S. HRG. 112–280

ONE YEAR LATER - THE WALL STREET REFORM AND CONSUMER PROTECTION ACT: IMPLEMENTATION OF TITLE VII

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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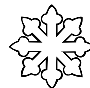

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ONE YEAR LATER - THE WALL STREET REFORM AND CONSUMER PROTECTION ACT: IMPLEMENTATION OF TITLE VII

Wednesday, June 15, 2011

UNITED STATES SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY,
Washington, DC

The Committee met, pursuant to notice, at 9:36 a.m., in room SR–328A, Russell Senate Office Building, Hon. Debbie Stabenow, Chairwoman of the Committee, presiding.

Present: Senators Stabenow, Klobuchar, Gillibrand, Roberts, Lugar, Chambliss, Johanns, Boozman, and Thune.

STATEMENT OF HON. DEBBIE STABENOW, U.S. SENATOR FROM THE STATE OF MICHIGAN, CHAIRWOMAN, COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

Chairwoman STABENOW. Well, good morning. The meeting will come to order of the Committee on Agriculture, Nutrition, and Forestry. We welcome our witnesses today and thank you to everyone that is joining us for our second in an ongoing effort to do oversight related to financial services reform.

We are here today to continue the oversight particularly of Title VII of the Wall Street Reform and Consumer Protection Act, and one year after passing financial regulatory reform, I think it is important to take a moment to remember why Congress passed this historic legislation.

In 2008 the world held its breath as we watched financial markets collapse and global financial institutions crumble. By the time the crisis subsided, millions of jobs were lost. Not only did hardworking Americans lose their jobs, but many lost their homes and their life savings in the process.

Make no mistake. The United States experienced an unparalleled crisis that required bold action. The reforms in the Wall Street Reform and Consumer Protection Act, and in particular in the derivatives title, were passed to protect the public, reduce systemic risk, increase transparency, and promote competition and decrease costs for companies that use these markets to hedge their risks.

I look forward today to the testimony and the discussion, to hear from our regulators and market participants on the implementation of Title VII. These rules and regulations will significantly impact global financial markets and our economy, which is why we must take the time to get the rules right while not unnecessarily delaying important reforms.

To that end, I would like to thank the CFTC for their commitment to phasing in the reforms, provided temporary relief for regulatory requirements, and allowing market participants to weigh in on the rules as a whole. We have seen a remarkable amount of work coming from the regulators in the past year, and I would like to commend everyone involved and their staffs for what I know is a tremendous amount of hard work moving forward.

I have several concerns that I hope the witnesses will address today as well. While we gave substantial new authority to the regulators, it will remain critical that the rules reflect congressional intent. The rules must maintain market liquidity, preserve the ability of end users to hedge and manage risk, and foster transparent, competitive markets. Regulators must also harmonize regulations not only domestically between agencies but also internationally with other jurisdictions. We must promote international harmonization to ensure that we do not undermine strong reforms to the financial markets.

These oversight hearings are an important part of the process, and I look forward to working with my colleagues and agencies and market participants to ensure that we never allow the failures of the past to be repeated.

So, again, welcome, and it is now my pleasure to turn to Senator Roberts, my partner on the Agriculture Committee. Senator Roberts.

STATEMENT OF HON. PAT ROBERTS, U.S. SENATOR FROM THE STATE OF KANSAS

Senator ROBERTS. Madam Chairwoman, I appreciate your calling this hearing today. CFTC oversight is a critically important function of this Committee, and I am looking forward to hearing from our witnesses today with regard to the implementation of the Dodd-Frank Act, especially since we are only a month away from the act's effective date. Roughly 11 months ago, the more-than-800-page Dodd-Frank bill was passed and began the process of what appears to be a re-engineering of our financial markets.

What has followed has been 385 new rules and thousands of pages of new regulations which cover areas, I think, well beyond the scope of the financial crisis or the Dodd-Frank legislation. Fifty-one of the new rules are proposed by the CFTC's 31 different rulemaking teams that are still in operation, I am sure. I fear some may suffer a classic case of the cure for Government regulations is more Government regulation.

I am curious to know whether these additional Government regulations will actually fix the mess created by non-market forces in the housing market and if any in-depth cost/benefit analysis of some of these rules has been done. That, by the way, was ordered by the President in his Executive order of January 18.

I am concerned with yet another agency putting out a litany of regulations that will raise transaction costs, stifle legitimate economic activity, increase unemployment, and create new risks and uncertainty where it did not exist before. Some of these regulations re-engineer the principles-based risk management of futures markets that did not cause the financial crisis and that have operated well for decades.

Madam Chairwoman, raising compliance costs and stifling the ability to actually manage the risks in today's global marketplace are not the objectives of this Committee, and I do not believe this administration as well. I have a real concern that choking off innovation and risk management by increasing the cost of entering into a swap transaction at a time when U.S. firms are struggling to compete globally may cause U.S. firms to seek distant shores for relief. I am worried that the Fed, the SEC, and the CFTC have spent too much time in their own respective foxholes, not really coordinating the overall regulatory impact of this act. And I am particularly concerned, as the Chairwoman and I have expressed in a recent letter to our European counterparts, that our regulatory process is headed for trouble internationally.

Here are just a couple of the pieces I am interested in exploring today. Senators Lugar, Chambliss, and I, all three former Chairmen of this Committee and a Committee in the House, sent a letter concerned that the Dodd-Frank Act creates a black hole when it comes to regulating swaps and transactions after July 16 of this year—sort of a swaps purgatory, if you will.

What happens next? I am expecting Chairman Gensler will fill us in on the Commission's actions today for members' own edification. The Chairman and the CFTC has made the top page of the Wall Street Journal, above the fold, so congratulations at least on honing in on that. Come to think of it, we could probably read this and not have the hearing, but then that is not what we are going to do.

