstances that they received their bailout? Please help me understand this.

Mr. CAWLEY. That is exactly what we are saying. We are saying that swap dealers serve no prudential need in the economy, and notwithstanding the fact that a bailout was necessary because of the bilateral nature of the swaps contract—and we saw that with AIG, and we saw that then with TARP, and we saw that then with subsidies of guaranteeing bonds issued by various broker-dealers. That is not a good—although we got through that, it is not a good way to do business. Fundamentally it is not, from the SDMA standpoint and from several other standpoints in the American public. Swap dealers should be treated the same way as any other business, whether it is Javelin Capital Markets or a restaurant on the corner. You live and die by the decisions that you make, and if the collection of decisions that you make are so catastrophic that it results in the demise of the company, that is really unfortunate, but so be it. And that is how the capitalist system works.

So what 716 asks for is merely that for those institutions who are swap dealers that don't hold deposits, there is really no prudential need to protect them, and we really need to get away from protecting entities or giving them special status when they really serve no prudential need in the economy.

Banks, to the extent that they allow the flow of funds to flow through our economy, have a prudential or serve a prudential need within the economy. That being said, it is well established that with that prudential responsibility comes regulation, that they themselves can't get over their skis and bring the economy to its knees.

When we look back at 2008, Congresswoman, I think it is fair to say we came very close to the cash machines not working on Main Street, and it scared a lot of us on Wall Street, because it was getting out of control. We can't go back there again, and one only needs to look across the Atlantic to see what is happening with the paralyzed economies with Ireland, Greece, and Portugal. We can't bail them out. Dexia last week was the first bank victim of the financial crisis, part 2. It was liquidated. It has now become the charge of the Belgian and French taxpayer. So what you see is the second notion, which is that the U.S. taxpayer simply can't afford it. We can't afford to bail out companies that serve no prudential interest.

Dodd-Frank goes to solving this issue by bringing in clearing. What it does is, it says something very, very simple. It says if you are going to trade swaps, they are going to trade in a clearinghouse. So if you go down, if you file for bankruptcy, you are not going to pull four or five firms with it.

Back in the late 1980s, when I was in college in Philadelphia, I remember one day I had an interview at a company called Drexel Burnham, and my interview was scheduled for the day after they filed for bankruptcy. It was unfortunate for me. It was also unfortunate mostly for the workers of Drexel and for the bondholders and shareholders of Drexel, but by Friday of that week, the market had moved on. It was unfortunate that Drexel saw its own demise, but it didn't create a systemic risk in the system. And this was

something that was highlighted that is unique to derivatives, which is the bilateral nature of a swap. If AIG was allowed to go down, they had written, I believe, \$300 billion of protection that they had taken no reserve against. So it is necessary that we recognize that today, and it is necessary that we don't encourage it in the future.

Ms. WATERS. Thank you very much. You make a very good case. I yield back the balance of my time.

Mr. BAILEY. May I respond?

Chairman GARRETT. I thank the gentlelady. The gentleman from Texas is recognized for 5 minutes.

Mr. BAILEY. I beg your pardon; may I respond?

Mr. HENSARLING. Thank you, Mr. Chairman. As one who participated in the legislative process for Dodd-Frank and served on the conference committee, I was consistently told that the whole reason for being for the legislation was to reduce and minimize systemic risk. And now in the testimony that I hear today, if I understood properly, Mr. Voldstad, you testified that, "Some parts of the proposed regulatory application of this legislation, however, work against the goal of systemic risk reduction."

Mr. Mason, I believe in your testimony you said, "Treating ERISA plans as high-risk financial end-users will actually create risk rather than reduce it, thereby adversely affecting plan participants."

Ms. Boulwood, I believe I heard you say, "We create jobs, not systemic risk. There may be others who for whatever reason disagree with that assessment."

So my first question is, I would really like, Mr. Voldstad, for you to elaborate on how the aspects of Dodd-Frank that we are discussing today actually could work against the goal of systemic risk reduction.

Mr. VOLDSTAD. Thank you, Congressman. Number one, ISDA is very much in favor of safety and efficiency of the markets in which we operate or our members operate, and I think there has been an awful lot of progress. The main things that actually improve the safety and soundness of the markets that are in Dodd-Frank relate to clearing and the trade repositories. Trade repositories have been set up largely through our guidance, and are being set up in the asset classes that haven't been done. Clearing is a very good process. It does reduce systemic risk. Our issues relate to the processes where through a proliferation of clearinghouses, you start introducing risk in the clearinghouses themselves. You also find that as you move transactions into clearinghouses, you often find that those transactions themselves were hedging other transactions which can't be cleared and which will now create risk. I mentioned in my oral testimony that as you push certain swap activities into a 716 subsidiary, you will also reduce netting benefits. I should point out—

Mr. HENSARLING. I am sorry, let me interrupt. My time is limited here.

I would like to move to Mr. Mason and get your views. I am particularly concerned, at least the latest figures I have seen on the PBGC say that we have a debt of \$23.03 billion, and we have a potential exposure from underfunding of plan sponsors of perhaps

\$190 billion. So when one tells me that a potential interpretation of Dodd-Frank could create even greater risk with ERISA plans, you certainly get my attention. Could you elaborate, please?

Mr. MASON. Absolutely. Because of the way the funding rules work, it is absolutely essential that pension plans be able to use swaps to manage risk, such as investment risk, but primarily interest rate risk. I was sitting with someone recently who said that an interest rate swing in 2009 created for them almost overnight a \$2 billion additional liability, and that was almost overnight, and the only way they can effectively manage that possibility is through the use of swaps. Swaps are a very effective tool to say, I can prevent that sudden emergence of \$2 billion of liability. Without swaps, we couldn't do it. And the proposed business conduct regulations would take swaps out of the hands of the pension plans and expose them to that sort of enormous volatility and risk, so this is a creation of risk. This is not a diminution.

Mr. HENSARLING. In the very brief time I have remaining, I am curious about what level of concern people on the panel have regarding if the SEC and the CFTC do not harmonize their SEF rules and whether one sees any particular harmonization between U.S. rules and international rules, and what impact could that have on moving these swaps offshore. Anyone who would care to—

Mr. BERNARDO. I think if the SEC and the CFTC don't harmonize their rules, just to give you a real-world experience, you could have a credit default swap desk in our corporate area, where a single broker who brokers both credit default swaps and indices following, two sets of rules. So he could be doing a trade, trying to follow the rules for indices of the CFTC and doing a single-name credit default swap following rules of the SEC. So it is quite burdensome.

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

Chairman GARRETT. We are going now to the gentleman from Massachusetts, but before—just to indicate to the committee, after you, we are going to take a 10-minute recess. We have 2 votes on the Floor, so we can all go and vote for the 15-minute vote, and the 5-minute vote, and then come back and reconvene, so that gives the panel a 10-minute recess as well.

The gentleman is recognized for 5 minutes.

Mr. LYNCH. I thank the chairman and the ranking member for holding this hearing. I also want to thank the witnesses for coming before us and helping us with this very important issue.

I would like to talk about H.R. 3045, which we were just speaking of, Mr. Mason was, regarding the ERISA plans. I am a former trustee of a union ERISA plan for the ironworkers, and I understand—first of all, the mission of preserving those resources in retirement for the beneficiaries, in this case ironworkers, is more conservative—with a lowercase “c”—with the eye towards steady growth, and lack of risk. And I don't dispute the appeal and the effectiveness of the use of some swaps in terms of balancing risk within the plan, especially with respect to interest rate swaps, currency swaps where the underlying actually changes hands, there's no leverage there, but you have to admit with the AIG example back in 2008, we had many ERISA plans that had billions of dollars in credit default swaps, in more speculative swaps that, but for

the taxpayers' rescue and pumping \$700 billion to satisfy the calls of Goldman Sachs and a lot of these pension funds, there would have been some—a fair number of ERISA plans that would have been put at risk, possibly even failed because the swaps, the counterparty there, AIG, would not have been able to meet the obligations, so there would have been some failure.

Apart from the swaps that you have talked about, interest rate swaps, I guess what we are getting at, and I think what the goal of Dodd-Frank was, is to get away from the speculative swap activity that might create some risk within those plans and really provide a greater stability within those plans.

Is there a balance that we could strike here that would lend the advantages that interest rate swaps for your example provide, yet stay away from some of the more speculative activities that unfortunately some pension funds—and you have folks who, like me, when I was an ironworker, you would go to a couple of meetings a month as a trustee and you would be asked to vote on investment strategy and things like that. So I am sure there are a lot of smaller ERISA pension funds where perhaps all the trustees are not fully up to speed on complex derivatives and the different type of swap arrangements.

Mr. MASON. I think, really, I find myself really agreeing with much of what you just said. The overwhelming portion of swaps by pension plans are hedges. They are not speculative. Interest rate hedging, currency hedging, just as you mentioned, some equity hedging. Credit default swaps have historically not been a major element. And in our discussions with regulators, with the legislators during Dodd-Frank, we have never defended the use of widespread credit default swaps.

What we have done, for example—last spring or the spring when Dodd-Frank was being considered—was come in to say, for example, on the major swap participant definition, we want exemptions when we are hedging. When we are speculating, we are not looking for that same kind of protection.

Mr. LYNCH. Right.

Mr. MASON. So I think we have common ground, and I guess what we are saying here today is, let's not throw out the vast majority of sound swaps by these rules, which is what these rules would do.

Mr. LYNCH. Right.

Mr. MASON. And let's look for other tools to be effective in sort of accomplishing the objectives, the worthy objectives that you just articulated. So I don't think there is a lot of space here.

Mr. LYNCH. Mr. Mason, to your point, I could see where the steelworkers' pension fund might want to enter into some type of commodity swap dealing with the price of steel, because that is going to affect their work hours, contributions in there, the health of their plan in general. They may want to balance that off with a swap so that it doesn't adversely affect the pension fund. So I certainly understand that instance. But there were some cases where pension funds got involved in swaps where it was completely gratuitous, it was real estate halfway across the country, there was no real physical connection, collateral connection between the—it wasn't a hedge is what I am saying; it was more gratuitous or spec-

ulative. And, I just think it might help us greatly if we could get away from that type of swap activity.

Mr. MASON. And I think we would love to sort of follow up afterwards because our objective here is to be able to hedge our risk, and there may be some minuscule sort of speculation, but I think we should talk about it in terms of what we can do together to preserve our ability to hedge without crossing lines, and we look forward to that discussion.

Mr. LYNCH. I thank the gentleman. I yield back.

Chairman GARRETT. The gentleman yields back. We are going to reconvene at exactly 20 minutes of—that will give us enough time to go over, vote, and come back, and take a break. So we will see you at 20 of.

[recess]

Chairman GARRETT. We are pretty close to 20 of. The committee reconvenes, and I think we are ready for the next series of questions from the gentleman from Arizona, and he is recognized for 5 minutes.

Mr. SCHWEIKERT. Thank you, Mr. Chairman, proving once again you will just let anyone ask questions here.

Mr. Bailey, one of the questions I have been somewhat interested in is the threat of sort of a regulatory arbitrage around the world. I know you are not necessarily speaking for Barclays, but that does provide you quite a world view and expertise. How much of a threat are we in if we made no changes, if we left the Dodd-Frank law as it is; that I wake up one day and someone like Barclays is moving employees or their trading to London or Singapore or somewhere else around the world? And I would love also some insight from everyone else on the panel on that.

Mr. BAILEY. Thank you. I think in relation to the global harmonization point, we do think it is terribly important that in certain particular regards, the regulators across the world land in more or less—and it doesn't have to be exactly the same—the same as to particular facets of the legislation that is being adopted globally. In one respect, I think we think that clearing is likely to be a fairly universal and reasonably harmonized activity globally, provided there is mutual recognition of clearinghouses by the respective regulators globally, and so that aspect of it, I think will likely be all right.

The issue around execution styles and execution venues and what the European MiFID regulations will eventually require in terms of the protocols for derivative trading is still somewhat unknown. We do expect some information from the European Union, I think next week, which will give us more definition as to what their intentions are in that regard. But we really would depend on where those liquidity pools go, which in turn I think depends largely on where our customers go. And if customers have a preference for transacting on a certain location or certain environment, then that is where we would want to be reciprocating with our own liquidity in order to service the needs of our customers.

I actually think one has to recognize that there are many products that—where the underlying elements are traded in the United States, will remain traded in the United States, particularly so in credit products and certain other interest rate products and com-

modities. It actually seems unlikely that there would be a massive exodus from our trading population out of the United States. But one has to respect that there are other markets, like FX, where it is very much a key stroke, it is a click of a button that will take your transaction almost anywhere you want to trade it in the world, and so I think we would—

Mr. SCHWEIKERT. Forgive me, but the 5 minutes goes by very, very fast when we are doing some of these. Our concern for us as policymakers often is how far ahead of the curve we are. Mr. Cawley?

Mr. CAWLEY. Yes.

Mr. SCHWEIKERT. Your specialty is you actually provide a platform?

Mr. CAWLEY. Yes.

Mr. SCHWEIKERT. From what you are seeing around the world, are we coming in to—is the world sort of heading towards a common regulatory scheme?

Mr. CAWLEY. Yes, from what we see. And Mr. Bailey is totally correct, there is definitely a global consensus that clearing is good, and execution then is up to debate as to how products trade. The notion that—and we agree with Mr. Bailey's thought that the domestics, certainly credit default swaps trading U.S. credits would stay here, and dollar credits would stay here as well for interest rate swaps. So, investors look for good execution. They also look to trade in fair markets where they know that they are going to—

Mr. SCHWEIKERT. One of my concerns is I have actually seen a number of articles talking about the hunger of some of the Singapore Exchange to try to find a regulatory edge, and very stable, so I am constantly concerned that we are going to see that regulatory arbitrage.

My last 30 seconds, is it Mr. Mason, forgive me, I am not wearing my glasses so I can't even read something that is a little esoteric, but I am trying to get my head around it. Would a pension plan ever do a very custom hedge—and I was actually thinking before the previous discussion with our friend from Massachusetts—I am in a steelworkers' union and in our pension plan, we actually take some ownership as part of our salary negotiations. Would a pension plan do a custom hedge on default of that particular entity?

Mr. MASON. The defaults, default swaps are really the exception in our world. In terms of your question, are there customized swaps in our world? Absolutely, because actually the interest rate swaps, the currency swaps, the equity swaps are all very customized.

Mr. SCHWEIKERT. But my fear is with the way the rules are working, if you are doing something with that level of customization, is the platform we are heading towards or the requirements, is that going to make it much more difficult to do those highly customized swaps?

Mr. MASON. No. I think—and this is something we are working a tremendous amount with the agencies on because we are completely on board with sort of the clearing structure. But a lot of the clearing structure, the sort of customization, is inconsistent with the fact that every pension plan has very different demographics,

and you need to coordinate with the precise demographics to create the right hedge, and so we are—I am sorry.

Mr. SCHWEIKERT. I hope you will forgive me. I am just way over my time. Thank you for your tolerance, Mr. Chairman.

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

Mrs. MALONEY. Thank you. I regret that I had a conflict with another hearing. I would like to ask a question that is affecting really the district I represent, the fact that the SEC rule and the CFTC rule have come out different. And I would like to in a general sense ask what is it about the SEC rule that is better or worse, in your opinion, and what is it about the CFTC rule—compare the two rules and what is better and worse. And I guess, Mr. Voldstad, since you are the International Swaps and Derivatives Association, can you explain what it will mean for brokers who are engaged in business in the equities market and in the commodities market to have two different sets of rules for swap execution facilities? And then, if people could comment on the two rules, and what it means to commerce in the industry competitiveness.

Mr. VOLDSTAD. I will start, I think, just by comparing the two rules. We talked before about the RFQ process that the CFTC has, and they say that any request for a “transaction” has to be put in front of five participants. The SEC does not require that. They are not out to change significantly the structure of the marketplace. And Mr. Bernardo said earlier that the CFTC will apply to credit default swap indices and the SEC will apply to single-name reference entities. So if you are a dealer, you will have to transact your single-name default swaps under one set of rules, and you will then have to use—then if you are hedging through an index, you will have to do that through another set of rules. And you will also have different reporting requirements, and this is very important. The SEC has pretty reasonable reporting requirements that can go out as long as essentially 20-some-odd hours, whereas the CFTC will require near instantaneous reporting requirements, except if it is a block. Then you will have a 15-minute delay, but the block thresholds are very, very high in the CFTC rules, so the SEC rules look quite a bit more reasonable from that standpoint. We don’t yet know how the SEC will apply rules with respect to equity derivatives, but I would imagine that they will be a bit more reasonable than what we have seen from the CFTC.

Mrs. MALONEY. It sounds complicated. Does anyone else want to—

Mr. BERNARDO. Just to add on to that, the SEC rules are much more flexible as far as the execution of these trades. They allow for voice, electronic, and hybrid means of execution. They allow for the wholesale market brokers and my competitors to be innovative and come up with new ways to trade certain products, whether it be a matching engine or an auction platform. The CFTC rules are really based off the futures market, and they are relying on an exchange model that doesn’t necessarily work in all the products that we are looking to regulate.

Mrs. MALONEY. Just getting to voice, so the SEC allows voice and the CFTC does not allow voice; is that correct?