[Laughter.]

Senator ROBERTS. Secondly, I have here an unusual letter from the Financial Services Agency of Japan asking why U.S. regulations would apply to Japanese financial institutions operating in Japan, and I think that is a fair question. They did not say, "Domo arigato." They said, "Wakarimasen," meaning "I do not know what is going on."

My third question today has me wondering why fundamental and commonly used methods of hedging on futures markets, not swaps but wheat and corn futures markets, which have been in operation for decades without incident, had absolutely nothing to do with the financial crisis, would suddenly be considered speculation by one of the rules that is proposed by the CFTC. More on that later.

In closing, I would simply suggest that instead of looking back over the past year at this hearing today, we should be examining the overall effect of all of these new regulations on our economy and globally over the next 10 years.

I thank you.

Chairwoman STABENOW. Thank you very much.

We have three excellent panels today. I am going to turn to our witnesses. I do want to say for my colleagues any opening remarks we would be pleased to enter into the record. And Senator Roberts and I, because of the importance of this hearing, have agreed that for our first panel we are going to lengthen the questioning from the regular 5 minutes to 7 minutes to allow a little more time rather than going to a second round because we have three panels today and that would make it difficult in the time allowed. But we

have agreed to lengthen for our first panel to a 7-minute round, and so I appreciate that.

Senator ROBERTS. Madam Chairman, if I may?

Chairwoman STABENOW. Yes, Senator Roberts.

Senator ROBERTS. Could I ask unanimous consent that the letter I received from the Financial Services Agency of the Government of Japan follow my comments and be inserted into the record at that point?

Chairwoman STABENOW. Without objection. Absolutely.

[The letter can be found on page 103 in the appendix.]

Chairwoman STABENOW. Let me turn now and welcome our first panelists. Of course, Chairman Gensler, Gary Gensler, is no stranger to the Committee. As Chairman of the Commodity Futures Trading Commission, we welcome you back. Chairman Gensler has spent his career in finance, both in the public and private sectors. He is widely known for his work on oversight of the accounting industry and corporate governance and Sarbanes-Oxley, and we thank you very much for joining us today.

Our second panelist is Michael Gibson, a Senior Associate Director within the Division of Research and Statistics of the Federal Reserve Board. Mr. Gibson joined the Fed after completing his Ph.D. in economics at MIT and has been there since, focusing on risk management, financial markets, and corporate finance.

We welcome both of you today, and we will ask Chairman Gensler to begin.

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

Mr. GENSLER. Good morning, Chairwoman Stabenow, Ranking Member Roberts, members of this Committee. I thank you for inviting me here today to testify. I am pleased to testify on behalf of the Commodity Futures Trading Commission.

Though the financial crisis in 2008 had many causes, it is clear that the swaps market did play a central role. Swaps added leverage to the financial system with more risk being backed by less capital. And they contributed, particularly through credit default swaps, to the asset bubble in the housing market and helped accelerate the crisis when we got closer to it. And I believe they also contributed to a system where large financial institutions which had been thought too big to fail, all of a sudden this new term, “too interconnected to fail.” So that swaps, initially developed to help manage and lower risk—and that is what they do for most of America—they also concentrated and heightened risk in the economy and to the public, and ultimately millions of Americans found themselves out of work due to the crisis.

It is essential that oversight ensures that the swaps market function with integrity, transparency, openness, and competition, free from fraud, manipulation—in essence, to make sure, as has been true for 100-plus years, that futures and then, later, swaps can be used to lock in a price, lock in an interest rate or currency rate so that businesses can focus on what they want to focus on and innovate and invest and lay off a risk to the marketplace somewhere else.

The CFTC has substantially completed the proposal phase of our rule writing. That took us about 9 or so months. And the public has had an opportunity to look at the entire mosaic. We reopened all the rules for 30 days of comments, and those comment periods closed June 3rd.

We will begin to consider final rules only after staff can actually analyze all of those comments. We have about 20,000 comments to date, 12,000 of which are on one rule, position limits, but the others you can see are spread across 50 other rules. We will summarize, consider those comments, but the Commissioners will weigh in individually. We have a wonderful Commission, and they will each weigh in on these 50 or so rules. We will start taking up some this summer, but no doubt we will be at this well into the fall, and it may well be, since we are human, that it takes a bit of time.

We are also coordinating and consulting closely with domestic regulators and international regulators. On the international front, Michel Barnier was just here a couple of weeks ago, and Europe looks to be moving on a similar approach to us. It is being debated in the European Parliament now, and they look to try to finalize their legislative package this fall on clearing, data repositories, capital, margin, and the like.

The Commission yesterday also addressed the issue that I thank the three Senators—it was a very timely letter, and we agreed with your letter. We addressed this issue of what happens with regard to July 16th. And what in essence we did yesterday is the law says that those things that are subject to a mandatory rule do not go in effect on July 16th. So until we finish these rules, they do not go into effect, and we published a list of what we thought were the mandatory rules.

But on those things that are self-effectuating, those things that would go into effect, we published relief in a proposed order until December 31st of this year. We will get public comment over 2 weeks; we will see what the public has to say about the proposed order and finalize an order of before July 16th so that the market has this certainty it needs over this period of time. If we come to November and there are still things that we have not done, then we can look and tailor appropriate relief at that time as we continue on this process.

We will be finalizing rules over the course of the summer and the fall, as I said, and you were kind enough and Congress gave the CFTC and SEC flexibility in phasing implementation dates. And it is our belief that we lower risk and we lower cost to phase the implementation rather than having it all at one time. We had a 60-day comment period. We had 2 days of roundtables on this. That comment period just closed last week, so we are trying to pull together thoughts on the phasing as we move forward.

With that, I look forward to taking any questions.