Mr. BERNARDO. That is correct. To tie that back actually to what the Congressman was asking before, even in Europe, the rules are much, much less flexible—or much, much more flexible on the modes of execution. They are not dictating how trades should happen. They are allowing for the market to have the ability to trade electronically, via voice or hybrid. Our companies—

Mrs. MALONEY. Now, NASDAQ trades in voice, right?

Mr. BERNARDO. NASDAQ, they have voice brokers, but yes.

Mrs. MALONEY. Can anyone tell me any reason why you shouldn't have voice? I, for one, like talking to people when I am making decisions.

Mr. CAWLEY. Congresswoman, maybe I can help. James Cawley from the SDMA. We, too, have several firms who have voice brokers who operate quite well today in the City and State of New York. By our read of the CFTC rules, we do not see that they restrict voice hybrid trading. They merely request that trades occur on a screen, on a hybrid basis with voice, which is consistent with many OTC markets today in the bond context, certainly within the wholesale market context. Voice, we should be clear, voice hybrid works within the central limit order book context, and so from our read of the rules, we do not see that there is an explicit restriction on people trading and using voice brokers in concert with screens so long as they meet their pre-trade trading objectives.

I would also say you can trade without a screen where you have two individuals purely voice broke a trade. Even in that context on a broker desk, there is a prohibition against what is known as “armpitting,” so the notion is that me as a broker will see both inquiry from one customer and another, cross the trade myself without showing it to my own desk; so we see that on a broader context, this is what the rules that have been suggested or promulgated by the CFTC to be an extension of. So even within interdealer brokers, there is a prohibition on armpitting, which is not showing the rest of the market that a trade is about to occur.

Mrs. MALONEY. How have companies in your industry improved your risk management practices?

Chairman GARRETT. Gentlelady, this will be the last question since you are over by a minute-and-a-half.

Mrs. MALONEY. I am over? I will wait for the second round then.

Chairman GARRETT. Okay. Then, Mr. Stivers is recognized.

Mr. STIVERS. Thank you, Mr. Chairman. I would like to thank the chairman for holding this hearing. I would like to thank the witnesses for sharing their time and expertise on many issues. And I am going to focus in on H.R. 2779. Not a lot of questions have been asked about that one. I would like to start with Ms. Boulwood. You represent an end-user, Constellation Energy; is that correct?

Ms. BOULTWOOD. That is correct; yes, sir.

Mr. STIVERS. Can you tell me without H.R. 2779, what would happen to the cost of risk management for companies that choose to perform their risk management function by using a central entity with experts and then using an accounting swap, for lack of a better term, to assign ownership to that internally? What would happen to your costs if this bill is not passed, and what could potentially happen to you?

Ms. BOULTWOOD. Congressman Stivers, our costs would rise. We would be forced to execute hedges for generation that we might have in Alberta, Canada, hedges that we might—or generation that we have in the United States. And with an inability to consolidate that risk and hedge centrally, we would be charged transaction fees as well as be forced to transact in markets that may in their location not be as liquid as other markets where we could potentially more efficiently execute that hedge.

Mr. STIVERS. And you could potentially be caused to raise your expense 3 times for collateralizing those swaps because you would have to collateralize the one side with an external entity and both sides of a second transaction, which is merely an accounting transaction that does not increase your risk; is that correct?

Ms. BOULTWOOD. That is correct. Mr. Bailey pointed that out in his testimony.

Mr. STIVERS. Right, and I heard him say that, but I wanted to make sure we were clear.

Ms. BOULTWOOD. Same impact.

Mr. STIVERS. Tell me what would happen if you had an incentive to do that, then, and your costs went up 3 times; do you think you would continue to have an external facing entity to execute your swaps or would you probably push it into your subsidiaries; and in doing so, would you have the same amount of expertise in each subsidiary that you are able to have in an external entity?

Ms. BOULTWOOD. So, two questions. We believe on the first, we would have higher costs of hedging that we would pass on to our wholesale and retail customers. That is the first item. And then second, the process that we undertake to hedge would be a lot less efficient and we would in many markets be forced to what might be called “dirty hedge” because we couldn’t find an appropriate hedge for that specific location, that particular product in that location, that we might more efficiently find through a centralized transaction.

Mr. STIVERS. Great. Thank you. I know Mr. Bailey brought up some great points earlier on the cost as well, and I think Mr. Voldstad quickly mentioned that he supports this bill because he thinks it will make things more efficient. Do either of you have anything that you want to add to why you believe this bill makes sense that Ms. Boulwood didn’t already cover?

Mr. VOLDSTAD. I might add something, if I may, Keith. I think if you have a plethora of individuals around the world executing swaps, there is an issue of expertise but there is also an issue of control. I have managed worldwide businesses, and I found that as you dispersed risk and authority around the world, it was difficult to control that, and typically, you would have much tighter risk controls in terms of how far somebody was from you and in terms of what kind of market they were operating in.

Mr. STIVERS. Anything to add, Mr. Bailey?

Mr. BAILEY. No.

Mr. STIVERS. Great. I yield back the balance of my time, Mr. Chairman.

Chairman GARRETT. Thank you.

Mr. STIVERS. Thank you to all of you.

Chairman GARRETT. The gentleman from New York, Mr. Grimm.

Mr. GRIMM. Thank you, Mr. Chairman. Let me ask Mr. Cawley, do you think that ERISA plans, those subject to ERISA, should be able to engage in swaps transactions?

Mr. CAWLEY. I am no expert on ERISA. We are more on the execution side, so I really don't have a view on that.

Mr. GRIMM. Okay. Mr. Mason? My understanding is that even at a most basic level of understanding, it is almost essential to properly managing such a portfolio. Is that correct? Could you expand on that?

Mr. MASON. Absolutely. Particularly interest rate risk. Interest rate risk can create enormous volatility and liabilities almost overnight, and the way that pension plans manage that liability, by far the most efficient, the most inexpensive is through swaps, and so—

Mr. GRIMM. But am I correct that under Dodd-Frank, as it is now, they would be precluded from those transactions?

Mr. MASON. Under the proposed regulations, they would be precluded, yes.

Mr. GRIMM. Okay. Mr. Bailey, you spoke very briefly about regulatory arbitrage, and one example would be the FX markets. Do you have any concern that traditional end-users—we spoke about some here—but even American companies like John Deere or Caterpillar, end-users in the most traditional sense, would be forced to send their business offshore where they don't have to post margin, things like that? Does that weigh into the regulatory arbitrage equation?

Mr. BAILEY. It does, absolutely, as to margin. We are hopeful, I think, that the margin treatments and the collateral and what has to clear will be sufficiently harmonious between the European and the U.S. environments to not have that be an issue. But absolutely, that would be a concern.

Mr. GRIMM. And whoever wants to weigh in, one of my—I would like to be as optimistic—but after Basel 2, I think we can definitely be concerned that the international markets may not move as quickly to promulgate the rules. I think it would also be safe to say that even if they promulgate the rules, there will be certain markets that will probably not implement nor enforce the rules to the standards that the United States would, and there would be a disparity. Am I completely off the mark? Maybe Mr. Bernardo could talk about that?

Mr. BERNARDO. I think you are spot-on. I think that, as I said before, the EU's rules on modes of execution are much more flexible than ours, so if we don't accept the clarification act, we are going to have an issue. Our companies are global companies. It is very, very easy for my company to move its employees literally at the click of a button over to Europe, over to Singapore, as you suggested. It doesn't take much, given that if the rules are too prescriptive and it is going to inevitably impact firms, they are not going to look to execute here; they are going to look to execute someplace else.

Mr. GRIMM. And lastly, Mr. Cawley, as you look at—I think your testimony, and correct me if I am wrong, but overall I think you said that the proposed rules for Dodd-Frank are close to spot-on, and it is what we need to prevent the systemic risk and future bail-

outs. Within your analysis, does U.S. competitiveness weigh in there, and if so, to what degree?

Mr. CAWLEY. Without a doubt, U.S. competitiveness weighs in, Congressman. And speaking directly to competitiveness, we only need to look at the hit that our GDP took and the unemployment rate skyrocketing as a result of the financial crisis back in 2008. So the notion of American competitiveness, specifically within the financial markets, is an area where the United States has led the charge.

Mr. GRIMM. If I could, because I am running out of time, would you say that the extremely high unemployment rate is solely due to the financial breakdown? It has nothing to do with the crash of the housing market, has nothing to do with the policies coming out of Washington from both sides of the aisle, maybe some overregulation and the lack of uncertainty in the marketplace overall?

Mr. CAWLEY. I wish the world worked in black and white. It doesn't. It works in gray, so I wouldn't use the term "solely," but I would say that the financial crisis and the role that derivatives played with the bilateral construct that is baked into an interest rate or credit default swap certainly brought about unnecessary bailouts of companies that shouldn't have existed.

Mr. GRIMM. My time has expired. I just want to make note, I think when you really analyze it at its core, derivatives definitely played a major role, but it was mostly the firms that were speculating as a business speculation. And Dodd-Frank, when you really look at it, goes way beyond speculation of derivatives and more into the end-users and legitimate users such as pensions, which you admitted you don't know very much about. But thank you, and my time has expired.

Chairman GARRETT. The gentleman from New Mexico, Mr. Pearce, is recognized for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman. Ms. Boulwood, Mr. Cawley mentions on page 2 of his testimony that transaction costs would fall by 30 percent under the current provisions that are being implemented; yet, you come out in support of the provision, and he opposes it. Can you help me harmonize those two positions? You are an end-user. It seems like you would want to be getting these 30 percent cost reductions.

Mr. CAWLEY. Indeed. So—

Mr. PEARCE. No, I was asking Ms. Boulwood.

Ms. BOULWOOD. I would say—I am not familiar with the study that Mr. Cawley refers to, but in our markets we transact in very often illiquid markets. In the products we require to hedge, there aren't many market participants willing to offer bids or offers on sale or purchase of a particular commodity in that location. Our transaction costs in terms of both the bid-ask spread and the level of market liquidity would clearly rise as a result of, say, for example, a broad definition of a swap dealer and the fallout of certain of our market participants from those markets; but also the fact that the SEF rules, if they, as Mr. Cawley supports, require either that we submit an RFQ or we only transact on a live screen, we will either be forced to hedge in very dirty ways in liquid markets and not match the underlying asset volatility that we are trying to hedge, or we would be posting information in a very public way

about an intent to hedge often very large amounts of generation in a particular region and in such a way that our intentions would be known so early in the market that getting a fair price would be near impossible.

Mr. PEARCE. Mr. Mason, you might address the same thing. It looks like you all would be interested in reducing your costs by 30 percent.

Mr. MASON. Yes. Again, I have not had the opportunity to study the numbers from Mr. Cawley. The input we have gotten from the pension plans is that the SEF rules proposed by the CFTC would drive costs up dramatically, and the one thing that was most identified was the requirement that you expose your RFQs to at least five market participants, which would make it immensely difficult for your eventual counterparty to hedge the trade, and that anticipated difficulty would be passed on in terms of higher costs. So that is the issue that at least the pension plans have identified.

I think some of my colleagues here are certainly more qualified to talk in more detail about the SEF mechanics, but for the pension plans, that was the issue which gave us by far the most heartburn.

Mr. PEARCE. Mr. Voldstad, is that volunteering that I see there? You might want to be hesitant of volunteering in front of Congress.

Mr. VOLDSTAD. I am volunteering, Congressman, and thank you for letting me weigh in. I saw the \$50 billion transaction cost number last night, and I was surprised about it, which is what was in Mr. Cawley's testimony, and I ran some numbers. I am an old derivatives guy, so I do this. Let's assume that interest rate products represent 80 percent of the market, so they represent 80 percent of the \$50 billion. That is \$40 billion. And so he is going to eventually—that was \$40 billion to exist in the marketplace. Let's look at the bid-offer spread on interest rate swaps. We did a study last year that showed there is essentially a two-tenths of a basis point bid/offer spread. Bring it down to zero, you save a tenth of a basis point per annum. If you take the \$40 billion and divide it by the savings or create the total amount of notionals that you were required to do, you get an amount of \$800 trillion a year of interest rate products. That compares with probably \$25 trillion a year that is actually done. So I would like to see Mr. Cawley's source for that information.

Mr. CAWLEY. If I may respond?

Mr. PEARCE. Okay, thank you. Mr. Cawley, you have 20 seconds if you want to—

Mr. CAWLEY. I would be more than happy to share the numbers with Mr. Voldstad and anyone else who would care to see them. What we looked at specifically was CDS, credit default swaps, being approximately \$25 billion, and interest rate swaps being \$25 billion. We saw the study that the ISDA had done last year. We don't think that it is—we thought it was a good study. There are other studies out there, but we would be more than happy to walk the ISDA and anybody else through the numbers by using essentially the same math that Mr. Voldstad is using.

Mr. PEARCE. Do you have that study available if our staff were to check with you after the hearing?

Mr. CAWLEY. Yes.

Mr. PEARCE. Thank you. I appreciate that, and I yield back.

Chairman GARRETT. Thank you. The gentlelady, also from New York, is recognized for 5 minutes.

Dr. HAYWORTH. Thank you, Mr. Chairman. It strikes me as I am listening, what we are endeavoring to do, Dodd-Frank is the equivalent of sending out a net to catch tuna and catching a lot of innocent species like dolphins, those being the dollars and the entities that we would like to devote to job creation.

I want to address for a moment, I did speak with the gentlelady from California, Ms. Waters, about H.R. 1838, and there are provisions in Section 716 which we are seeking to repeal with H.R. 1838 that are redundant with other provisions of Dodd-Frank, I believe, that would prohibit a bailout. So I have offered to Ms. Waters that I will be happy to work with her and her staff to reassure that essential protections against taxpayer risk are in place. That is an important concern for all of us.

Mr. Bailey, could you address a bit further the whole issue of—vis-a-vis what we were just talking about—the whole issue of access to the discount window and its equivalency or nonequivalency to a bailout concept?

Mr. BAILEY. Thank you. The foreign banks have access to the discount window on the very same terms that the U.S. banks do. They have the same rate, they have to post the same quality of collateral at the same discount. It is understood to be a part of a foreign bank's prudential risk management liquidity process to have that access.

We also understand that the Federal Reserve has for a long time regarded it as a prudential tool, it is a monetary policy tool, and that it is a valuable means by which the Federal Reserve can maintain a sound financial system. The foreign banks in the United States lend about 18 percent of the commercial loans that are made in the United States, so they are part of a system, and they do benefit from the access to the window on those terms, but those terms are the same as the U.S. banks do.

Dr. HAYWORTH. So essentially, what we are saying is it is a mechanism—I am a physician, so it is a mechanism for maintaining a certain amount of what we would call homeostasis, if you will; it is a way of keeping things on an even keel as opposed to then having to go in and exert extraordinary resources to correct a large risk, if you will. Is that a fair way to think about it?

Mr. BAILEY. Yes.

Dr. HAYWORTH. Okay. Thank you—

Mr. BAILEY. I should just qualify that. My earlier response refers to the U.S. branches, of course, of the foreign banks.

Dr. HAYWORTH. Yes, and I appreciate that clarification.

Mr. Voldstad, we have been talking about Section 716. The formation of subsidiaries under a swaps pushout provision would, of course, require a certain allocation of capital that I think we would agree is better spent in other ways or better deployed in other ways. Could you talk a bit more about the potential cost of this kind of activity?

Mr. VOLDSTAD. I think one first must recognize that the interest rate swap market will remain in the bank, that the credit default swap market with respect to investment grade securities will remain in the bank, as will the costs, the transactions involving pre-

cious metals and so on, so a large majority of the business will stay in the bank and continue to be regulated by the bank regulators.

The costs, I don't think we have quantified the costs, but the costs would arise out of doing transactions where you might be dealing with a hedge fund who wants to take a spread risk between a high-yield transaction and an investment grade transaction, so he is buying protection on one side, selling protection on the other side. If those two transactions are within the same legal entity, they could be netted for purposes of managing the counterparty risk. If you split them apart, you end up having risk in both of those entities. I don't know how much that would actually create in terms of a loss of netting, but it would be a reasonably good-size amount.

If you also then look at how much money will you have to put into a new standalone entity to make it creditworthy enough, that to me would be a very, very large number. And if anybody wants to be a significant swap dealer for high-yield and equity transactions, you would have to, I would think, have a swap dealer with multiple billion dollars' worth of capital that wouldn't otherwise be needed.

Dr. HAYWORTH. So there are issues of ballasting, if you will, and stability when we talk about this, and that requires the deployment or the deferral, if you will, to other entities and a lot of capital that otherwise would be used in better ways by these banks?

Mr. VOLDSTAD. Because you are capitalizing a separate entity, you are creating extra capital that is needed. That extra capital could be used otherwise in the operations of the bank.

Ms. HAYWORTH. Thank you, Mr. Voldstad, and all of our panel. Thank you, Mr. Chairman.

Chairman GARRETT. The gentlelady yields back.

The gentleman from California.

Mr. SHERMAN. Thank you.

Are there any parties to these over-the-counter derivatives which are too-big-to-fail or too-interconnected-to-fail as AIG was? Is there any entity in the market today which, if they went completely bankrupt and paid zero dollars and zero cents to all creditors, would pose a systemic threat to the United States economy? I don't see a volunteer, so I will go with Mr. Bailey.