[The prepared statement of Mr. Gensler can be found on page 77 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Dr. Gibson?

STATEMENT OF MICHAEL S. GIBSON, PH.D., SENIOR ASSOCIATE DIRECTOR, DIVISION OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. GIBSON. Thank you. Chairwoman Stabenow, Ranking Member Roberts, and other members of the Committee, I appreciate this opportunity to provide the Federal Reserve Board's views on the implementation of Title VII of the Dodd-Frank Act. The Board's responsibilities with respect to OTC derivatives fall into three broad areas: consultation and coordination with other authorities, efforts to strengthen the infrastructure of derivatives markets, and supervision of many derivatives dealers and market participants.

Our consultation and coordination with other authorities consist of both domestic and international activities. Domestically, Dodd-Frank requires that the CFTC and SEC consult with the Board on many of their Title VII rulemakings. Staffs of the Commissions and the Board have fashioned a process for this consultation, and to date, Federal Reserve staff have commented on the proposed rules of the Commissions at each stage of their development.

Internationally, the G–20 leaders have set out reform commitments for the OTC derivatives markets that will form a broadly consistent international regulatory approach. The Board also participates in international groups such as the

Basel Committee on Banking Supervision and the Committee on Payment and Settlement Systems that are coordinating policies related to derivatives markets.

The goal of all of these efforts is to develop consistent approaches to the regulation and supervision of derivatives products and market infrastructures to promote both financial stability and fair competitive conditions to the fullest extent possible.

Dodd-Frank gives central counterparties an expanded role in the clearing and settling of OTC derivatives transactions, and the Board believes benefits can flow from this reform. If they are properly designed, managed, and overseen, central counterparties can reduce risk to market participants and to the financial system. Central counterparties that are designated as systemically important by the Financial Stability Oversight Council will be subject to heightened supervisory oversight.

Title VII requires that the CFTC, the SEC, and the prudential regulators adopt capital and margin requirements for the non-cleared swap activity of swap dealers and major swap participants. The Board and the other prudential regulator have released a proposed rule on capital and margin requirements. Our proposal is currently out for public comment.

Our proposal would impose initial and variation margin requirements on the non-cleared swaps held by swap dealers or major swap participants that have a prudential regulator. For swaps with a non-financial end-user counterparty, the proposed rule would not specify a minimum margin requirement. Rather, in keeping with the statute, it establishes a risk-based rule that would allow a banking organization that is a dealer or major participant to establish an exposure threshold below which the end user would not have to post margin. The proposed rule would not impose any caps on the thresholds for non-financial end-user counterparties. In con-

trast, for swaps with other counterparties, the proposal would cap the allowable thresholds.

Thank you and I look forward to answering your questions.

[The prepared statement of Mr. Gibson can be found on page 88 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Again, we will use a 7-minute question period for the first panelists.

Chairman Gensler, I want to talk for a moment about pensions and business conduct standards. We continue to hear a lot of concern from the pension community that the proposed business conduct rules conflict with the Department of Labor's current and proposed fiduciary rules. As a result of this, there is a lot of concern that banks may not enter in the swaps with pensions, in part because of the concerns about legal risk. It is important that we do not create a situation where the protection of pensions and other entities, special entities, unintentionally limits their ability to use swaps. And so I am wondering what you are doing to address this issue. Can you provide us with certainty that pensions will continue to be able to hedge their risks using swaps?

Mr. GENSLER. I think it was the clear intent of Congress that pensions would be able to use swaps to hedge their risk. They do it quite often to hedge fluctuations in the bond markets and interest rate risks. We have been working directly with the Department of Labor to ensure that the provisions of Dodd-Frank are harmonious with what they are doing, and in essence that a swap dealer working with a special entity and complying with Dodd-Frank with special entities does not somehow inadvertently become a fiduciary under ERISA rules. The Department of Labor sent us a very specific letter, which is a public letter—I believe you all have that as well—which we think addresses much of this. But we continue to talk with the pension industry, talk with the Department of Labor on remaining concerns that they have.

Chairwoman STABENOW. And I very much appreciate in general the Commission's efforts to provide legal certainty for swap transactions to mitigate disruptions in the market. But it is important to provide certainty to market participants regarding the timing and scope of the new requirements as well, and I know you have spoken to this, but I am concerned that we have not seen enough clarity on the order and the timing of implementation, which would help market participants prepare for the changes.

Does the CFTC have sufficient authority in your mind to do all of the phase-in of the reforms that you believe need to be done? And how do you plan to provide that certainty needed to allow the market participants to really be able to plan going forward since that is so important as we phase in these rules in terms of the ability to avoid disruptions?

Mr. GENSLER. We do believe that we have sufficient legal authority. Congress said that any rule can go effective no sooner than 60 days after the rule, but we feel that we can phase after that. We put concepts out publicly in late April, 13 key concepts of how to phase them, and we had 2 full days of roundtables and a 60-day comment period that people commented.

What we are looking to do is through each of the final rules to provide timing, but we might also summarize that which we have brought together from these roundtables and comment periods and so forth and provide that with further guidance to the marketplace overall.

We think it is very important that the data repositories, the clearinghouses, and the various execution platforms be what we have come to call "registration ready" or "open for business," have their rule books in place before there is any mandatory clearing or mandatory trading, and that mandatory clearing, trading, transaction compliance be phased after that and have the marketplace have sufficient time.

Chairwoman STABENOW. Let me also ask you to speak a little bit more about what is happening globally, and this is something I am hearing a great deal of concern about in terms of the international harmonization. And we know that Europe is behind us. You have spoken about their process. Senator Roberts and I recently sent a letter to our European counterparts. When we look at what is happening, given the importance to our financial industry in a global economy, to having international coordination and the need for a holistic understanding of the rules, how are you addressing the different timelines if there are significant differences in the rules themselves? What steps are you taking to avoid regulatory arbitrage? And from a practical standpoint, how do you plan on regulating global financial institutions, particularly in this time of limited resources? To me, this is a very important piece of how we move forward.

Mr. GENSLER. All great questions, on which you could have a whole hearing. But, first, the President and the heads of 19 other nations came together in September of 2009 and committed to mandatory clearing and the trading and some of the keys that were in Dodd-Frank. Some nations moved ahead of us—Japan, as Senator Roberts mentioned. But Japan, Canada is ready, we are moving about it.

Europe, they will move their legislative package through by this fall on clearing and many of the key issues. The trading components they will take up through something called MIFID probably in the fall and into next year. We, of course, are a little—we are taking some more time to get our rules in place, and it is appropriate. So some of the timing will become aligned, but also we are setting up work streams with the Europeans in particular to look at any differences.

We are an agency of only about 675 people now. We need a lot more resources. But we have had a long history of doing mutual recognition agreements where we recognize comparable and consistent regulation overseas and then defer to overseas regulators. The best example might be in London where the largest clearinghouse actually that exists today is registered with us, but we sort of defer to the British regulators, the FSA, who take the lead on that clearinghouse that clears swaps.

So we look to enter into maybe 15 or 20 mutual understanding arrangements with foreign regulators where we sort of defer where we can, as long as there is enough comparability. It does not have to be exact, but that is the standard approach that we have taken.

Chairwoman STABENOW. Thank you very much.

In a very short time limiting, Dr. Gibson, let me just say that I am particularly concerned as we go forward about the intent regarding protecting end users by providing exemptions for clearing, exchange trading, and margin rules. I want to follow up with you. I am going to do that in writing in order to respect the time that we have here, but I am concerned about the divergence of interpretation of the statute between the CFTC and our prudential regulators in terms of the stringency of the approach that is taken and very concerning to me and I know to the Ranking Member and others on the Committee that full legislative intent is followed related to this issue. So I will follow up with you in writing on that.

Senator Roberts?

Senator ROBERTS. Thank you, Madam Chairwoman.

The commodity industry from growers to buyers is concerned with your proposal, Mr. Chairman, to what constitutes a bona fide hedge. I would like to give you an example and then get your thoughts, if I may.

A Sumner County, Kansas, elevator expects in the near future to enter into a forward contract with the area wheat farmers at a fixed price with delivery at a later date. To hedge this risk, the elevator goes short on wheat futures. Under the CFTC's proposed rule, this would seem to make the elevator's future transaction a speculative one and, therefore, not eligible for the commercial hedge exemption from any position limit since at the time the elevator's futures position was taken, there, in fact, was not an underlying physical contract. This example seems to me to be a very normal transaction by a person who deals in the physical commodity, and he was trying to help farmers manage the risk. This is not AIG. This scenario is real and current. We are cutting wheat today back home, and we need clarity. Are they hedging or not?

Mr. GENSLER. I think what you have described is a hedge, so—and I think that is my answer. What you have described—somebody in the wheat markets, whether they are a farmer, a wheat elevator operator, or anyone in the supply chain, your merchant producer, they can take that physical grain into their ownership, enters into a forward or, for that matter, enters into a future, they have for a long time—and I think it was consistent with what Congress did in Dodd-Frank, is a bona fide hedger under the bona fide hedge definition.

Senator ROBERTS. So they would be eligible for the commercial hedge exemption?

Mr. GENSLER. Well, there is a number of different hedge exemptions. I believe you are referring to—Congress addressed it—I am asking because I am not entirely sure. Are you referring to the bona fide hedge transaction exemption from position limits?

Senator ROBERTS. Yes.

Mr. GENSLER. As you described it, Senator, I believe so. If there is ambiguity in the language, I would love to follow up with your staff, and we know your staff very well. Thank you, by the way. He is very good. You took him from us, but he is good. And we would be delighted to follow up to understand the ambiguity that it might be——

Senator ROBERTS. They are not on loan, by the way.

Senator Lugar, Senator Chambliss, and I sent you a letter May 27 asking for clarity on what exactly happens on the effective date of Title VII of Dodd-Frank. In your response you told us to wait for your meeting yesterday. Then yesterday you said to wait until the details were made public.

I finally saw your answer just this morning. We had one staffer who got it 7 o'clock last night, and with the 23 pages and two addendums, and are starting to digest it. I tried to digest it this morning, but I got indigestion.

I believe you have done—this is not the way to deal with a Committee hearing. Madam Chairman, I do not think we can have this kind of—I do not want to call it a "cavalier attitude," but that is about what it amounts to. In fact, if you are sent a letter, you respond a week later and say we are going to have a meeting, you have a meeting and then the very next day we come here and we still do not know the details—and I am going to recommend very strongly we have additional hearings. I know we have 7 minutes, but 7 minutes? We need 17 to get into this.

From what I understand you included a sunset date of December 31 of this year. Even if the rules are still not in place, that means we would have a 6-month purgatory. Won't that put us back in the same position of uncertainty as the date draws near? Why does it make more sense to just simply provide certainty until the new regulations become effective?

Mr. GENSLER. Senator, any regulation that is called for in the statute does not go effective until that regulation is finalized. The 6-month date only is to those things that might otherwise be self-executing, so the clearing rules, the business conduct rules, and position limit rules, and many of the rules, if the statute says write a rule, it does not happen until we—and the pressure is on us to finish that, but it does not happen even if that is March of next year.

This sunset of December 31st is only on those things that might otherwise be self-executing, and we will take a look again in November and I am committed to take a look in November to see if there are things that we should do and working with this Committee and working with market participants, if there is tailored, appropriate relief at that time.