Mr. BAILEY. I believe that Dodd-Frank is, through the means of living wills and a variety of other provisions, recognizing that there are still risks in the system for interconnectivity across banks—

Mr. SHERMAN. So until we either limit the size of the entities involved or we limit their participation in over-the-counter derivatives, we, every day could come into this Congress and be told, oh, my God, we need another \$7 billion in unmarked bills; is that the current situation?

Mr. BAILEY. I think part of—Dodd-Frank is attempting to make certain—

Mr. SHERMAN. I know what it is attempting to do. I am asking, is it successful? Is there any entity in the market whose destruction tomorrow would imperil the U.S. or world economy? Is there anyone else with a firmer answer?

Mr. CAWLEY. Let me just—one other way, Congressman, is to actually not limit participation or limit the—there is activity. One

way which I think the Dodd-Frank Act does cleverly is to restructure the derivative itself. So, by making it—taking the leverage out of it and making it a little safer to trade—

Mr. SHERMAN. So that makes it less likely that this problem—is anyone on this panel going to guarantee the United States Congress that is there is no one in the derivative markets today that we are going have to bail out tomorrow come hell or high water, no matter what? I don't see any hands. Let's go on to the next question.

How do you anticipate the Department of Labor's withdrawal of their role on fiduciary duty under ERISA will impact the final role on business conduct standards for swap deals?

Mr. Mason?

Mr. MASON. I think there has been a perception that the fiduciary conflict between the Department of Labor rules and the business conduct rules has gone away with the withdrawal of the proposed fiduciary rules, and that is not the case. Under current law, current DOL law, if a swap dealer is required, as the proposed business conduct rules would do, is required to review the qualifications of a swap—of a plan's advisor, that would, under current ERISA law, make the swap dealer a fiduciary, which would mean all swaps with plans would have to cease.

So the withdrawal took away other bases on which the swap dealer would become a fiduciary, but it left one under current law, and you don't need to die 3 times. It is enough to die once, and we, unfortunately would, not be able to enter into swaps.

Mr. SHERMAN. I thank you for your answer.

I thank the gentlelady from New York for her indulgence. I have to rush back to the Foreign Affairs Committee.

Chairman GARRETT. Does the gentleman yield to the gentlelady from New York?

Mr. SHERMAN. I do yield to the gentlelady from New York so that she will have more than the 5 minutes that she would be entitled to otherwise.

Mrs. MALONEY. That is kind of you. Thank you for your question. It was an important one.

I would like to ask all of you or anyone who would like to comment, how have companies in your industry improved their risk management practices since the financial crisis? What is different? What is improved in risk management specifically? Nothing?

Mr. BERNARDO. I can speak for the Wholesale Markets Brokers Association. We act as intermediaries, so we do not take risks. We are just matching buyers and sellers. We help facilitate trades, and we generate liquidity for the markets that we are speaking about, but all of our companies have invested previously and continue to invest hundreds of millions of dollars in technology to make these markets more efficient. So if certain products can be electronic, we make them electronic. We provide efficiencies for straight through processing, so once a trade is executed, we will send that trade electronically to the counterparties of the trade or send it off to a clearing. We even at this point in time send it to a swap—what you would consider a swap data repository in the future.

Ms. BOULTWOOD. May I make a comment? I think there has been significant advancement. I think there has been a natural move-

ment in the market toward more clearing of products as cleared products have become available on exchanges. I think, to the point Mr. Bernardo made, there have been massive IT investments, and many companies have invested more in the analysis of their own liquidity risk in understanding the boundaries of their own balance sheet and how large their businesses can be become before they would be vulnerable to a large price swing.

I want to make the point also that risk doesn't go away because we change the structure of the market; it simply changes form. So in saying that we want to move toward clearing, we may be reducing the amount of counterparty credit risk in a system, but we are increasing the amount of liquidity risk because we are increasing the amount of capital that would be posted and held aside in separate accounts as collateral or margin.

We are increasing the amount of potential operational risk because we are centralizing where transactions occur in clearing-houses and exchanges. So the point is, unless we significantly curtail or eliminate business activity, you are not reducing—or you are not eliminating risk; you are simply changing its form.

Chairman GARRETT. Thank you. The gentlelady's time has expired.

Mrs. MALONEY. Could Mr. Bailey answer this, too, from his perspective? I am going into my next 5 minutes, right?

Chairman GARRETT. No.

Mrs. MALONEY. I am finished? Okay.

Chairman GARRETT. You are not finished, but you are a little bit over. And we have a few other Members who have yet to ask a question.

So we will go to Mr. Hurt.

Mr. HURT. Thank you, Mr. Chairman.

I thank you all for your testimony today and your appearance.

Mr. Cawley, I wanted to explore with you what I thought was a very rousing defense of the taxpayer and of free markets. And so I am surprised to hear you also in the same breath talk about having the government come in and define these exchanges in such a way that, according to the other witnesses, will not lead to efficiency, will not lead to true price discovery; you have the government coming in saying, this is the way we want you to do it.

At the same time, when you have, from my understanding, derivatives markets that have been migrating to clearing, which I think everybody seems to say is necessary to secure the marketplace, and then also reporting, these are things that seem to me there is universal agreement on. So why is it you think that the government is better positioned to be able to impose an exchange structure that somehow makes the market more efficient when we hear from both sides, buy and sell, that we don't want this? After you are finished, I would love to hear from Mr. Bernardo and Ms. Boulwood, as well.

Mr. CAWLEY. We don't see a conflict between both points of view, but speaking specifically to government interaction in private markets, there is certainly precedence where those markets serve a systemic need or a prudential need. So we disagree, obviously, with most everybody here on the panel, but when we go out to speak to customers, who are the end-users of derivatives, when we speak to

them, they tell us that they want to have a choice of execution. Now, we don't see a conflict with the rules that have been promulgated by the CFTC. We frankly don't see that. We see a choice there between central limit order books, which are anonymous. We see a choice there that if you want to use an RFQ, you can. You can use anonymous RFQ, and you can use regular RFQ. If you want to shield your identity to get a better price, you can execute on a central limit order book anonymously. We don't see a conflict with our restriction on voice hybrid broking because as I understand it and as we understand it and after having been a broker and a trader and being a hybrid broker and using its services, it is in context a central limit or wholesale market construct—let me explain that—where buyer and seller have the ability to cross the bid offer spread and thereby make savings.

So, with regard to government interaction there, let me just say we see there is a systemic need because of liquidity—

Mr. HURT. Thank you. That is very helpful.

Because my time is limited, I would like to allow Ms. Boulwood and Mr. Bernardo speak to the question of, okay, if you don't want this imposed on you because there are real consequences, real costs to having to have the exchange, the execution facility operate this way, please, what are those costs? I would like for us to—what are the costs of going with Dodd-Frank the way it is currently constructed and setting up these execution facilities that way?

Mr. BERNARDO. The CFTC rules are too prescriptive.

Mr. HURT. Could you speak into the microphone?

Mr. BERNARDO. The CFTC rules are too prescriptive. Again, if we use a real-world analogy, when we are talking about the RFQ, request for quote, and you are asking five people to send in a quote, if five of you indicated that you wanted to buy something at a certain price, that is going to indicate to the entire market, it is probably going higher, and you are going to give people the ability or the opportunity to get in front and push those markets higher.

Now, if you were with someone who was willing to sell at that time, would you actually be willing to sell knowing that the market is going to immediately go against you? It wouldn't make sense; you wouldn't do that. Even if we talk about the 15-second rule, which is also in there, why would somebody take risk and create uncertainty in the market when you are asking a buyer and the seller that we have matched up, we already have an executed trade, so you are allowing someone to offset risk, why would you then allow the market to view that price that something is going to trade at, again, to jump ahead of them and move the market in a direction?

Mr. HURT. Again, my time is running out.

Ms. Boulwood, if you have any comment on that, I would appreciate it.

Ms. BOULTWOOD. Sure, with respect to the specific rule around SEFs, there are practical implications that really make the rules as currently drafted very impractical for an energy end-user in our market. Often, we are hedging in markets with less than five potential buyers or sellers. And that market is very—once they know you are selling, they will be on the other side of that sale looking for the price to go down and can wait or time your sale. We do not

believe we will get the fair price for, as we do in today's market, for what we are selling the physical asset.

And beyond SEF rules, I think what we are seeing is regulatory overreach, way beyond congressional intent. We all want the goal of transparency to be a point. That can be achieved through clearing and reporting, not by forcing all entities in the United States to become swap dealers.

Mr. HURT. Thank you. My time has expired. Thank you for your answers.

Chairman GARRETT. Mr. Canseco for 5 minutes.

Mr. CANSECO. Mr. Mason, the Dodd-Frank Act classified ERISA plans as a special entity, which could end up triggering fiduciary liability for swap dealer that wishes to enter into a transaction with such a plan. Given the historical role of swap dealers as near counterparties in transactions with ERISA plans, and the fact that the law already requires ERISA plans to hire fiduciary that has expertise in the area they are advising, does the new standard make sense for the swap dealer/ERISA plan relationship?

Mr. MASON. Absolutely not. I would say one point is that the creation of the concept of a special entity was supposed to identify entities that were not as capable as the swap dealer and thus needed more assistance with respect to entering into a swap. That has by law no application to ERISA plans. ERISA plans by law are required to hire a prudent expert in the field before they can enter into the swap world. So the idea that they need help from their counterparties, just simply doesn't make any sense. And that has been the consistent theme. We have talked to pension plans around the country, and the idea that they would ever look to their dealer for advice just is sort of beyond the pale. And by law, it really makes no sense.

Mr. CANSECO. So if a swap dealer were to be considered a fiduciary to an ERISA plan, that would preclude them from transacting any business with them, is that correct?

Mr. MASON. That is absolutely correct.

Mr. CANSECO. So under Dodd-Frank law, and subsequent agency rulewriting, pension plans now would be unlikely to have the ability to use swap dealers to hedge risk in their portfolios; is that correct?

Mr. MASON. That is correct.

Mr. CANSECO. And for millions of Americans who rely on income from pension plans, you would say that the special entity status conferred by ERISA plans in Dodd-Frank is not a good deal for them; is that correct?

Mr. MASON. That is absolutely right.

Mr. CANSECO. Could you walk us again through a scenario where a pension plan is unable to use swaps to hedge their interest rate risk? And how would this affect their portfolio? And what alternative methods would they be forced to use?

Mr. MASON. I was actually in a meeting, and I started giving a hypothetical. One of the people next to me was a chief investment officer for a company and jumped in and gave a real-life example, so I will give her example. She was in a situation where her pension plan had \$15 billion of assets, and \$15 billion of liabilities. Interest rates dropped rather quickly 100 basis points. What that did

to her liability is it took her liabilities from \$15 billion to \$17 billion. That created a \$2 billion shortfall almost overnight. That would have required her and her company to fund approximately \$250 million a year for 7 years.

The way that people use swaps is they use a swap to hedge against that possibility. In other words, by creating an asset, the swap, that in a perfectly hedged transaction, the swap would go up by the same \$2 billion, so they would stay at 100 percent funded. That is an enormously useful and popular tool to manage risk in a pension plan. If we didn't have it, you would have two choices. One is, you would have to reserve that \$2 billion; take \$2 billion out of operating assets and say, I am not using this to create jobs; I am not using this to invest in a company, but I am putting this aside because I might have a \$2 billion liability over the next few years. That would obviously be disastrous.

The other thing to do is to invest in bonds. The problem with investing in bonds—there are several problems. One, there are not enough of them to hedge these risks. They are not of the right duration. They have a lower yield. And if pension plans poured tens and hundreds of billion dollars into bonds, the bond yield would go down, further exacerbating this problem. So there is not currently an effective way to prevent that very frightening scenario, that \$2 billion shortfall, under current law.

Mr. CANSECO. So the result would be that the pension plans would invest in less risk-averse assets and reducing future returns; is that correct?

Mr. MASON. Absolutely.

Mr. CANSECO. I see that my time has expired, and I thank you very much.

Chairman GARRETT. The gentleman's time has expired.

We have a question here from one of our Members who is out, so I ask unanimous consent to allow 2 more minutes from each side for questions, so, without objection, 2 more minutes to the other side, and then 2 minutes to answer this question that one of the other chairs of the other subcommittee asked that we ask and be done.

Mrs. MALONEY. I would like to ask the panelists to respond to the CFTC's 15-second rule. I have been getting comments on it. Can you describe what it is and why it is important?

Mr. BERNARDO. The 15-second rule is derived from the futures market, and it really isn't conducive with the OTC markets. In the OTC markets, again, you are talking about liquidity that is episodic; it is not liquid if trades are not happening every second. So 15 seconds in our markets is an eternity. Once you have a buyer and a seller that are matched at a certain price, you are then saying, 15 seconds, let's take a pause and let's let the rest of the market see where that is about to trade, which would allow other people, again, to front run or move the market in a certain direction, which would inevitably impact companies like Constellation when they are trying to do a trade. Again, it doesn't fit in with the OTC markets; it is being cut and pasted from the CFTC rules.

Mrs. MALONEY. And you are saying that 15 seconds is an eternity in the markets. Could you just explain to me how a company actually executes transactions? Why is 15 seconds an eternity in

the markets? I think a day is an eternity in politics, but if 15 seconds is an eternity, I want to understand why it is an eternity.

Mr. BERNARDO. In these markets, you don't want to create unwanted uncertainty. There is no reason for it. So if you have a customer who rings in—so let's hypothetically say they ring in to me as a voice broker, and I have Barclays Bank on one side, and I have Goldman Sachs on the other side. And I am willing to execute—they are willing to execute at a certain price. Once they are willing to execute that trade, it has probably taken a long time to get us to that price they are willing to execute at. For us to then say, all right, guys, hold on, we are not going to execute at this price—we are going to execute at this price—we are going to let the rest of the market see what you want to do. If it is a big size trade, if it is a \$1 billion trade or a \$2 billion trade, if other people see that somebody is willing to buy at that level, it is going to go higher. So you would entice people to come in and front run and move the market up or move the market down. And again, us as intermediaries, we are not taking the risk, but it is going to impact the end-users, which is exactly what you don't want to do.

Mrs. MALONEY. In the proposed SEF Clarification Act, which would allow voice to clarify that there is voice, would you see that as an improvement or a rollback of the trading requirements of Dodd-Frank, or is it the same?

Mr. BERNARDO. Voice is part of any means of interstate commerce. Congress had the opportunity to say we wanted to be fully electronic in an exchange like trading, but they realized a lot of these products don't necessarily trade fully electronic. You need multiple modes of execution. You need to be able to trade by voice. You need to be able to trade via a hybrid platform. So you are allowing flexibility. And along with the flexibility, you are allowing innovation. My company, Tullett Prebon, as well as the other members of the Wholesale Markets Brokers Association innovate in these markets. We created other systems before legislation even came about. So we have auction platforms. We have risk-mitigation tools. We have a lot of things that would be ruled out if we kept the legislation as it currently is.

Chairman GARRETT. Thank you.

Mrs. MALONEY. Thank you, Mr. Chairman.

Chairman GARRETT. I think I just started something here. By allowing that now to go over about a minute and 30 seconds, I have another request on the other side. So I will yield my—I will be brief on my 2 minutes and maybe just wrap this up.

Mrs. Biggert asks, there has been discussion about the need for swaps definition to exclude instruments and products, such as those used by the insurance industry, for example, those that mitigate risk of life insurance products, which did not cause a financial crisis. Why are narrow swap definitions important? What can the impact of a broad definition have on insurance consumers, pension plans, and other low-risk financial end-users?

Mr. Mason?

Mr. MASON. I can speak to one. Probably the most popular investment in a 401(k) plan is a stable value fund, which is really—it is similar in some ways to a money market fund, capital preservation, but with a higher rate of return. Because of the sort of ex-

treme breadth of the definition of a swap and sort of lack of clarity, there is a concern the stable value contracts would be treated as swaps. The SEC and the CFTC are studying that. If they are classified as swaps, the regulatory structure doesn't fit. It would drive costs so far up that this investment, which is the most popular investment in 401(k) plans, would simply be wiped out.

Chairman GARRETT. Got it.

I yield the remainder of my time to the gentleman from New Mexico.

Mr. PEARCE. Thank you, Mr. Chairman. I will use all 40 seconds wisely.

Mr. Cawley, I find myself nodding in agreement with a lot of what you say; no more bailouts, government shouldn't be picking winners and losers. I would like to drill down a little bit on the intervention of the government should not intervene. Yet, at the end of your testimony, you say that we should get out of the intervening business from Congress, throw the two bills out, and immediately request the finalization of clearing, execution, and trade reports done by the regulators. Now, the regulators are saying that we can't use the telephone trades, but we can use electronic trades. So you don't favor intervention in the first party or anything, or favor the intervention to not allow the competitors to your business. Is that—am I misreading?

Mr. CAWLEY. It is a good question. Let me be clear, we don't favor intervention, but we recognize that there is a need under certain circumstances for intervention. We would love as free marketeers to have no government intervention. We recognize that in certain instances, the government is required to step in to maintain the stability of the economy. And we certainly saw that, whether some of us liked it or disliked it, we certainly saw that back in 2008, and hopefully, we won't see that again.

We recognize that government intervention is sometimes necessary, and the test then is, is the systemic test that goes into that is, what would require the government through its agencies to intervene either directly or indirectly?

Within the context of execution, and I think this debate has really fallen down to one thing, if I can be blunt, and that is the RFQ for five. We see that within—we don't see a conflict, first of all, when we see government coming in through the CFTC or the SEC to say, we view this as systemically important to the execution of contracts, not just the clearing of contracts, but the execution of contracts and the notion of transparency, pre-trade transparency and post-trade transparency.