Senator ROBERTS. I appreciate that. The CFTC has proposed over 50 rules since the passage of Dodd-Frank, comprising thousands of pages of materials. As I understand the Administrative Procedures Act, major revisions to a proposed rule require that an agency re-propose the rule for further comment. Who at the CFTC will make the ultimate determination on what changes require a rule to be re- proposed? Are you encouraging interested parties to suggest changes to rules that would not require re-proposal? We have heard this from various market participants. Will you be willing to re-propose rules if necessary? Or will the only changes that get made to your original proposed rule be those that can be made without requiring re-proposing? My commentary would be: Isn't really getting the rules right the most important thing, not timing?

Mr. GENSLER. I would agree with you, getting the rules right. The American public, though, is also still unprotected, so there is

a balancing, and we are focused on trying to get these rules completed.

On your central question, with 51 proposed rules there is no doubt that there will be some that will be re- proposed. That is the nature of rule writing, and that does not, I do not think—I am very proud of the CFTC, but really what we have asked the market to do is to give us their best comments. Given the statutory construction, we do not want to overread the law or underread it. We want to do just what Congress intended us to do, and I think that most of our rules, the final rules, will have come changes to them, and those final rules will be logical outgrowths of what we proposed. But if it is more than a local outgrowth, if it truly something new, then the Administrative Procedures Act says you re-propose.

Senator ROBERTS. I am concerned that a large number of regulations that the CFTC is proposing and the huge regulatory costs that will be imposed on industry will threaten the economic utility of derivatives. Is there a detailed analysis—has CFTC done any of the detailed analysis of the costs of being imposed on this financial system and the impact of those costs on participation in this market? That is what the President intended in his January 18 directive to all Federal agencies. There was some question as to whether or not independent agencies like yourself are included. He has since clarified that and said, yes, they are, and I certainly give him a lot of credit for that.

If CFTC has done the analytical work, would you please provide it to this Committee?

Mr. GENSLER. We worked to comply with the cost/benefit considerations as laid out by Section 15(a) of our statute. You may have well worked on it years ago helping us get that. Subsequent to the President's Executive order, which you correctly said does not technically come over us, we had our chief economist and our general counsel issue new guidance to all of these 30 or so teams as to how to comply with 15(a) but also take in mind what the President said, and that is what we will be following for our final rulemaking and any new proposals we——

Senator ROBERTS. I really appreciate that, and you will please provide it to the Committee, in terms of the analytical work, who is doing it, the detailed analysis of the cost, i.e., the cost/benefit yardstick. Just show us the yardstick.

Mr. GENSLER. Well, we include cost/benefit considerations in each of the rules we have in our proposals. We will continue to do that in the finals. We have new guidance which we would be glad to share with this Committee, that new guidance.

Senator ROBERTS. I appreciate that. Thank you.

Chairwoman STABENOW. Thank you very much.

We will go to Senator Klobuchar and then Senator Lugar.

Senator KLOBUCHAR. Thank you very much, Madam Chairwoman, and thank you for holding this hearing.

I think we all know that reckless trading of unregulated over-the-counter derivatives played a significant role in triggering the financial crisis in 2008. Bringing transparency and accountability to this market is essential, and that is why I am glad we are having this oversight hearing and that you are both here to talk about the implementation of Wall Street reform.

I think it is also important to remember, as I think both of you know, that while many financial institutions gambled in the over-the-counter derivatives market, farmers, cooperative manufacturers, and a host of other businesses that produce goods and provide services were successfully using derivatives to reduce risk in their business. Derivatives, when used properly and backed by sufficient collateral, play a crucial role in our financial and economic system.

Now, my questions are first about the speculation in the oil market. I do not think you are surprised by this first question, Chairman Gensler. We have had an ongoing dialogue about it, and I would like to hear what progress the CFTC has made. Frankly, the CFTC was required by law to implement position limits by legislation adopted by this Congress, passed in January. Back in January, these position limits were supposed to—the rules were supposed to be put in place, and I am concerned that we have not been moving ahead, at least in the energy market. We have seen some recent drop in gas prices, but I also think that we know that the recent run-up has already had a significant impact on our economic recovery.

We all know speculation alone cannot be blamed for the rising price of oil, but I think the evidence is pretty clear back in 2008 and now that excessive speculation can contribute to volatility in the market and a periodic spike in prices that we have also seen more and more of the speculation in the hands of hedge funds and others and not in the hands of people like, say, Delta Airlines that are legitimately hedging their bets.

So could you explain the reasons behind the delay and how you are going to address this to get this done?

Mr. GENSLER. One of the critical components of the Dodd-Frank Act is that Congress mandated that we, as the Senator says, get this done. We have had position limit at since the 1930s, but Congress specifically broadened that to include part of the swaps market and also narrowed certain exemptions from it.

We proposed these rules in January of this year, received a little over 12,000 comments on them. We put significant resources on summarizing those comments so we can comply with the Administrative Procedures Act and get the best judgments of the public as well. And we are trying to bring that together in a way that we can put a version of this, a document in front of our Commissioners and get Commissioner feedback based upon what to do with these 12,000 comments. There is nothing that would please me more if I could tell you that we are going to vote on it next week, but I am not here. I cannot tell you that with 12,000 comments.

But we are moving forward on large trader reporting. I think we will vote on that in the next month, and that is an important piece of this to get the data in on these position limits. And we are going to try to move this as soon as we humanly can.

Senator KLOBUCHAR. I appreciate that. I continue to be concerned, and as you know, biofuels are now 10 percent of our fuels in this country, and there has been a lot of sudden discussion about that and some potential sudden changes that I think could also affect the price of gas. So I hope that we will move forward quickly with this speculation issue.

Minnesota boasts the largest number of agricultural co- ops in the country, and there has been a concern that they could be classified as a swap dealer under the new rules. As the co-chair with Senator Thune of the Congressional Farmer Co-op Caucus—I do not know if you know that exists, but it does—I believe——

Mr. GENSLER. I have known it from you.

Senator KLOBUCHAR. I believe that we must maintain the ability of farmers to band together to market their products and manage their risk. I know the farmer co-ops have been in to meet with you as well as Commission staff to discuss this issue. How do you see agricultural co-ops that offer risk management tools to their members fitting under the new regulatory structure? Do you think they will be classified as a swap dealer?

Mr. GENSLER. We have been working I think very actively and constructively with them. Most of what they do are actually probably not even swaps. They are forwards, and under our product definition rule, which we look to get comments on, I think that will be clarified. But to the extent they do do swaps only with their members in the agricultural space, we have been trying to look through how we can sort of define that into the swap deal definition so that it is out, not in. Congress gave us authorities under de minimis definitions, and so we have been actively sort of working with the various members, not just from your State but from other States as well.

Senator KLOBUCHAR. Well, thank you, because I hope there is a way to uniquely define farmer co-ops so they can continue to do the kinds of things that they do.

Dr. Gibson, I would like your take on the margin issue. While the CFTC made clear that end users will not have to post margin, the Federal Reserve, along with the other banking regulators, proposed rules that exempt end users up to a certain threshold of exposure after which the margin would have to be collected. Can you take me through the Federal Reserve's thought process—I always like the entire Federal Reserve's thought process—on this proposed rule? And what practical effect do you think it will have on end users?

Mr. GIBSON. Yes. As required by the statute, the proposed rule of the prudential regulators applies to all swaps of a swap dealer, and also as required by the statute, it takes a risk-based approach so it divides the swap dealer's counterparties into three groups: other swap dealers or major swap participants, which is a high-risk group; financial end users are in the middle; and commercial end users are the low-risk group, because we believe that the commercial end users pose little or no systemic risk, so that justifies putting them in the low-risk group.

Our proposed rule, like the CFTC's proposed rule, would not require any margin to be collected from commercial end users as long as the exposure is below a threshold that the bank swap dealer establishes, which we believe is consistent with the status quo where banks set limits on their exposures to all their customers, limits above which they would not be comfortable having an exposure. So we believe the general structure we have proposed is consistent with the status quo for commercial end users.

Also, like the CFTC, the prudential regulator proposed rule would require trading documentation, including a credit support agreement, or a CSA. We understand that would be a change for some commercial end users that currently do not have that sort of trading documentation. So that would be an additional burden, both of our rule and the CFTC's rule. But in keeping with the general improved transparency and regulation of the derivatives market, we feel like that is a reasonable requirement. So that is it.

Senator KLOBUCHAR. Okay. Thank you very much.

Chairwoman STABENOW. Senator Lugar.

Senator LUGAR. Thank you, Madam Chairman.

Chairman Gensler, you mentioned that as many as 15 agreements may have been coordinated with trading commissioners in other countries. My question comes from this letter that has been mentioned from the chairman of the Japan Financial Services Agency which expressed "a concern regarding extraterritorial application of rules relating to the U.S. Dodd-Frank Act," and especially in regard to registration and clearing requirements.

Leaving aside the specifics of the Japanese concern, what concerns do you have or what has already developed as far as traders in the United States or others who might use the CFTC deciding to use other countries' mechanisms? To what extent, in other words, has there been deliberate evasion or really plans, simply, to express whatever they want to do through these swaps markets in some other situation?

Mr. GENSLER. Well, money and capital and risk know no geographic border or boundary, and today's modern financial system and modern communications can be moved anywhere. So that is why it is so important that we seek to work with other regulators and harmonize what we are doing.

I do not know the specific of that one letter, but I think the Dodd-Frank Act was quite specific on it in a section in Title VII where if it has direct effect, you know—if there is a U.S. counterparty somewhere in the mix— it is not, say, a Japanese bank doing a trade with a Japanese insurance company. But if it is U.S. counterparties, that may come under that. I say "may" because there are lots of specifics that could be aligned with that.

So if a foreign bank is doing business here in the U.S., they may have to register as a swap dealer. But we also were given authority by the Congress to be able to recognize some foreign regulators if they are consistent regulation or comparable, if they have capital regime or the clearing regime. Again, it does not have to be identical but, you know, that it is comparable enough that we can recognize some of those regimes.

Senator LUGAR. To what extent, if there was a crisis that occurred really through swaps, could those who created the crisis in the United States simply transfer their operations to another country? In other words, have we suppressed the specifics of at least American situations, but simply transferred to the international community something that may come back to bite us in another way?

Mr. GENSLER. I now understand the question. I think that the worst example one might say is AIG. AIG Financial Products was operating in Connecticut and London. Just because it was—actu-

ally, the gentleman that ran it ran it out of London. Just because he was in London, it was the American taxpayers that ended up on the hook for $180 billion. So because capital can be placed anywhere around the globe, yes, it can hurt the U.S. economy.

I think what we are looking at and what Congress asked us to look at is if it has a direct or significant effect on U.S. commerce or the U.S. economy, you know, we have to at least consider that and ensure that the public is protected and there is the transparency and openness to that transaction.

Senator LUGAR. Give that predicament, it is not too late ever to amend the Dodd-Frank Act, but from your experience taking a look at the problems that occurred in the markets they are trying to regulate, what should Congress have done here? Was an attempt made to overregulate situations that really do not require that and simply bollix up the situation? Or is there a legitimate concern on your part that the Dodd-Frank Act was necessary? Can you give some feel for our market?

Mr. GENSLER. I think that Title VII, the derivatives title, was necessary. I think that the American public remains exposed today and unprotected because the market. The $300 trillion size market or $20 for each $1 in our economy is yet to have the transparency and risk-reducing features like clearinghouses that can help. So I think what Congress did was both historic but necessary.