Now, ideally, it is my own personal opinion that pre-trade transparency is not met by the RFQ scenario, simply put because, as Shawn has mentioned, you cannot have several people once that bidder offer is exposed, only one person can hit it. With that said, we do recognize that in certain market contexts, certainly credit default swaps—less so indices and less so interest rate swaps—but certainly credit default swaps, the idea of having RFQ certainly works.

We do say that we see no tension and no discord between either rule sets promulgated that deny a voice broker from interacting with a trade, so long as that trade has some modicum of pre-trade

transparency. That operates, Congressman, with lots of OTC markets, with lots of products that tell it and other firms that his organization trade and also that they may trade today.

Chairman GARRETT. Since these answers are going much longer than we thought, is there any objection to giving the final word to Mr. Canseco for 1 minute?

Mr. CANSECO. Thank you, Mr. Chairman.

Again, I want to go back to Mr. Mason. Some have labeled ERISA employee benefit plans as high-risk financial entities that should be subject to initial margin and daily variation margins. What is your opinion of that classification?

Mr. MASON. It was, in our mind, simply a mistake. We are being classified with hedge funds. ERISA plans cannot go bankrupt. Even if the plan sponsor goes bankrupt, the PBGC steps in and honors our swap liabilities. We are not operating companies. In fact, in all the discussions we have had, with dealers and companies, and we sort of talked to a wide range of folks who are integral to this business, we have never heard of any pension plan ever failing to pay off its swap liabilities. So for us to be treated as high-risk financial end-users, we think, and based on conversations with some of the regulators, was simply an oversight. But it is a very dangerous oversight and needs to be corrected because it would create enormous costs and real risk for pension plans. Our folks are telling us they would have to cut back their risk mitigation strategies, and that is not what we want.

Mr. CANSECO. Thank you very much, Mr. Mason.

Chairman GARRETT. I thank you for yielding back. I thank all the members of the panel.

And I thank everyone here on the committee.

Before you leave, I ask unanimous consent to insert into the record the following statements: the Commodity Market Council; the Coalition for Derivatives End-Users; and the American Bankers Association.

Also, there were letters I referenced earlier today in support of the legislation: Chatham Financial; ICI Investment Company Institute; and last but not least, BlackRock. Without objection, it is so ordered.

And again, I thank the members of the panel.

The Chair notes that some members may have additional questions for these witnesses which they may wish to submit in writing. Without objection, the record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record. And if it is done, as always, we appreciate your response to those.

With that, the committee is adjourned. Good day.

[Whereupon, at 12:00 p.m., the hearing was adjourned.]

A P P E N D I X

October 14, 2011

**Testimony of
Keith Bailey
On Behalf Of The
Institute of International Bankers
Before the
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises**

“Proposals to Amend Title VII of the Dodd-Frank Act”

October 14, 2011

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

My name is Keith Bailey. I am a Managing Director in the Fixed Income, Currencies and Commodities Division of Barclays Capital where I have responsibilities in e-commerce and for evaluating and implementing the changes to our derivative businesses globally resulting from enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). I have over twenty five years of experience in the derivatives market both here in the U.S. and abroad. I am very pleased to be here today to testify on behalf of the Institute of International Bankers (IIB) regarding H.R. 1838, H.R. 2586, H.R. 2779 and H.R. 3045. Many of the issues sought to be addressed by these bills are very important to the IIB membership. The IIB

represents internationally headquartered financial institutions from over 35 countries around the world; its members include international banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States. International banks provide an important source of credit for U.S. borrowers and enhance the depth and liquidity of U.S. financial markets. Their U.S. operations contribute billions of dollars each year to the economies of major cities across the country through the employment of over 250,000 U.S. citizens and permanent residents and through other operating and capital expenditures.

At the outset, let me say that the IIB and its members support Dodd-Frank's objectives of reducing systemic risk and increasing transparency in the financial markets. Many IIB members' home country jurisdictions are also working to supplement their existing regimes to incorporate derivatives clearing and market transparency reforms to achieve regulatory objectives similar to those in Dodd-Frank and to support the commitments of the G-20 leaders to setting high, internationally consistent requirements for OTC derivatives. In addition, even before Dodd-Frank was enacted, many of those jurisdictions already regulated swap dealers under their existing regimes for the regulation of market professionals.

It is also important to note that foreign banks and U.S. banks alike seek to minimize the number of legal entities through which they conduct swap dealing activities, and where possible, to use a single legal entity to transact with swap counterparties globally. This increases efficiency and decreases risk by permitting the bank and its counterparties to net and offset their exposures. It also allows counterparties to transact with a more creditworthy entity, which for foreign banks is usually located and supervised outside of the U.S. The personnel who have relationships with U.S. customers or manage U.S.-related portfolios on behalf of their head office are often, however, located inside the U.S.

The IIB has been particularly active in developing a proposal that we hope will assist global regulators to develop a workable regime for supervising U.S. and foreign firms that operate global swap businesses. This proposal recognizes that these firms structure their swap businesses in various ways and has been carefully crafted to ensure that, where these businesses (however structured) involve transacting with customers in the United States, U.S. customers are protected by dealing with a U.S.-registered swap dealer that is responsible for compliance with U.S. clearing, trading, reporting and business conduct standards. Recognizing the resource constraints of U.S. regulators, our proposal suggests that U.S. regulators should leverage effective foreign supervision while still retaining their full enforcement authority. Thus, if U.S. regulators determine that home country capital and other entity-wide regulations are sufficiently comparable to U.S. regulations, then, under our proposal, compliance with those regulations would constitute compliance with U.S. requirements, and failure to comply would be treated as noncompliance with U.S. requirements, enforceable by U.S. regulators.

While I would like to focus my testimony on H.R. 1838 and 2779, it is important that we not lose sight that, as the swaps market is a global one, it is imperative that the laws of the many jurisdictions in which global swap dealers operate be harmonized to the greatest extent possible. For example, OTC derivatives trade in a global market and market participants can currently execute in venues that operate in multiple jurisdictions. Accordingly, U.S. regulators should seek to harmonize their rules on swap execution facilities (SEFs) with analogous rules in other major jurisdictions, since material differences would likely fragment liquidity into separate, locally regulated venues. In particular, U.S. rules on pre-trade transparency should not be structured in such a manner so as to discourage foreign market participants from trading on U.S. SEFs or effectively to preclude organized trading facilities in other jurisdictions from being

eligible to execute trades for U.S. market participants. We believe that H.R. 2586's clarifications would help to achieve these objectives.

In addition, the IIB supports the clarifications proposed to be made in H.R. 3045 as it clarifies that foreign plans will not be considered Special Entities. We also urge that consideration be given to clarifying that other foreign entities, such as endowments, will not be treated as Special Entities.

H.R. 1838

This bill, sponsored by Representative Hayworth, would repeal Section 716 of Dodd-Frank, also known as the swaps "push-out" provision. Our principal concern with Section 716 is its impact on uninsured U.S. branches and agencies of foreign banks. Many foreign banks operate uninsured branches and agencies in the U.S. In the aggregate, these branches and agencies have more than \$2 trillion in assets. In addition to lending and engaging in certain securities, asset management and other similar activities, many such branches and agencies also engage in swap dealing. Dodd-Frank provides that branches and agencies engaged in swap dealing activity be required to register with the Commodity Futures Trading Commission (CFTC) and/or the Securities and Exchange Commission (SEC) with respect to their swap dealing activity. Accordingly, they will be "swap entities" under Section 716.

Section 716 generally provides that no "Federal assistance" may be provided to any swaps entity with respect to any swap, security-based swap or other activity of the swap entity. "Federal assistance" is defined to include advances from the discount window and FDIC insurance. Uninsured U.S. branches and agencies of foreign banks are licensed by a federal or state banking authority, they are subject to the same type of safety and soundness examination

and oversight as U.S. banks, and, like U.S. banks, they are eligible to borrow from the Federal Reserve discount window so long as the advance is secured by high quality collateral and subject to discount.¹ From the Federal Reserve's perspective, maintaining U.S. branches' and agencies' access to the discount window is an important tool for maintaining a sound and orderly financial system.

The general prohibition under Section 716 relating to Federal assistance applies to both U.S. FDIC-insured banks and uninsured U.S. branches and agencies of foreign banks that are swap entities. The general prohibition is, however, subject to several important exclusions, grandfathering provisions and transition periods, but these provisions apply only to "insured depository institutions" (IDIs). As a result, uninsured U.S. branches and agencies would appear not to be eligible for the exclusions, grandfathering and transition provisions applicable to IDIs.

When Section 716 was enacted, members of Congress acknowledged that this differential treatment of uninsured U.S. branches and agencies of foreign banks was "clearly unintended" and recognized the need "to ensure that uninsured U.S. branches and agencies of foreign banks are treated the same as insured depository institutions," consistent with the U.S. policy of national treatment.² However, as was explained at the time, in the rush to complete the conference and finalize Section 716 there was no opportunity to rectify this "significant oversight."³

¹ See Federal Reserve Regulation A, 12 C.F.R. § 201.1 (extending rules relating to eligibility for Federal Reserve Bank lending to "United States branches and agencies of foreign banks").

² 156 Cong. Rec. S5903-S5904 (daily ed. July 15, 2010) (colloquy between Senator Dodd and Senator Lincoln).

³ Id.

As a result, the exclusion in Section 716(d) that permits IDIs to continue to engage in certain traditional swap dealing activities, including dealing in interest rate and foreign currency swaps, and to use swaps for hedging and other similar risk-mitigating activities, would appear not to be available to uninsured U.S. branches and agencies of foreign banks. If uninsured branches and agencies that are swap entities were ineligible for this exclusion, then their U.S. customers would lose the benefit of trading with them. These customers would have to establish new trading relationships away from the U.S. branch or agency in order to engage in traditional swap transactions, as well as those swap activities that are not covered by the Section 716's exceptions. This would significantly reduce competition and worsen pricing in the U.S. swaps market, especially given that 8 of the 14 largest global derivatives dealers are foreign banks.

In addition, the resulting differential treatment relative to U.S. FDIC-insured banks would overtly discriminate against and competitively disadvantage foreign banks. This represents a significant departure from the long-standing U.S. policy that U.S. branches and agencies of foreign banks are subject to the same rules, regulations and oversight, *i.e.*, national treatment, as U.S. banks. Finally, it would provide precedent for foreign jurisdictions to provide advantages to their local banks at the expense of the foreign operations of U.S. banks, if not in the context of swaps then potentially in other contexts.

Section 716(b)(2)(B) also excludes from the scope of Section 716 an IDI that is a major swap participant or major security-based swap participant. This exclusion is important to those IIB members that may be deemed to be major swap or security-based swap participants. The definition of major swap participant encompasses not only persons engaged in ongoing swap activities but also potentially persons with only legacy positions. Thus, if uninsured branches and agencies were not treated as IDIs for this purpose, then they could be subject to Section 716 as a result of legacy positions in a way that a U.S. FDIC-insured bank would not.

Finally, Section 716(e) provides that Section 716's prohibition on Federal assistance "shall only apply to swaps or security-based swaps entered into by an insured depository institution after the end of [Section 716's] transition period." Therefore, the existing swaps of IDIs are grandfathered from Section 716. Relatedly, Section 716(f) gives an IDI's appropriate Federal banking agency the authority to grant the institution a transition period of up to three additional years beyond Section 716's July 16, 2013 effective date before the institution must divest or cease its swap activities. The purpose of this transition period is to prevent the restructurings necessary to comply with Section 716 from adversely disrupting the institution's lending and other non-swaps activities.

The implications of these issues are potentially serious. The less than two years remaining before uninsured U.S. branches and agencies that are swap entities must "push out" all their existing swap positions and ongoing swaps activities is precious little time, particularly relative to the longer period—close to five years—before IDIs will have to make their transition. Moreover, the absence of any grandfathering of existing positions would mean that the transition for foreign banks and their counterparties would be much more disruptive, more similar to an insolvency in many respects than to an orderly business restructuring:

- Swap dealing is typically conducted as an integrated part of a bank's overall business. Swap positions often hedge loan and other non-swap positions, and risk management and other systems are often shared across many different types of trading activities, not just those involving swaps. Winding down or restructuring swap dealing activities will as a result have significant spill-over effects on non-swaps businesses, with material impacts on the overall U.S. economy, given that the U.S. branches and agencies of foreign banks provide 18 percent of all commercial and industrial loans made by banks in the U.S.
- A significant number of customers have master agreements directly with the uninsured U.S. branches and agencies of foreign banks, or have multi-branch netting agreements to which

one or more uninsured U.S. branches or agencies are parties. The assignment, novation or modification of these agreements, even to an affiliate, almost always requires counterparty consent and will in many cases require renegotiation of existing terms and conditions.

- Counterparties may even refuse assignment or novation, for example, due to the inability to net and setoff collateral and payment obligations, thereby triggering litigation over exercise of “illegality” and similar provisions in those agreements.
- Renegotiation and litigation will lead to delays in trading, resulting in diminished liquidity and higher spreads and costs to participants and counterparties.
- Assignment or novation of existing positions will likely have significant tax consequences both for the foreign bank and its counterparties.
- Assignment or novation could also potentially trigger other requirements under Dodd-Frank, such as mandatory clearing and trading requirements.
- There are significant capital and technology costs associated with capitalizing a U.S. subsidiary to engage in traditional swap activities and using a new booking structure. Additionally, the modification of existing systems to track new booking structures will put a very heavy strain on information technology resources that are already overwhelmed with the other changes necessary because of Dodd-Frank.

In repealing Section 716, H.R. 1838 effectively accords equal treatment to foreign banks, aligning with longstanding U.S. national policy, and eliminates the significant negative impacts on capital, netting and risk management that would result from conducting derivative trading through multiple U.S. legal entities. For this reason, the IIB strongly supports H.R. 1838.

H.R. 2779

The IIB and others have taken the position that swap transactions between affiliates should not trigger certain Title VII requirements, including registration, margin, clearing and exchange/SEF-trading.⁴ Inter-affiliate swaps serve several purposes. From the client end-user perspective, inter-affiliate swaps provide them with the ability to enter into derivatives transactions with firms that have the requisite expertise in a given swap product or a presence in a particular geographic market while, at the same time, minimizing the number of legal entities with which they transact by permitting the firm to manage the market risk of the transaction in a different entity than the one transacting with the client. Inter-affiliate transactions also provide end-users with the ability to net their exposures and margin calls, as well as reduce the amount of collateral that must be posted. Global swap dealers use inter-affiliate swaps to most effectively hedge risks associated with particular swap transactions and, at the same time, centrally and more efficiently manage its overall risk.

Congress intended that Title VII's requirements apply to swap transactions with third parties.⁵ Inter-affiliate swaps neither raise additional counterparty exposure nor increase interconnectedness between market participants. As both the CFTC and the SEC have acknowledged, inter-affiliate transactions are, in most cases, entered into to allocate risk within a corporate group, not to supply liquidity to, or accommodate the independent trading objectives

⁴ See Financial Trade Association Letter on Treatment of Inter-Affiliate Transactions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, dated September 8, 2011.

⁵ Senator Blanche Lincoln stated, "it would be appropriate for regulators to exempt from mandatory clearing and trading inter affiliate swap transactions which are between for [sic] wholly owned affiliates of a financial entity." 156 Cong. Rec. S5921, July 15, 2010. Senator Susan Collins also noted that it was not Congress's intent to "capture as swap dealers end users that primarily enter into swaps to manage their business risks, including risks among affiliates." 156 Cong. Rec. S5907, July 15, 2010. Senate Banking Committee Chairman Chris Dodd agreed with Senator Collin's assessment of the law. *Id.*

of, a third party. In fact, requiring inter-affiliate swaps to comply with many of the Title VII requirements could actually increase risk for individual swap dealers, as well as for the broader market, by impeding internal risk management and mandating strict adherence to costly and burdensome regulatory requirements that provide little to no benefits.

As discussed above, our proposal for swap dealer regulation and supervision contemplates that U.S. affiliates of foreign banking organizations will enter cross-border inter-affiliate transactions. To subject these cross-border transactions to U.S. swap requirements could expose global swap dealers to multiple and possibly conflicting regulatory requirements. Most importantly, applying swap rules to inter-affiliate transactions could have the unintended and counterproductive effect of lessening market transparency, increasing costs generally, and increasing risk both within individual institutions as well as to the overall market.

The IIB supports H.R. 2779, co-sponsored by Representatives Stivers and Fudge, as it addresses many of our concerns and makes clear that Title VII's requirements do not apply to inter-affiliate swap transactions. Prudential regulators would continue, through their supervisory role, to have oversight of these transactions and to impose capital and other requirements as appropriate, both at the holding company and subsidiary levels. The CFTC and SEC, as market regulators, would, under H.R. 2779, continue to have access to inter-affiliate transaction data as reported to either regulated swap data repositories or the CFTC or SEC as appropriate. To the extent that the Commissions uncover specific evasive conduct involving inter-affiliate transactions, they would retain their authority to address that conduct. We believe that H.R. 2779 strikes the right balance by ensuring that the prudential supervisors and the market regulators have the requisite tools with which to perform their regulatory responsibilities and, at

the same time, ensuring that Dodd-Frank objectives of reducing systemic risk and increasing transparency are not undermined.

Conclusion

Thank you for the opportunity to testify today on behalf of the IIB. We appreciate your attention to these important issues under Title VII of Dodd-Frank, and encourage you to continue to work with the CFTC, the SEC and the prudential regulators to assure that Title VII is implemented in a way that establishes a level playing field, makes efficient use of U.S. and foreign supervisory resources and promotes international harmonization.



Testimony of

Shawn Bernardo

**Before the House Financial Services Subcommittee
on Capital Markets and Government Sponsored Entities**

**Legislative Proposals to Bring Certainty to the
Over-the-Counter Derivatives Market**

**Managing Director,
Americas Head of Electronic Broking
Tullett Prebon**

**Chairman,
Wholesale Markets Brokers Association, Americas**

October 14, 2011

Introduction

Thank you Chairman Garrett, Ranking Member Waters and members of the Committee for providing this opportunity to participate in today's hearing.

My name is Shawn Bernardo. I am a Senior Managing Director and a member of the Americas executive committee for Tullett Prebon, a leading global inter-dealer broker of over the counter financial products. I am also the Chairman of the Wholesale Markets Brokers Association, Americas (the "WMBAA"), an independent industry body whose membership includes the largest North American inter-dealer brokers.¹ I am testifying today on behalf of the WMBAA.

Tullett Prebon's business covers treasury products, fixed income, interest rate derivatives, equities, and energy products, and offers voice, hybrid, and electronic broking solutions for these products. Tullett also offers a variety of market information services through its inter-dealer broker market data division, Tullett Prebon Information.

I began my career in the inter-dealer broker industry in 1996 as a US Treasuries broker. As you may know, the secondary market in US Treasuries traded exclusively over-the-counter, both electronically and via voice, and stands as an example of one of the most liquid and efficient markets in the world. My experience as a broker allowed me to help create electronic brokering systems for US Treasuries and CDS Index products and I have spent the vast majority of the past 15 years building various electronic and hybrid brokering platforms to promote more efficient markets in Fixed Income, Energy, Credit, FX Options and Interest Rates.

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.

Tullett Prebon 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.

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.

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, Tullett Prebon 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.

CFTC Commissioner Bart Chilton had this to say about a recent visit he made to one of the WMBAA member’s 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 Clarification Act

Mr. Chairman, introduction, consideration, and passage of your 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 supports the SEF Clarification Act.

The WMBAA appreciates the bipartisan efforts of Chairman Garrett, Subcommittee Member Carolyn Maloney and Congressmen Robert Hurt and Gregory Meeks 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 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 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 US 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

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.”

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.

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.

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”.

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 CFTC's approach does not appreciate the fact 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. The OTC swaps market, unlike the futures market, contains thousands of products that are not continuously priced. This sporadic trading activity requires a different approach to its architecture and regulation than the futures model.

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 US 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 US economic growth, competitiveness and, most critically, much needed American job creation. Getting 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.

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 US 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.

⁴ See, 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.

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, Tullett Prebon businesses are operating and subject to oversight in the UK by the FSA and the European Securities and Markets Authority and globally by regulatory agencies in Canada, South America, throughout Europe, Australia, Singapore, Hong Kong, China, and Korea, among others. European and Asian markets are not imposing restrictions on methods of execution. US regulations need to be in harmony with those of foreign jurisdictions to avoid driving trading liquidity away from US 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.”

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 market place, 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 5 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

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.

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 Tullett Prebon. 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.

American Capital Markets Risk Being Driven Offshore – Again

In closing, it is clear that the US 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 US 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 US Dollars held outside the US - 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 US member banks could pay on US Dollar deposits. Because of these ceilings, Dollar deposits in non-US banks, paying a higher interest rate, became more attractive than deposits in US banks. As a result, the overseas Euro-dollar market grew rapidly. Combined with various US foreign exchange controls, Reg Q led to the development of a major non-US marketplace for deposits of US

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.

currency. That non-US 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 US regulations of SEFs. We must look carefully at these regulations not only in their own right, but also for their impact on US 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 US swaps markets?
- Will the "15 second rule" be the new Reg. Q shifting US 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 US 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

The Honorable Gary Gensler
 Chairman
 U.S. Commodity Futures Trading Commission
 1155 21st Street, N.W.
 Washington, D.C. 20581

The Honorable Mary Schapiro
 Chairman
 U.S. Securities and Exchange Commission
 100 F Street, N.E.
 Washington, D.C. 20549-2001

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 Commodity 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

¹ The 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 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.

² See, 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.

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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 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

³ The 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.

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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

⁴ Further 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).

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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 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.

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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 US increases and create other opportunities for regulatory arbitrage."⁵ If the U.S. regulations are implemented before

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>.

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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 offered 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.

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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

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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, overreliance 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

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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.

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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 expectant 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

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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 essential 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,

A handwritten signature in black ink that reads "Stephen Merkel". The signature is written in a cursive, flowing style.

Stephen Merkel, Chairman

**Statement of Brenda Boulwood, Chief Risk Officer and Senior Vice President
Constellation Energy**

On behalf of the end-user coalition

**Before the Committee on Financial Services Subcommittee on Capital
Markets and Sponsored Enterprises**

United States House of Representatives

Friday, October 14, 2011

Good Morning, Chairman Garrett, Ranking Member Waters, Members of the Subcommittee, 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, transparency is achieved through reporting, not by 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 and about Constellation 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 twenty-five 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.

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.

I would like to also speak briefly in support of H.R. 2586, the Swap Execution Facility Clarification Act. This measure provides clarity for existing voice-broker markets that can qualify as SEFs. Constellation utilizes several means of interstate commerce to execute trades including voice brokers, request for quote systems, auction systems, and other electronic means that are able to accommodate the characteristics of the swaps market. Preserving these markets is important to Constellation as these markets are often the primary means to facilitate transactions for many illiquid locations/contracts in energy that do not trade frequently enough to justify screen-based requirements. Limiting the means of interstate commerce market participants may

utilize, may result in the unintended consequence of reducing liquidity, price discovery, and access to markets that are simply not developed enough to justify the costs of mandatory screen based trading. Furthermore it is not consistent with the actual language contained in Dodd-Frank, which sought to allow trading through *any* means of interstate commerce. The CFTC's proposed regulations concerning SEFs compromises efficiency and transparency.

Through Dodd-Frank, Congress intended for swap trading on SEFs to develop over time in a transparent way that maximizes competition through utilization of multiple modes of interstate commerce and consistent regulation. That is why we support the goals of H.R. 2586 which seek to address these issues and ensure that end-users will have a variety of options for hedging their risk.

Finally, I would like to address the not-yet-introduced legislative proposal that seeks to clarify the swap dealer definition—a fix of critical importance to many end-users. The 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, then 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. As I previously mentioned, 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.

In conclusion, I want to thank Chairman Garrett, Ranking Member Waters and Members of the Subcommittee 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 (IOUs), 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.

Testimony of James Cawley

Javelin Capital Markets

Swaps & Derivatives Market Association

for

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

United States House of Representatives

October 14th, 2011

Chairman Garrett, Ranking Member Waters, and Members of the Subcommittee, my name is James Cawley. I am Chief Executive Officer of Javelin Capital Markets, an electronic execution venue of OTC derivatives that will register as a Swaps Execution Facility under the Dodd Frank Act.

I am also here to represent the interests of the Swaps & Derivatives Market Association which is comprised of several independent derivatives dealers and clearing brokers, some of whom are the largest in the world.

Thank you for inviting me here today to testify.

HR 1838 Repeal of Dodd Frank Act Section 716

Let me first address HR 1838 that calls for the repeal of Section 716 of the Dodd Frank Act. Section 716 requires that the US Government can no longer bail out swap dealers that do not hold deposits from the American public.

The SDMA respectfully opposes HR 1838 because it will allow for further bail outs of Wall Street by Main Street.

We oppose HR 1838, because it is not the role of government to intervene in private business by picking winners and losers. Government bail outs of private business run contrary to the fundamental tenets of free enterprise in this country.

Swap dealers, like all other private businesses must be allowed to succeed or fail on their own merits.

Swaps dealers serve no prudential role in the economy. To be sure, as we have seen from the Financial Crisis of 2008, systemic risk born of the bilateral construct of an uncleared swap increased the systemic risk of these firms. But, the swap clearing mandate, under Dodd Frank, substantially mitigates such risk and thus, in the future, these firms will be allowed to fail without threatening our economy.

We oppose HR 1838 also because of the moral hazard implications. For swap traders to know that somehow their firms and their jobs will be protected by the US tax payer would only encourage further high risk behavior, and drastically increase the likelihood of another bail out.

Lastly, the SDMA opposes such a bill because even if the US taxpayer wanted to bail out Wall Street, it simply can't afford it. With budget deficits running close the 100% of GDP, the US taxpayer doesn't have the funds. Moreover, one need only look to the paralyzed economies of Ireland, Portugal, and Greece to appreciate the ills of taking bailing outs a 'bridge too far.'

As unfortunate as it is, bad actors in finance should be rewarded as bad actors in other industries; not with bail outs, but with bankruptcy.

HR 2586 Swap Execution Clarification Act

With regard to the Swap Execution Clarification Act that calls for an override of various pre trade transparency provisions of the Dodd Frank Act, the SDMA respectfully opposes it.

To not require SEFs to show live, firm bids and offers to the entire market so that participants can transact on them, would dangerously limit fair dealing, restrict competition and increase systemic risk.

As empirical experience and academic research show, the dissemination of live, actionable prices to all market participants simultaneously increases market integrity, promotes a level playing field, and increases liquidity.

Fair and open markets, attract more dealers and buy-side participants which, in turn, foster even greater liquidity. As evidenced by Financial Crisis of 2008, the credit default and interest rate swap markets can never have enough liquidity.

The SDMA opposes HR 2586 because it would increase transaction costs.

With regard to transaction costs in the swaps markets, it is estimated that market participants pay \$50 Billion annually.

By fostering greater pre and post trade transparency, it is estimated that such transaction costs will fall by 30% or \$15 Billion annually in the first few years after Dodd Frank.

That is \$15 Billion that corporations can use on their own balance sheets to invest in research and development or hire more workers.

That is \$15 Billion that loan portfolios can pass back to consumers in the form of cheaper small business loans or cheaper mortgages for American families.

To be clear, the current SEF rules promote transparency, fair dealing and lower transaction costs.

The SEF and CFTC have mindfully permitted different execution methods such as exchange-like anonymous *Central Limit Order Books* and *Request for Quote* methodologies. Moreover, the Commissions do not restrict voice/hybrid broking methodologies. They merely require that they operate with certain pre trade transparency precepts in mind.

The Commissions have wisely allowed the markets to decide which method works best in each market context.

The SDMA, too, has several voice broker constituent firms with many hundreds of voice brokers. After our review, we support the Dodd Frank Act as passed.

To be sure, to change the rules now would be expensive to roll back. Clearing houses, dealers, buy-side and trading venues have already invested hundreds of millions of dollars in anticipation of such rules. To reverse the rules now would be costly, inhibit capital formation, cost jobs and sacrifice economic growth.

No More Delay

To conclude, the SDMA calls on the members of this subcommittee to forgo proposed Bills HR 1838 and HR 2586 and instead request an immediate finalization of clearing, execution and trade reporting rules by the regulators.

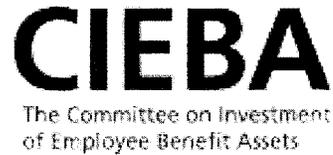
As we enter our second global financial crisis in three years, we should all be mindful that the swaps markets are no better protected today than they were in 2008.

The sooner we implement Dodd Frank, the safer the American economy will be.

I thank you for your time and am glad to answer any questions.

James Cawley
CEO
Javelin Capital Markets

Founder
SDMA



TESTIMONY OF

KENT MASON

ON BEHALF OF THE

**AMERICAN BENEFITS COUNCIL
AND THE
COMMITTEE ON INVESTMENT
OF EMPLOYEE BENEFIT ASSETS**

BEFORE THE

**SUBCOMMITTEE ON CAPITAL MARKETS
AND GOVERNMENT-SPONSORED ENTERPRISES
OF THE
COMMITTEE ON FINANCIAL SERVICES
OF THE
U.S. HOUSE OF REPRESENTATIVES**

OCTOBER 14, 2011

My name is Kent Mason and I am a partner in the law firm of Davis & Harman LLP. I have been working in the retirement plan area for almost 30 years. I am testifying today on behalf of the American Benefits Council (the "Council") 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 Subcommittee 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:

- H.R. 3045, introduced by Representatives Canseco and Garrett, which would address critical issues arising under the proposed business conduct standards applicable to swaps between dealers and ERISA plans;
- Needed legislation that would modify the anomalous treatment of ERISA plans under proposed margin regulations;

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.

- H.R. 2308, introduced by Representatives Garrett, Bachus, Hensarling, Conaway, Neugebauer, Jones, McHenry, Conaway, King (of New York), Campbell, Schweikert, Stivers, Dold, Manzullo, Hurt, Canseco, and Yoder, which would set forth specific factors that must be considered by the SEC in connection with the cost/benefit analysis of any regulation or proposed regulation; and
- H.R. 2586, introduced by Representatives Garrett, Maloney, Hurt, and Meeks, which would make critical clarifications regarding the rules applicable to swap execution facilities.

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 1 percentage point. That alone would increase liabilities substantially. 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 seven 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 1 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.

SUMMARY OF KEY CONCERNS

We have five 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. H.R. 3045 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., defining ERISA plans as entities that pose systemic risk). 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 is 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. 2308 would be very helpful in addressing this issue.
- ***Swap execution facilities.*** We are concerned that the CFTC’s proposed regulations regarding swap execution facilities (“SEFs”) could inadvertently have the effect of dramatically increasing the cost of swaps traded through SEFs. The cost increases would be attributable in part to proposed rules that would expose “request for quotes” to multiple parties prior to execution. This in turn could make it much more expensive for the dealer to hedge the trade; that anticipated additional cost would likely be passed on to the

counterparty, the ERISA plan in our case. H.R. 2586 would address this issue very effectively without jeopardizing any of the important Dodd-Frank protections and objectives.

- **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 repropose 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. There needs to be a clarification 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. At this point, Congress needs to step in and enact H.R. 3045, 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 then takes the dealer's pitch and

fully analyzes it with its 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.

This issue can also be addressed very simply by removing ERISA plans from the definition of a Special Entity. As noted above, ERISA plans are required by law to be advised by an entity with the needed expertise; thus, there is no reason to include ERISA plans in the category of Special Entities without sufficient expertise to enter into swaps without extra protections. H.R. 3045 would very appropriately remove ERISA plans from the definition of a Special Entity, thereby avoiding the problematic and unnecessary “advisor” issue. We support this.

- **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 an advisor to a Special Entity, such as an ERISA plan; 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. By law, as noted, ERISA fiduciaries must have expertise in the area in which they are advising and must use their expertise prudently. Thus, Congress’ objective is by law met in the case of an ERISA plan and there is no reason to treat ERISA plans as Special Entities, with the corresponding adverse effects described above. Again as noted, H.R. 3045 would solve this problem by excluding ERISA plans from the Special Entity definition. We support H.R. 3045.

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.
- **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 activities. 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. 2308 would be a major step forward in that regard.

Swap Execution Facilities (SEFs).

The CFTC has proposed regulations regarding SEFs that could trigger very significant cost increases for ERISA plans and other end-users. The regulations would require market participants using a "request for quote" ("RFQ") system to send RFQs to no fewer than five market participants. By requiring that an RFQ be exposed to this large a group, the rule could raise costs by making it much more difficult for a plan's dealer counterparty to hedge the trade with the plan. The dealers will likely anticipate this difficulty and raise costs. Moreover, there is no reason for the "five RFQs" requirement. ERISA plan fiduciaries have a duty under ERISA to act in the best interests of the plan participants. If a fiduciary decides that sending the RFQ to fewer market participants is in the plan's best interests, why should the CFTC regulations prohibit that? ERISA fiduciaries should have the ability to decide how best to serve the interests of the plan participants.

Similarly, the CFTC's proposed regulations would also apply other counterproductive requirements that are inconsistent with the spirit or letter of the Dodd Frank Act. For example, contrary to the statute, the proposed regulations would restrict the means by which swaps that are not required to be exchange traded can be executed on a SEF.

H.R. 2586 would provide clear workable solutions to the critical problems raised by the CFTC's proposed regulations and we support it.

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 Subcommittee 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 Subcommittee, the full Committee, 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.

**Testimony of Conrad Voldstad
Chief Executive Officer
International Swaps and Derivatives Association
Before the
US House of Representatives Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
October 14, 2011**

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

Thank you for the opportunity to testify today. I would like to begin my remarks by emphasizing several key points.

- ISDA and our members are deeply committed to safe, efficient OTC derivatives markets that support the health and growth of the real economy. We support the G20's efforts to reduce systemic risk by focusing on improving counterparty credit risk management and transparency in the OTC derivatives markets.
- Much of the Dodd-Frank Act works toward those goals, and we espouse those provisions that do so. Some parts of the proposed regulatory application of this legislation, however, work against or do not support the goal of systemic risk reduction. Furthermore, current regulatory interpretations of some DFA provisions are neither mandated by the Dodd-Frank Act nor called for by policy concerns. They seek, instead, to impose changes to the market's structure without posing any quantifiable benefit. In addition, they would create and codify an uneven and uncompetitive operating environment for firms doing business in the U.S.
- We believe these changes will adversely affect the market's functioning, impose unnecessary costs and limit the ability of firms to effectively manage their risks. The bills you are considering today attempt to fix some of these problems and for that reason, ISDA supports them.