Senator LUGAR. The House of Representatives, perhaps you know, in their budget has reduced funding for the CFTC by 15 percent, as I understand it. That is not the final word on how the Federal budget may come out this year, but what are the implications for CFTC if a 15-percent reduction were to occur? How do you manage at that point?

Mr. GENSLER. It would be bad for the American public. We will get these rules done. Anybody who is thinking of the delay, and cutting our budget is a good way to slow that down, I think that would be sort of unlikely. I think we will find a way even if we are cut. But the immediate effect of cutting the budget 15 percent is that we would have to cut staff. We are only a little bit larger than we were in the 1990s. We are 675 people. We are taking on a market seven times the size—you know, you are from a great State, but think of seven more States that your police force has to take on. You need more funding. We have asked for about 50 percent more funding, and given our Nation's budget deficits, I am a little hesitant to ask for that 50 percent more. But we are taking on seven times the size. So that is, I think, a good investment for the American public. A cut to our funding would mean we could not oversee these markets. We will get the rules done, but not only could we not oversee and be a cop on the beat, but all those questions that market participants, that some of the later panels—we will not have the people to answer their telephones. There will be more market uncertainty in 2012 than necessary. We would rather have the lawyers and economists and accountants to answer the questions, give interpretations, and actually work to make sure this is a smooth transition.

Senator LUGAR. Thank you very much.

Chairwoman STABENOW. Thank you very much.

Senator Johanns?

Senator JOHANNS. Thank you, Madam Chair.

Mr. Chairman, let me start out by reading into the record just a couple paragraphs from an article that—very, very recent, in fact, within the last 10 days. This article says, “Europe’s relatively pragmatic approach to reforming derivatives regulations offers a ‘terrific opportunity’ at the expense of the United States, which risks scoring ‘one of the biggest own-goals in financial markets history,’ a senior banker said.”

It goes on to say, “‘The U.S., through Dodd-Frank and other means, is excessively focused on derivatives markets,’ Colin Grassie, chief executive of Deutsche Bank’s operations in the United Kingdom, told the recent annual conference of International Capital Market Association.”

He goes on to say, “Grassie said that Europe’s reforms of over-the-counter derivatives were so far more pragmatic than those in the U.S. and much more in tune with the derivatives markets. Derivatives are like cars and guns,” and this is a quote from him, “not inherently bad. ‘It is what you do with them,’ he said. ‘If they do what they should do, they play a very important role. Europe understands this,’ he says. The U.S. has failed to understand it.”

Now, you know, I listened to the testimony today, and you throw these phrases around like the rest of the administration, to be honest with you. I sit on Banking, I sit on Ag. You know, this parade of people come and taxpayers are on the hook for $180 billion. I am so tempted to walk through where that money went to with you, but I will spare everybody that. You talk about the American public is currently unprotected. You talk about capital and risk know no boundaries, et cetera. All of the right things to say. But I sit here and listen as a former Cabinet member, a former Governor, trying to promote economic development, et cetera, and I say to myself, “How did a wheat farmer and a co-op in Kansas get tangled up in this?” And, you see, to me and the average person out there, that makes no sense whatsoever. They just go, “This is ludicrous.”

But, most importantly, what is happening out there in my personal opinion is this: You are seizing up the marketplace. People cannot decide what to do next. They do not know if you are going to be regulating them, not regulating them, what the extent of the regulations are. And I think it is just having a depressing impact on the whole economy, and I am not just talking about the Kansas wheat farmer. I am talking about the entire financial markets. They are just freezing up from this fear of what Dodd-Frank is turning into.

Let me just ask you directly. Don’t you think we overdid it here?

Mr. GENSLER. With all respect, I think that the Dodd- Frank derivatives title was very necessary. A market that is so large does affect the wheat farmer. That wheat farmer in Kansas is not going to be a swap dealer, is not going to be an end user, is not going to have to post—come into clear or post margin under the proposed rules. If there are any doubts about the co-ops, we are working with the co-ops, because that is clear, that is congressional intent. But is lowering risk because that wheat farmer actually lost out. They lost out when the financial system failed in 2008. And, by the way, the regulatory system failed. It was not just Wall Street. The regulators failed, too. And so that is, I think, what is necessary and

appropriate. Based upon a lot of public input, we are going to get the rules finished and balanced. We have given more time here. I think that balance is important. But I think that was very much appropriate because millions of Americans were put at risk by a financial system that at least in part failed due to derivatives. There were a lot of other reasons as well.

Senator JOHANNS. You know, and my response to that is, "There you go again." You just create this impression that if we are not out there regulating everything and eliminating risk from the marketplace, that somehow the wheat farmer in Kansas is going to get punished again. And all I am asking you—and I think it is a very fair question here: Doesn't it occur to you that with the risk of losing this business, literally forcing jobs and capital to the place of least resistance, which, holy smokes, that might be Europe? I mean, can you imagine? Haven't we just gone too far? Aren't we just crazy in our overregulation here? Isn't there someplace where you would just give me a little victory here and say, "I think maybe we did too much here"? Because it looks to me like we have punished everybody for no good reason.

Mr. GENSLER. I think that Congress took a balanced approach in Title VII and that there is going to be more transparency and more competition in a marketplace and that markets work best when there is that transparency and competition in the marketplace. We are going to work closely with European regulators to harmonize and where we can within the statute try to harmonize and bring it together.

There are certainly things that we are doing to try to interpret the statute in a way to harmonize. It was even a good question the Chairman and the Ranking Member raised about indemnification in the data repositories that Chairman Schapiro and we have come together to try to find a way and thread the needle to lower that concern of the Europeans. So where we can, we are looking to try to harmonize as best we can to bring alignment but also to make sure that our financial markets are strong and that the taxpayers do not stand behind the large financial institutions as they, unfortunately, have.