* * *

ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

Over the past three decades, ISDA has helped to significantly reduce risk in the OTC derivatives markets. The ISDA Master Agreement and supporting documentation materials, along with the Association's work in ensuring the enforceability of their netting and collateral provisions, have helped to reduce credit and legal risk. The Association has also been a leader in promoting sound risk management practices and processes.

ISDA, major dealers, buy-side institutions and other industry associations have also worked collaboratively to reduce potential systemic risks in the global over-the-counter (OTC) derivatives markets.

The industry, for example, has proactively worked with clearinghouses to develop a better way for managing counterparty credit risk. Clearing of interest rate swaps began in 2000 and today, over \$300 trillion, representing more than 50 percent of outstanding interest rate swaps volume is cleared. Over \$20 trillion of credit default swaps volume has been cleared. Approximately \$200 trillion of OTC derivatives transactions have been eliminated through portfolio compression.

To improve regulatory transparency, ISDA and market participants have established trade repositories for interest rate, credit default and equity swaps. Trade repositories are also being established for commodity and foreign exchange swaps. These repositories provide global regulators with unprecedented visibility into risk exposures in the OTC derivatives markets.

ISDA and market participants have worked to standardize and automate middle and back office processes in order to strengthen the industry's operational infrastructure.

As these initiatives demonstrate, ISDA and the OTC derivatives markets support and are working to build robust, stable financial markets and a strong financial regulatory framework. This work is on-going and reflects our belief that improving risk measurement and management is and will remain a high priority for market participants.

* * *

Over-the-counter derivatives play an important role in the U.S. financial markets and the U.S. economy. The bills you are considering today will:

- Significantly benefit the U.S. financial markets and the thousands of American firms who use OTC derivatives to manage their risks;
- Help to ensure a fair and level playing field for financial institutions doing business in the U.S. and their customers without impacting the significant work and progress that policymakers and OTC derivatives market participants have made to reduce systemic risk;
- Work towards ensuring that the DFA is implemented in a manner more reflective of its original intent; and
- Eliminate unnecessary and burdensome costs for financial markets participants.

Let me briefly address each of these bills.

H.R. 1838

ISDA supports H.R. 1838, which would repeal Section 716 of the Dodd-Frank Act. Section 716, commonly called the swaps push-out provision, requires banks to separate and segregate portions of their derivative businesses.

As you know, Section 716 currently exempts interest rate, FX, centrally cleared credit default swaps on investment grade names, and precious metal derivatives from its provisions. These areas currently comprise 90% or more of a bank's derivatives business. Those portions of the swaps business that are not exempt from Section 716 (which would include equity derivatives and certain CDS and commodity derivatives transactions) would have to be conducted in separately capitalized affiliates that were legally apart from FDIC-insured banks.

It is difficult to see how Section 716 reduces systemic risk. This is particularly true given that firms face regulatory reporting requirements for all transactions, including transactions exempt from and covered by Section 716. Such regulatory reporting will help to ensure that exposures can not build up unnoticed in the financial system. Separately, forcing the derivatives business outside of the better-capitalized, better-regulated bank into new standalone subsidiaries could actually increase risk to the system. Section 716 will also increase risk as it leads to greater inefficiencies and the loss of exposure netting as it requires firms to conduct swaps across multiple legal entities.

While it is clear that Section 716 brings no real risk-reducing benefits, it is also clear that it has several disadvantages. It will tie up additional capital that might better be used to support investment and employment. It would also create higher funding and operational costs for the financial institutions that are required to implement it. Those financial institutions currently include only firms doing business in the U.S., as there is no similar law or regulation in place in any major foreign jurisdiction. These firms will be at a competitive disadvantage to their non-U.S. counterparts. American customers of these firms would therefore face higher costs, or will seek out lower cost non-U.S. firms to assist with their risk management initiatives and transactions. Customers will also need to evaluate the strength and capital of each Section 716 subsidiary that they may do business with, rather than that of the parent company, which will also impact their competitiveness. Section 716 also complicates the ability of financial institutions to net their exposures and to most efficiently manage their risks.

Finally, we would note that due to a drafting error, certain non-U.S.-based firms with significant U.S. operations and U.S. employees may be put at a competitive disadvantage with respect to Section 716, as they do not have the benefit of certain statutory exemptions now enjoyed by U.S.-based firms. ISDA believes the Section 716 exemptions should be extended to U.S. branches of foreign banks. This inarticulate drafting is just one of the many problems with Section 716, all of which support the need for significant action such as the repeal proposed by H.R. 1838.

H.R. 2586

ISDA and our members also support HR 2586, which would refine the definition of swap execution facility (SEF) in Title VII of the Dodd-Frank Act by requiring flexibility in the

interpretation of SEFs. In so doing, the bill would correct a number of flaws in the current proposed regulatory interpretation and better align the proposed rules with Congressional intent. These flaws have the potential to significantly and adversely affect the dynamics of the swaps market by reducing liquidity and choice and by increasing costs and ultimately risks for OTC derivatives markets participants.

One other important issue relating to the ways in which market participants can enter into and execute swap transactions would also be addressed by H.R.2586. ISDA believes the definition of a SEF under DFA is flexible: a SEF is "a trading system or platform in which multiple participants have the ability to execute swaps by accepting bids and offers made by multiple participants ... through any means of interstate commerce, including any trading facility." This leaves the definition of a SEF open to a relatively broad interpretation, not the narrower one that the CFTC and, to a somewhat lesser extent, the SEC appear to be considering. This view echoes that of The International Organization of Securities Commissions, which in its recent report on the trading of OTC derivatives, found that "[b]ased on the benefits to be gained from increased trading on organized platforms, the Task Force recommends that a flexible approach to defining 'exchanges or electronic trading platforms' for the purposes of addressing the G-20 objectives be taken in order to maximize the number of standardized derivative products that can be appropriately traded on organized platforms."

Among the most significant flaws in the proposed regulatory interpretation is the fact that the law can be, and is being, implemented differently in the SEC and CFTC proposed rules and the ways in which they address the request-for-quote (RFQ) systems. The latter mandates that RFQs be sent to five market participants and the former mandates they be sent to one. This divergence in approach means that different regulatory requirements will be imposed inconsistently on different, yet ultimately very similar, segments of the market, which will have an obviously harmful effect and create significant market and compliance inefficiencies.

Furthermore, while both proposed rules appear to go beyond that required by or contemplated in the legislation, the CFTC's proposed treatment of RFQ systems is particularly problematic. As noted above, the DFA defines a SEF as a "trading system in which multiple participants have the ability to execute swaps by accepting bids and offers made by multiple participants." Allowing a requester to direct an RFQ to the number of recipients that it chooses, rather than a number arbitrarily selected by a regulatory agency, does not deprive the requester of the ability to go to multiple participants and, in many instances, will allow for the most efficient and least costly execution. The statute permits this approach. The SEC agrees and permits an RFQ to be made to a single recipient, so long as the SEF has the capability of permitting RFQs to multiple recipients.

The CFTC SEF requirement has raised a number of questions among market participants. To our knowledge there is no objective evidence that supports or that indicates why five is the optimal number of dealers from whom quotes should be requested on a SEF. As noted above, the law itself only specifies that participants have the ability to request quotes from multiple participants. It is widely believed that the requirement will adversely impact the liquidity and ultimately pricing of OTC derivatives markets and, perhaps most importantly, limit the liquidity available to entities using derivatives to hedge and mitigate risk, such as asset managers and corporate end-users. In addition, it does not offer any significant countervailing benefits. The prices of OTC

derivatives transactions that will be cleared -- and which as noted must be traded on a SEF if there is one that makes them available for trading -- are already very competitive. It also should be noted that regulatory visibility into trading patterns and risk exposures can already be provided by trade repositories without any downside.

At this point in the process, the CFTC SEF requirement has no regulatory parallel in the EC or other major jurisdictions. Consequently, the proposal could uniquely and adversely impact U.S. markets and U.S. competitiveness.

There are other potentially negative elements of the proposed SEF regulation that H.R.2586 would also mitigate. The CFTC's proposals regarding the posting of firm and indicative quotes on a centralized electronic screen accessible to all market participants who have access to the SEF is an example. As CFTC Commissioner Sommers has said, "this provision is not mandated by the Dodd-Frank Act and may limit competition by shutting out applicants who wish to offer request for quote services without this functionality."

Finally, while they are not specifically addressed in H.R. 1838, there are others aspects of the proposed regulatory requirements for SEFs that ISDA and market participants believe should be addressed. The proposed rules for real-time reporting of OTC derivatives transactions will be onerous and reduce liquidity in the markets. The end result is increased costs and less efficient and effective risk management for derivatives users. We also believe that the "15 second delay" requirement needs clarification and should not apply to RFQs. We believe it should only apply in the limited circumstance when a dealer is contacted by one of the dealer's customers with an order to execute a trade on an Order Book and it should only apply to two orders being entered on the same Order Book. For any execution platform other than Order Book, it is not clear how the requirement would work or whether it would benefit customers. In addition, ISDA remains concerned with provisions on the SEF proposals such as high block trading thresholds, and the SEC's proposed treatment of off-SEF block trades and its proposed requirement to "sweep the book."

H.R. 3045

I would briefly like to address H.R.3045, which would amend the Employee Retirement Income Security Act of 1974, the Commodity Exchange Act, and the Securities Exchange Act of 1934 to ensure that pension plans can use swaps to hedge risks, and for other purposes. The need for this bill arose because of provisions contained in the DFA that can be read to put a swap dealer in a fiduciary relationship to a retirement plan. Such an interpretation would effectively require a swap dealer to represent both counterparties to a swap transaction, and is legally unworkable. The practical result of this will be that financial institutions will be unwilling to accept the legal risks inherent in such transactions and will limit their activities with pension plans, effectively precluding such pension plans from using OTC derivatives to manage their investments and hedge their risks, which could adversely impact their ability to generate and provide retirement income to their plan participants.

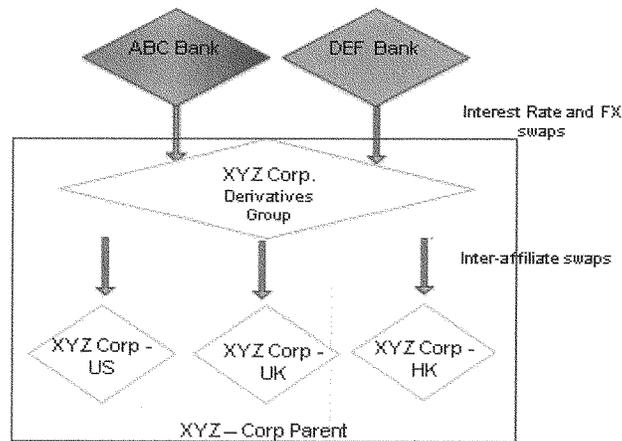
H.R. 2779

Finally, I would like to address H.R. 2779, a bill that would exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd Frank Act. This is an issue of significant interest and concern to major swaps market participants.

As their name implies, inter-affiliate swaps are transactions between two legally separate subsidiaries. They are commonly used by financial institution dealers in connection with their roles as market intermediaries and by end-users to hedge capital and manage balance sheet risks.

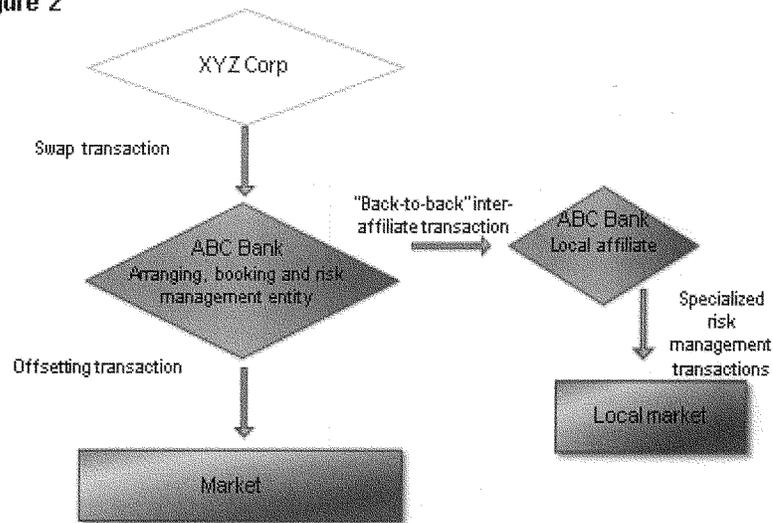
End-users (both financial and non-financial) use inter-affiliate swaps transactions for several reasons: to hedge their capital, manage risks inherent in a particular balance sheet asset/liability mix and manage other related risks arising from their general operations. For example, capital invested in overseas subsidiaries may need to be hedged for foreign exchange fluctuations. A commercial bank whose core lending and deposit taking business causes its balance sheet and earnings to be highly susceptible to interest rate changes will need to hedge for interest rate risks.

If a firm issues debt overseas, it will need to use interest rate and foreign currency derivatives to lock in costs. Inter-affiliate swaps are key to the effective management of interest rate, foreign exchange, liquidity, capital and balance sheet risks inherent in the general business of financial institutions, just as is the case for non-financial corporations. (Figure 1.)

Figure 1

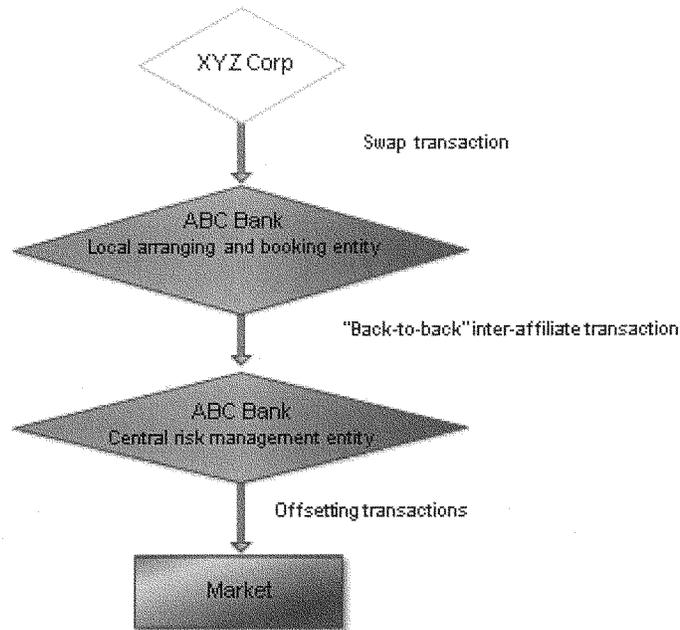
To illustrate how dealers commonly use inter-affiliate transactions: a financial institution will typically deal with swap clients in one of two ways. It will face the client with its central risk managing entity, but where necessary, hedge specialized risks through an affiliate that is permitted by local regulations to hedge that specific risk in the relevant jurisdiction. (Figure 2.)

Figure 2



The other way in which a financial institution will typically deal with a swap client is by providing local clients economic access to a variety of products through the customer's choice of a local counterparty. But at the same time, it will manage more centrally the general risk of such products by having that local entity hedge its risk through inter-affiliate swaps with a central risk managing affiliate. (Figure 3.)

Figure 3



Inter-affiliate swaps generally do not raise the systemic risk concerns that Title VII regulation is intended to address because they do not create additional counterparty exposure outside of the corporate group and do not increase interconnectedness between third parties. Inter-affiliate trades, in fact, *reduce* systemic risk by making it possible to increase the use of netting with clients and, by bringing together a diversified portfolio in one entity (e.g., the risk-managing entity), to use more offsets to manage and reduce risk.

Applying the full panoply of regulations under Title VII to inter-affiliate swaps as if they were third-party swaps will not reduce risk to the financial system, increase transparency or improve the market integrity of the financial system. On the contrary, such regulations could balkanize risks within a corporate enterprise, by forcing individual entities with limited portfolios and limited ability to access risk management to manage their own individual risks.

Imposing unnecessary requirements on inter-affiliate swaps will impede efficient, centralized risk management and thus *increase*, rather than decrease, the level of risk within the enterprise and the broader financial system.

Inter-affiliate swaps are not given separate consideration in DFA or in the proposed rules, implying that the rules may apply without taking into account the unique role of such swaps. We note, however, that several of the leading architects of Dodd-Frank specifically stated that the legislation should not apply to inter-affiliate transactions.

For these reasons, ISDA supports H.R. 2779. We note that it would not exempt inter-affiliate swaps from the reporting requirements of the DFA. All such swaps would be reported to the trade repositories as required by law and regulation and as consistent with current industry practice.

* * *

As noted earlier, ISDA and the OTC derivatives industry support regulatory reform that mitigates systemic risk by reducing counterparty credit risk and increasing regulatory transparency. Some of the current legislative and regulatory framework for OTC derivatives markets does not support or works against this important goal. ISDA believes that the remedies contained in H.R. 1838, H.R. 2586, H.R. 2779 and H.R. 3045 are an important step in addressing these problems and ensuring that markets participants are able to effectively and safely manage their risks.

October 14, 2011

Statement for the Record

On behalf of the

American Bankers Association

before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

of the

Committee on Financial Services

United States House of Representatives



October 14, 2011

Statement for the Record

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United States House of Representatives

October 14, 2011

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee, the American Bankers Association (ABA) appreciates the opportunity to submit this statement for the record on legislative proposals that would bring certainty to the over-the-counter derivatives market. 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 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 achieve that goal and also preserve 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:

- H.R. 1838 would repeal Section 716 of the Dodd-Frank Act, which will prohibit swap dealers from receiving various forms of federal assistance including FDIC insurance and access to the Federal Reserve discount window. This provision will essentially require banks that are swap dealers to "push out" many swaps transactions to a nonbank affiliate. ***ABA supports repealing the push-out provision because failing to do so would have a negative impact on bank and bank customer risk management practices and create competitive imbalances between U.S. and foreign banks.***
- H.R. 2779 would exempt inter-affiliate swaps from certain regulatory requirements put in place by the Dodd-Frank Act. ***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.***

The remainder of this statement provides more detail on ABA's position on these bills.

ABA Supports Repeal of the Dodd-Frank “Push-Out” Provision

Banks currently have the ability to centralize risk management for each customer relationship by conducting a customer’s swaps transactions together with that customer’s other transactions. ***In other words, banks can assess the credit risk of the customer and negotiate loan, swap, collateral, and other credit terms as part of a complete package.*** Customers benefit because they can receive more attractive loan terms or a higher credit limit if the bank can net and setoff different exposures from each of the customer’s transactions. ***If the push-out provision is not repealed, bank customers will face higher costs and reduced credit availability.***

Many customers also prefer to have a bank as a swap counterparty because it enables customers to centralize their own risk management of loans and other forms of credit. Customers now have “one stop shopping” for all of their credit needs, including swaps that may offset their credit risk. Swap customers may also prefer to have a bank as a counterparty from a credit risk standpoint. If banks have to push out some swaps transactions into a separate affiliate, then customers will not be able to centralize credit risk management with a bank even if it is their preferred swap counterparty.

The push-out provision would also create competitive imbalances between U.S. banks and their foreign counterparties. To date, it does not appear that other countries are considering adopting “push-out” requirements. Therefore, it is likely that foreign banks will still be able to offer integrated credit and risk management products in one entity. Customers who still want “one stop shopping” for their credit needs – including swaps – may choose to move their business to foreign banks.

If banks have to create a separate affiliate to conduct swaps transactions, then the affiliate also will have to be funded separately and meet separate capital requirements. The capital requirements for the affiliate may be entirely different from bank capital requirements if the swap transactions are done through a broker-dealer affiliate. Bank customers would have to sign new credit agreements with the bank and its affiliate. Considering all of these costs and complexities, it is likely that only large financial institutions would be able to create, fund, and capitalize a separate affiliate to conduct swaps activities that need to be “pushed out” of a bank.

ABA Supports Exempting Inter-Affiliate Swaps From Certain Regulatory Requirements

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 trades, in fact,

October 14, 2011

reduce systemic risk by making it possible to increase the use of netting with clients and, by bringing together a diversified portfolio in one entity (e.g., the risk-managing entity), to use more offsets to manage and reduce risk. Inter-affiliate swaps do not create additional counterparty exposure outside of the corporate group and do not increase interconnectedness between third parties, which is why banks have argued that these swaps should not be subject to the same rules intended for swaps entered into with a third party. *ABA is, therefore, very supportive of provisions in H.R. 2779 that would exempt inter-affiliate swaps from certain regulatory requirements.*

However, other provisions in this legislation would require additional reporting of these inter-affiliate transactions. This requirement would *not* add relevant market information. *Rather, it would be duplicative and would distort information that is already available.* ABA would like to continue to work with the Committee on this reporting provision to ensure it accomplishes the committee's goal of transparency without causing confusion to the users of reported information.

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.

BLACKROCK

July 18, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises
House Financial Services Committee
2244 Rayburn House Office Building
Washington, DC 20515

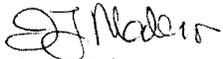
Dear Chairman Garrett:

We are writing in support of the Swap Execution Facility Clarification Act which you have proposed to introduce shortly. Based on the July 14, 2011 copy of the bill which we have reviewed, we believe this legislation will promote trade executions on SEFs, one of the goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Swap Execution Facilities ("SEFs") are a material change to the current market structure for the existing bilateral over-the-counter ("OTC") derivatives market. The success of SEFs will determine the success of cleared derivatives as they migrate from the OTC bilateral market. The current OTC market provides investment managers with a deep and liquid market, with transparency of prices linked to dependable liquidity from a range of liquidity providers. For SEFs to succeed, regulations governing trade execution need to be less prescriptive and allow flexibility in trade execution. As SEFs are phased in, market participants will gain confidence in these new market platforms which will promote liquidity.

BlackRock fully supports the objectives of the Dodd-Frank Act to establish a comprehensive regulatory framework that would reduce risk, increase transparency for both price and liquidity and promote market integrity. We believe the Swap Execution Facility Clarification Act is consistent with these objectives.

Sincerely,



Joanne Medero
Managing Director

Chatham Financial

The Honorable Scott Garrett
 Chairman, Subcommittee on Capital Markets
 House Committee on Financial Services
 Washington, D.C. 20515

Dear Chairman Garrett,

The purpose of this letter is to express support for legislation that ensures new trading requirements established by Title VII of Dodd-Frank preserve market flexibility and liquidity. The Swap Execution Facility Clarification Act, which clarifies and elaborates on the definition of "Swap Execution Facility," addresses these important end-user concerns. We therefore wanted to express our support for The Swap Execution Facility Clarification Act.

Chatham Financial is a consulting firm that works with more than one thousand end users of over-the-counter derivatives and has been actively engaged in the public policy debate on derivatives. Chatham appreciated and strongly supported the Committee's efforts to enact legislation that reduces systemic risk and increases transparency in the derivatives market. Additionally, we appreciated your work and the work of your colleagues to ensure that Main Street businesses were not unduly burdened by regulations intended to insulate the economy from the speculative trading activity of systemically significant derivatives users such as AIG.

Though non-financial end users were exempted from the clearing and trading requirements of the Dodd-Frank Act, financial end users – including community and regional banks and the pension funds of industrial companies – were not. Additionally, regulatory incentives related to capital and margin may induce non-financial end users to clear and trade on organized platforms. As such, the trading requirements are important to end users.

The Swap Execution Facility Clarification Act provides end users with discretion to choose the method of execution they deem most effective in accomplishing their objectives. This is especially important in the OTC derivatives market, where lower trading volumes and larger transaction sizes increase the risk that widely disseminated prices may offer signals to other market participants that adversely impact an end user's ability to manage risk efficiently. Though end users often prefer putting multiple dealers in competition with each other to achieve the best possible price, they will narrow the competitive dynamic if the wide dissemination of prices would have an adverse impact on pricing.

These concerns have been recognized by a diverse set of policymakers and market participants. In its February 2011 report¹, the International Organization of Securities Commissions (IOSCO) discussed the benefits of a flexible trading approach, such as would result from the Swap Execution Facility Clarification Act. IOSCO noted, "*The standardization and liquidity characteristics of the current OTC derivatives markets – including fewer active participants, a wide range and number of instruments/contracts traded with varying levels of customization, lower frequency of trading, and significantly larger average transaction sizes – create an environment in which it is more likely that trades have the potential to adversely impact execution prices.*" IOSCO further emphasized, "*For this reason, buyers and sellers may seek to retain more control of information concerning their trading interest, and while this would not be possible with a more structured model like a [Limit Order Book], it would be possible using a less structured model, such as a multi-dealer RFQ model. Both*

¹ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>

telephone trading and organized platforms that employ RFQ trading models have been used for OTC derivatives trading in part because they may maximize the dealer's and the counterparty's ability to control the flow of pre and post-trade information and thus reduce the potential for adverse impact upon the price of the dealer's subsequent hedging transactions, as well as the transaction between the dealer and its original counterparty."

In a comment letter² to regulators, the Coalition for Derivatives End-Users highlighted that "Communicating the details of these large transactions to more than one or two other parties could adversely affect end-users' ability to execute trades efficiently." The Coalition further emphasized that, "This would frustrate rather than fulfill the goals of promoting SEF usage and could work against the goals of price transparency and price efficiency." An inflexible approach to trading, the Coalition notes, "may unnecessarily prevent end users' from having access to efficient cost-effective hedging."

A bipartisan group of Senators also emphasized the importance of a flexible approach to trading requirements when it wrote³, "...regulators must avoid creating a prohibitively expensive and rigid structure for the trading of derivatives to prevent the shifting of this market overseas. An overly prescriptive derivatives market in the U.S. would no doubt encourage market participants to take advantage of less punitive derivatives marketplaces abroad."

The New Democrat Coalition expressed similar concerns in its letter to regulators⁴. They noted that, "Congress also recognized, however, that there is not always sufficient liquidity in the exchanges to support all types of swaps...The rules implementing these provisions should provide SEFs with the flexibility to operate distinctly from exchanges. We believe the SEC's proposed rule on SEFs is consistent with this goal and the CFTC's final rule should mirror the SEC's approach."

These groups and others have emphasized the importance of a flexible trading approach for an important reason. A flexible trading approach furthers the aims of the Act by ensuring that derivatives markets remain vibrant and robust for end users and support their ability to efficiently manage uncertainty. Thus, the Swap Execution Facility Clarification Act contributes to the good function of the derivatives market.

Thank you for your time and consideration of this important matter. We look forward to working with you and we are available for any questions regarding this letter.

Sincerely,



Luke Zubrod
Director

²

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31328&SearchText=coalition%20for%20derivatives%20end-users>

³ http://www.johanns.senate.gov/public/?a=Files.Serve&File_id=600d4fd6-349d-4105-b74b-c7e99f5d7796

⁴ <http://www.chathamfinancial.com/wp-content/uploads/2011/04/New-Dem-Derivatives-Implementation-Letter.pdf>



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June 10, 2011

The Honorable Debbie Stabenow
 Chairman
 The Honorable Pat Roberts
 Ranking Member
 Senate Committee on Agriculture,
 Nutrition & Forestry
 328A Russell Senate Office Building
 Washington, DC 20510

The Honorable Tim Johnson
 Chairman
 The Honorable Richard Shelby
 Ranking Member
 Senate Committee on Banking,
 Housing, and Urban Affairs
 534 Dirksen Senate Office Building
 Washington, DC 20510

The Honorable Frank Lucas
 Chairman
 The Honorable Colin Peterson
 Ranking Member
 House Committee on Agriculture
 1301 Longworth House
 Office Building
 Washington, DC 20515

The Honorable Spencer Bachus
 Chairman
 The Honorable Barney Frank
 Ranking Member
 House Committee on Financial
 Services
 2129 Rayburn House Office Bldg.
 Washington, DC 20515

Re: CFTC Proposed Treatment of Bona Fide Hedging

Dear Chairmen Stabenow, Johnson, Lucas, Bachus and Ranking Member 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.

Page 2 of 3

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 (202) 842-0400 or christine.cochran@commoditymkts.org.

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

Written Testimony for the Record

of

Commodity Markets Council

October 14, 2011

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

Washington, DC

Chairman Garrett, Ranking Member Waters and Members of the Subcommittee: Thank you for having convened this hearing on various elements of the Dodd-Frank Act. This is the written testimony for the record 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 US, Kansas City Board of Trade, Minneapolis Grain Exchange and the New York Mercantile Exchange. CMC 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 Future Trading Commission (CFTC) has been working aggressively to implement the regulations required under the Dodd-Frank Act. Today, CMC 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 "bookkeeping" 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. 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.

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 connection with a committed sale of physical cotton 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 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 [Sec4a(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 transactions 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. We 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

As stated above, 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.

Narrowly interpreting anticipatory hedges is far afield from the intent of the legislation, which is to design rules of engagement for systemically important firms. Commercial grain companies, farmers, and end-users are not systemically important to the financial system. The impact of the CFTC’s proposed rule would be to increase volatility and transaction costs to producers, processors, and end users. This is the opposite intent of the legislation.

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.

Coalition for Derivatives End-Users

October 11, 2011

House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

House Agriculture Committee
1102 Longworth House Office Building
Washington, DC 20515

Re: Support for H.R. 2779, a Bill to Exempt Inter-Affiliate Swaps from the Regulatory Requirements of Title VII of the Dodd-Frank Act

To the Members of the House Financial Services and Agriculture Committees:

We are writing to express support for H.R. 2779, introduced in August by Representatives Stivers and Fudge. The bill would prevent internal swaps transactions from being subject to a significant regulatory burden, consistent with the objectives of Title VII of the Dodd-Frank Act – to mitigate systemic risk and increase transparency in the derivatives market. Without this bill, companies could be forced to alter business structures that reduce risk and lower costs, and corporate business judgment would be sidelined in favor of government micromanagement.

Each of the undersigned companies uses derivatives to help manage risks we face in the course of our business activities. Each of us also employs, or may employ in the future, a business model through which we limit the number of affiliates within our corporate group that enter into derivatives transactions with dealer counterparties. 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 us to more effectively manage our corporate risk on an enterprise basis and to secure better pricing on our derivatives transactions. We are concerned that inter-affiliate swaps may be subject to regulations that could tie up liquidity, reduce capital investments and ultimately cost jobs. Notably, such regulations could force us to abandon a successful model for one that is less efficient.

As we understand it, regulators are 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, imposing substantial costs on the economy and on consumers.

Regulation of inter-affiliate swaps should square with a simple economic reality: purely internal swaps do not increase systemic risk. Instead, inter-affiliate swaps merely allocate risk within a corporate group. The CFTC’s regulatory approach should reflect this reality and the many

Coalition for Derivatives End-Users

benefits associated with the centralized model. In addition to the aforementioned benefits, this model makes good business sense for the following reasons:

- **Centralized Expertise:** The model centralizes trade expertise and execution in a single or limited number of entities. This concentration of expertise improves a corporate group's ability to efficiently and effectively manage its risks.
- **Exposure Compression:** Centralized models facilitate netting of positions across an entire corporate group, which lowers the overall credit risk a corporate group poses to the market generally.
- **Improved Transaction Pricing:** Centralized models allow affiliates to benefit from their parents' corporate credit ratings, allowing them to enjoy pricing benefits associated therewith.

Many of the benefits and opportunities for risk reduction provided by the centralized hedging model would disappear if regulators imposed the same requirements on both external and inter-affiliate swaps. This is because the increased costs associated with full regulation of inter-affiliate swaps would push firms away from centralized hedging and back to a decentralized model.

In addition to negatively impacting company risk management, regulation of inter-affiliate swaps could also subvert achievement of the Dodd-Frank Act's objectives. For example, while the Dodd-Frank Act's real-time reporting requirements aim to increase market liquidity and enhance price discovery,¹ reporting real-time transaction data for inter-affiliate swaps would accomplish neither goal. Because inter-affiliate trades are executed between commonly controlled affiliates, these transactions do not contribute to the price discovery inherent in trades executed between unaffiliated parties. It could instead misrepresent market liquidity by double-counting transactions, potentially flooding the market with irrelevant pricing data. Rather than enhancing price discovery, such information could have a distorting influence due to what could amount to the reporting of one trade twice.

The regulators have not provided definitive guidance on inter-affiliate transactions to this point. As a result, the Dodd-Frank Act could be misunderstood to require commonly-controlled affiliates to comply with a substantial set of regulatory requirements designed to mitigate risks found in certain external-facing trades. These regulations would undermine efficiencies that end-users currently realize through their centralized hedging affiliates without mitigating systemic risk.

The Stivers-Fudge bill provides a simple solution to the uncertainty that clouds the regulatory prognosis for inter-affiliate swaps. Under the bill, inter-affiliate trades would not be regulated as "swaps." While such trades would be transparent to regulators, H.R. 2779 would ensure trades

¹ Dodd-Frank Act § 727.

Coalition for ~~Derivatives~~ End-Users

between affiliates are not subject to regulations that were designed for trades between unaffiliated parties, and would honor the intent of Congress in passing the Dodd-Frank Act.

Sincerely,

Agricultural Retailers Association
American Petroleum Institute
Bayer Corporation
BP America
Business Roundtable
Cargill, Inc.
Commodity Markets Council
Constellation Energy Group, Inc.
Deere & Company
Eaton Corporation
EOG Resources, Inc.
Financial Executives International
FMC Corporation
General Electric Company
National Association of Corporate Treasurers
National Association of Manufacturers
PepsiCo Inc.
Prudential Financial, Inc.
Shell Energy North America
The Real Estate Roundtable
Toyota
U.S. Chamber of Commerce
Volvo Group North America



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Paul Schott Stevens, PRESIDENT & CEO

202/326-5901 FAX: 202/326-5806
paul.stevens@ici.org

July 19, 2011

The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and Government-Sponsored Enterprises
U.S. House of Representatives
2244 Rayburn House Office Building
Washington, DC 20515

Re: Swap Execution Facility Clarification Act

Dear Chairman Garrett:

I am writing on behalf of the Investment Company Institute¹ to express support for the Swap Execution Facility Clarification Act, a bill to refine the definition of swap execution facility ("SEF") in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). This bill would encourage migration of swap trading to the cleared and SEF-executed market.

Mutual funds and other registered investment companies (collectively, "funds") use swaps and other derivatives in a variety of ways. ICI and its members thus have a strong interest in ensuring that the new regulatory framework for the derivatives markets fulfills the objectives of the Dodd-Frank Act by supporting and fostering markets that are highly competitive, efficient, transparent and liquid. We are concerned that SEF-related proposals by the Commodity Futures Trading Commission's ("CFTC") and the Securities and Exchange Commission's (together, "Commissions") do not provide a sufficiently flexible execution framework to obtain these goals.²

ICI supports the provisions in the bill that limit the Commissions' ability to adopt overly prescriptive requirements for SEF trading systems or platforms. The structure of SEFs will decisively influence whether funds use SEFs, or some other vehicle, to interact with the derivatives markets. The appropriate regulation of SEFs will be of critical importance to the success of the Title VII regulation and rulemaking. ICI believes that the proposed trading restrictions in the Commissions' SEF-related proposals do not strike the right balance. The proposed restrictions enhance transparency at the expense of liquidity and efficient pricing, which could

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.3 trillion and serve over 90 million shareholders.

² See Statement for the Record of the Investment Company Institute, Hearing on "Emergence of Swap Execution Facilities: A Progress Report," Subcommittee on Securities, Insurance and Investment, Committee on Banking, Housing and Urban Affairs, U.S. Senate, July 29, 2011.

Letter re: Swap Execution Facility Clarification Act
 July 19, 2011
 Page 2

discourage the use of SEFs. The bill should help to correct this problem by preserving a SEF's flexibility to develop execution frameworks that will attract market participants.

For example, one of the provisions in the Swap Execution Facility Clarification Act would prohibit the Commissions from requiring a SEF to have a minimum number of participants respond to any trading system or platform functionality. This provision speaks to the Commissions' proposals regarding the request for quote ("RFQ") process for the execution of swaps. ICI supports the Commissions' proposed use of RFQ systems but questions, for instance, the CFTC's proposal to require that an RFQ be sent to five or more dealers. If a fund is required to go to five swap dealers prior to executing a swap transaction, it likely would suffer from information leakage and "signaling" regarding the potential transaction, which would result in the market moving against the fund. Funds and their shareholders would bear the related costs in the form of a wider bid-ask price.

A second provision in the bill would prohibit the Commissions from requiring a SEF to mandate that bids or offers on one of the SEF's trading systems or platforms must interact with bids or offers on another of its trading systems or platforms. This provision would address components of the Commissions' proposals that would require market participants to interact with resting bids or offers. In the swaps market, forcing quotes to first interact with better priced existing bids and offers may result in several negative consequences. First, it nullifies the RFQ process and thereby hinders a fund's execution strategies and objectives. Second, it fails to recognize that factors in addition to price must be considered when calculating the quality of a potential swap execution. Third, it results in fragmentation of orders, instead of a single execution, resulting in higher transaction, reporting and margin costs to be borne by funds and their shareholders. Each of these factors alone may discourage swap trading on SEFs.

As you know, funds participate in these markets on behalf of tens of millions of fund shareholders—Americans who invest through us to achieve their most important financial goals. On their behalf, we are keenly interested in ensuring that the emerging new regulatory requirements for the derivatives markets achieve legitimate policy objectives with minimal disruption to the markets, market participants, and their customers. Preserving the flexibility of SEF trading systems is one of the key steps along the way. We hope that you will keep our views in mind as you consider this legislation and otherwise oversee regulatory efforts to implement the Dodd-Frank Act.

Sincerely,



Paul Schott Stevens
 President & CEO
 Investment Company Institute

With kindest regards,

cc: Representative Carolyn Maloney
 Representative Gregory Meeks
 Representative Robert Hurt



June 5, 2011

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC SUBMISSION

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 "Commercial 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.

¹ The 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.

² CMC 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 US, Kansas City Board of Trade, Minneapolis Grain Exchange, and New York Mercantile Exchange. Please note that Hunton & Williams LLP is not counsel to CMC.

³ The 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).

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;

⁵ See *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).

⁶ See 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.

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June 5, 2011
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- Hedges of services;
- Hedges of “spread” and “arbitrage” positions;
- Hedging in the last five 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.

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

David A. Stawick, Secretary
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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 (202) 842-0400, or R. Michael Sweeney, Jr., counsel to the Working Group, at (202) 955-1500.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

R. Michael Sweeney, Jr.

David T. McIndoe

Mark W. Menezes

on behalf of the Commercial Alliance

cc: Hon. Gary Gensler, Chairman
Hon. Michael Dunn, Commissioner
Hon. Bart Chilton, Commission
Hon. Jill Sommers, Commissioner

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).

David A. Stawick, Secretary
June 5, 2011
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Hon. Scott O'Malia, Commissioner
Dan Berkovitz, General Counsel, Office of General Counsel
Bruce Fekrat, Special Counsel, Division of Market Oversight

ATTACHMENT AEXAMPLES 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 US 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 \$4.00/mmbtu and sell a calendar strip of NYMEX Henry Hub natural gas futures contracts locking in a sale price at a weighted average of \$4.33/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

⁸ Note 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.

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 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 five 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 2 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 five 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 five 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, AgriCorp 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 five 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 shipbuilder 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 US, 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.



November 22, 2011

The Honorable Scott Garrett
 Chairman
 Subcommittee on Capital Markets &
 Government Sponsored Enterprises
 Committee on Financial Services
 United States House of Representatives
 2129 Rayburn House Office Building
 Washington, DC 20515

The Honorable Nan A. Hayworth
 United States House of Representatives
 1440 Longworth House Office Building
 Washington, DC 20515

Dear Chairman Garrett and Congresswoman Hayworth:

Thank you for the opportunity to expand further on my comments before the Subcommittee's October 14 hearing to consider *Legislative Proposals to Bring Certainty to the Over-the-Counter Derivatives Market*. Specifically, I appreciate the opportunity to provide greater insight regarding the efforts of the industry to reduce systemic risk in the over-the-counter ("OTC") derivatives market.

The International Swaps and Derivatives Association, Inc.'s ("ISDA") mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

Over the last several years, ISDA and the OTC derivatives industry have worked to reduce systemic risk in order to make derivatives markets safer and more efficient. One of the most important areas of progress has been in reducing counterparty credit risk through greater use of central clearing facilities and through portfolio compression (also called tear-ups). Clearing and compression, combined with netting and collateralization of derivatives exposures, significantly reduce derivatives risks.

This letter starts with a brief summary of these initiatives and then outlines in more detail ISDA's and the industry's work in these areas. It is important to note that further progress is anticipated in both clearing and compression of derivatives transactions. Also, first half 2011 market statistics will be available shortly from the Bank for International Settlements ("BIS"), at which time much

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of the data in this letter can be updated.¹

To summarize our major points:

Clearing and compression have a significant impact on the size of the market

- Portfolio compression has helped to reduce the size of the OTC derivatives markets by \$176 billion (at year-end 2010 and by \$249 trillion today).
- Due to the impact of compression, and after adjusting for clearing, the OTC derivatives markets decreased in size by approximately 12% from year-end 2007 to year-end 2010.
- Due to the impact of compression and clearing, the level of outstanding credit default swaps has declined by some 75% over this time frame.

The industry is making significant progress in clearing derivatives:

- Over 50% of the interest rate swaps market is centrally cleared.
- The amount of uncleared interest rate swaps has decreased by 42% from the end of 2007.
- Over \$20 trillion of credit default swaps ("CDS") have been centrally cleared

Netting and collateral substantially reduce counterparty credit risk:

- The gross credit exposure of derivatives -- after netting and collateralization -- is 0.2% of notionals outstanding.

The OCC reports minimal losses due to counterparty defaults at US banks

- According to reports published by the Office of the Comptroller of the Currency ("OCC"), US bank losses on OTC derivatives products due to counterparty defaults totaled less than \$2.7 billion since 2007.

More detail about each of these points is provided below.

Impact of Clearing on Notional Outstanding

As shown in Table 1, BIS OTC derivatives statistics from December 2007 through December 2010 show that the notional outstanding of OTC derivatives markets rose throughout the period and totaled approximately \$601 trillion at December 31, 2010.

¹ Notes on data sources:

- LCH volumes (<http://www.lchclearnet.com/swaps/volumes/>) are adjusted for double-counting.
- BIS figures are based on their report: Semiannual Over-The-Counter (OTC) Derivatives Markets Statistics. As noted in the report, the published data may be subject to revisions so ISDA market analysis conclusions may vary according to BIS reports".
- BIS figures are adjusted for double-counting of positions between reporting institutions (Notional amounts outstanding are adjusted by halving positions vis-à-vis other reporting dealers), http://www.bis.org/publ/otc_hy1105.pdf.
- ISDA, <http://www2.isda.org/functional-areas/research/surveys/margin-surveys>
- Portfolio compression numbers combine tear-ups of interest rate swaps and credit default swaps for the three year period. In 2008, 2009 and 2010, TriOptima compressed US\$130 trillion, <http://www.trioptima.com/resource-center/statistics/triReduce.html> and Creditex compressed US\$6.6 trillion, https://www.theice.com/post_trade_processing.jhtml.

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The BIS figure includes foreign exchange ("FX") contracts (\$57.8 trillion outstanding). FX contracts differ significantly from other OTC derivatives contracts outstanding. They are much older products and are typically very short term. These differences are reflected in the US Treasury's decision to exempt FX swaps and forwards from the clearing and execution requirements enacted under the Dodd-Frank Act. For these reasons, FX derivatives are excluded in Table 1 from the level of OTC derivatives outstanding.

The OTC interest rate derivatives market, which accounts for the vast majority of OTC derivatives notional outstanding, totaled US\$465 trillion at year-end 2010. Of this amount, \$364 trillion was related to interest rate swaps ("IRS"). Dealers have been clearing IRS through LCH SwapClear ("LCH") for over a decade. LCH publishes monthly data on cleared volumes, and according to their data, the total amount of cleared OTC IRS at the end of 2010 was US\$248 trillion, measured in terms of notional amounts.

As the BIS has noted with regards to the effect of central clearing activities on the statistics:

"When a derivative contract between two reporting dealers is cleared by a CCP, this contract is replaced, in an operation called novation, with two new contracts: one between counterparty A and the CCP and a second between the CCP and counterparty B. As the BIS data records all outstanding positions, it would capture both the contracts in this example. This measure of the market size, i.e. a measure that captures all outstanding contracts, may be appropriate for gauging counterparty risk, given that any outstanding contract could potentially be defaulted on. However, this approach overstates the size of the derivatives market if used to proxy other aspects, such as the transfer of underlying risks, for which a single counting of the centrally cleared contracts would be more appropriate."

Table 1 shows total market activity in all OTC derivatives from Dec 2007 through Dec 2010. It also shows total OTC derivatives notional amounts adjusted by excluding FX and the impact of clearing, reducing the notional values of cleared trades by 50%. ***Measured on this basis, the OTC derivatives markets decreased in size by approximately 12% from year-end 2007 to year-end 2010.***

This reflects in part the impact of portfolio compression, which reduced notional outstanding by approximately \$176 trillion during that period (and by \$249 trillion as of October 2011.) The decline in notional amount outstanding does not necessarily indicate a change in new OTC derivatives market activity.

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Table 1
BIS, Notional amounts outstanding

US\$ trillions	Dec.2007	Dec.2008	Dec.2009	Dec.2010
Total contracts - OTC derivatives	585.9	598.1	603.9	601.0
Foreign exchange adjustment	56.2	50.0	49.2	57.8
LCH SwapClear volumes, adjusted for double-counting	54.4	75.8	107.7	124.3
OTC derivatives, adjusted for FX & LCH cleared volumes	475.3	472.3	447.0	418.9

Cleared and Uncleared IRS Volumes

Table 2 shows the total size of the OTC interest rate derivatives market, the portion of that market related to IRS, and the estimated impact of clearing on outstanding IRS volumes. It shows that the notional outstanding of all OTC interest rate derivatives was \$465 trillion at year-end 2010. As noted above, this includes \$364.4 trillion of IRS. When adjusted for double counting of cleared swaps, IRS notional outstanding is US\$240 trillion.

The cleared volume of IRS represents over 50% of the total IRS market, up from 21% three years ago. The uncleared volume of IRS has declined by 42% from \$201 trillion at year-end 2007 to \$116 trillion at year-end 2010.

Table 2
BIS, Notional amounts outstanding

US\$ trillions	Dec.2007	Dec.2008	Dec.2009	Dec.2010
OTC Interest Rate Derivatives (including FRA, IRS, options)	393.1	432.1	449.9	465.3
Interest Rate Swaps (IRS)	309.6	341.1	349.3	364.4
LCH SwapClear volumes, adjusted for double-counting	54.4	75.8	107.7	124.3
IRS, adjusted for LCH cleared volumes	255.2	265.4	241.5	240.0
IRS volumes cleared, %	21.3	28.6	44.6	51.8
IRS, uncleared	200.7	189.6	133.8	115.7

Risk Mitigation Benefits of Netting and Collateral

Notional principal amounts overstate exposure as they do not reflect the market value of the underlying contracts and benefits of close-out netting.

Table 3 shows the risk mitigation benefits of netting and collateral. After applying close-out netting, total credit exposure as reported by BIS at the end of 2010 was \$3.3 trillion, a reduction of 84% from gross market value and a reduction of 99% from total OTC notional value.

Collateralization further reduces credit exposure. According to the ISDA Margin Survey,

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collateralized exposure for all OTC derivatives on average was approximately 70% of the netted credit exposure at the end of 2010. This reduced credit exposure from 15.8% of gross market value (impact of close-out netting) to approximately 5% (impact of netting and collateral) at the end of 2010 or 0.2% of total notional amount. Expressed as a percentage of notional, at year-end 2010, the gross market value was approximately 3.5% of notional, gross credit exposure after netting was 0.6% of notional and gross credit exposure after netting and collateral was 0.2% of notional.

Table 3

BIS

US\$ trillions	Dec.2007	Dec.2008	Dec.2009	Dec.2010
Gross market values, Total OTC contracts	15.80	35.28	21.54	21.15
% of Notional Amounts	2.70%	5.90%	3.57%	3.52%
Gross Credit Exposure (after netting)	3.3	5.0	3.5	3.3
% of Gross Market Value	20.6%	14.2%	16.3%	15.8%
% of Notional Amounts	0.6%	0.8%	0.6%	0.6%
Exposure collateralized, average, all OTC deriv, ISDA Margin Survey				
Gross Credit Exposure (after netting and adjusted for collateral)	1.1	1.7	1.1	0.9
% of Gross Market Value	7.2%	4.8%	5.1%	4.3%
% of Notional Amounts	0.2%	0.3%	0.2%	0.2%

OTC Derivatives Credit Losses: Banks

Table 4 below shows the losses from charge-offs by banks since 2007 related to their OTC derivatives exposures. The table shows that losses have been modest during that period, even with the Lehman default period in 2008. Losses since 2007 totaled less than \$2.7 billion, including \$847 million (or nearly one-third of the losses over the four-year period) in the fourth quarter of 2008, when losses related to the Lehman default were most likely realized.

Table 4

OCC, Bank Charge-Offs

US\$ Millions	Q1	Q2	Q3	Q4	Total
2007	2.9	(9.2)	(119.4)	(30.7)	(156.4)
2008	(14.8)	(120.0)	(91.9)	(846.7)	(1,073.4)
2009	(218.1)	(166.3)	(213.9)	(159.3)	(757.6)
2010	(103.5)	(118.6)	(284.5)	(111.0)	(617.6)
2011	(74.3)				(74.3)
Total					(2,679.3)

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Based on this data, it would appear the US banking system managed very well through the crisis with respect to the counterparty credit risk in its plain vanilla OTC derivatives businesses. During 2011, losses have declined, with charge-offs in the first quarter amounting to \$74.3 million. Remarkably, the OCC Report also notes that only \$42 million (at fair market value) of OTC derivatives were 30 days or more past due in the entire US banking system at the end of the first quarter of 2011. Note Bene, structured derivatives tied to mortgage product were not typically booked in US banks. Large losses on these products were booked by non banks in the US and by international banking organizations mostly as the result of default by monoline insurance companies.

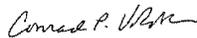
It should be emphasized that Table 4 reports the losses created by counterparty default, not the mark-to-market or trading book losses taken in trading OTC derivatives or in writing credit default swap protection on reference entities that subsequently went bankrupt. Trading losses may or may not have been realized and most likely added to the uncertainty and volatility of markets during the financial crisis. These types of losses, if not realized, would be reversed when and if markets recover.

Table 4 does include credit losses that may have been initially provided for through credit valuation adjustments (CVA) to trading income. As an example, assume that a bank had exposure of \$100 million to a weak counterparty. Accounting rules require banks to mark the exposure to market by valuing the derivatives cash flows not at LIBOR but at a rate that reflects the counterparty's credit spread. This might have reduced the valuation of the derivative receivable by \$10 million. Suppose in the following quarter the counterparty defaults and the bank is only able to recover \$75 million from the counterparty. The loss as reported in Table 4 would be \$25 million even though \$10 million would have been taken through a CVA charge in the earlier period.

* * *

Thank you for providing me the opportunity to expand further on my comments before the Subcommittee. Please feel free to contact me or my staff if you would like to discuss these issues further.

Sincerely,



Conrad P. Voldstad
Chief Executive Officer