A perverse outcome of the crisis is that a lot of people in the market think it is even more likely that taxpayers will bail these companies out because they are even larger. They are larger as a percentage of the economy now. And we did it once. We did it in 2008. That is a perception, and Title VII helps to address that in part.

Senator JOHANNS. Thank you, Madam Chair.

Chairwoman STABENOW. Thank you.

Senator Chambliss?

Senator CHAMBLISS. Thanks, Madam Chairman. Chairman Gensler, Dr. Gibson, good to see both of you.

Mr. Chairman, you will recall leading up to the debate on Dodd-Frank as well as throughout the debate, you and I had tons of conversations in my office and by telephone and in this Committee room about the implication of these drastic changes in the regulation and how the impact of it was just—as Senator Roberts, Senator Lugar, and Senator Johanns just alluded to, it is going to drive business offshore. And we were very concerned about that,

and you kept reassuring us, as well as Secretary Geithner kept reassuring us that, no, no, that is not going to happen. We are going to lead the way. The Europeans are going to follow us. The Asians are going to follow us, and everybody is going to be happy, and everybody is going to have the same amount of business.

Well, I hear you defending the language in Dodd-Frank with respect to the overregulation, in my opinion, of the swaps and derivatives market and that, you know, the Europeans are still going to come along. But very honestly, Mr. Chairman, the facts are not on your side. The letter Senator Lugar referred to earlier was dated back in April. It came from the head of Japan's Financial Services Agency. In that letter he says they have a concern regarding the extraterritorial application of rules relating to the U.S. Dodd-Frank Act. He went on to voice a particular concern over registration and clearing requirements, and the letter concludes by saying that Japanese institutions might have to avoid trading with U.S. institutions, exactly the concern that we had back then.

Last week Secretary Geithner gave a speech in which he said the U.K. had set a tragic example through light-touch regulation, and he warned that it was essential for European and Asian jurisdictions to fall in line with the United States on derivatives regulations. Well, what did the Europeans do? A gentleman, a European regulator from Britain, Martin Wheatley, responded in this way: "To suggest that the United States sets a gold standard that other markets should follow is nonsense."

I mean, Mr. Chairman, if we continue down the road of overregulating this industry—and certainly there was some participation by this industry in the collapse of 2008, but it was not the sole reason. There were many, many other reasons why the collapse occurred. And if we continue down the road of overregulation, it is pretty obvious that the concerns that a number of us had that were attempted to be allayed by you during the debate and, unfortunately, you prevailed and we did not, but our fears are going to come true, and are true today. We are seeing swaps and derivatives traded around the world in markets even like Panama, and we are supposed to take some confidence in the fact that because we are going to overregulate the financial markets in the United States that everything is going to be safe and secure in the future.

I would like your comment to that.

Mr. GENSLER. Well, I think that what happened in 2008 and what was addressed by Congress was to ensure that the transparency comes to these markets and we lower risk in the markets if U.S. commerce is affected. "Directly and significantly affected" I think are the words of the statute. So if it is a transaction, whether it is in Panama, Germany, Japan, and it is between, you know, Germans, Panamanians, or Japanese, that is not what is under this. But if it relates to the U.S. commerce, to have that transparency, to have that openness in the marketplace. And that is going to—that is the core of it. We are going to work very closely with the Securities and Exchange Commission, with the other domestic regulators like the Federal Reserve but also with the international regulators on this harmonization. We share just about all of our draft rules with the Europeans and sometimes with the Canadians and the Japanese and have them take a look—they give

us comments—even before we published them as proposals. And we have gotten a lot of very constructive feedback.

We meet with the most senior folks and the staff folks. We have ongoing work streams with them on this. And so we are not going to end up identical, and certainly if there is a transaction in Germany between German parties, that is not what we are covering here. But it is really related to U.S. commercial and derivatives markets.

Senator CHAMBLISS. Well, I appreciate your response, but very honestly, I do not think that is good enough to provide security in the U.S. marketplace. For example, it is my understanding that 54 percent of the credit default swaps that have been issued by financial institutions in Greece are owned by U.S. financial institutions. We know what is going on in Greece, and if the economy of Greece collapses and the financial institutions in Greece collapse, I am not sure what impact that will have, but I would like your comment on whether or not that is, in fact, the case, what regulatory measures do you have in place to ensure that U.S. institutions do not get overloaded and countries that are on the brink of collapse like Greece? And what would be the impact of the collapse of the Greek economy as to our financial institutions?

Mr. GENSLER. The last part of it I might let the Federal Reserve answer, but I think that that is actually an example why you would want U.S. regulators to be looking at U.S. banks for the credit default swaps they might write, as you say, on Greece or any other country, because if they are providing insurance—and that is in essence what a credit default swap does, is insures against the risk of a default in a country overseas, and if that is going to come back and hurt the capital base of U.S. banks and maybe hurt the taxpayers in the U.S., you would want the banking regulators and the appropriate market regulators to be looking at that.

I do not know if the 54 percent number is accurate. We could try to get back to you on that specifically. But if it were accurate, I think that is an example why you would want U.S. regulators, banking regulators particularly, to be able to see into those banks and make sure there is enough capital and margin behind those credit default swaps.

Mr. GIBSON. I can add that we have been looking closely at the exposures of U.S. banks to Greece in particular for a number of months, and exactly as Chairman Gensler said, making sure that we are comfortable that the exposures are kept in check relative to the capital and resources available.

Senator CHAMBLISS. Do you know if that number is correct?

Mr. GIBSON. I do not know about the specific number you cited, but we can look into that.

Senator CHAMBLISS. Are you concerned about the amount of money that U.S. banks hold on Greece-issued credit default swaps?

Mr. GIBSON. We have been monitoring it closely for a number of months, and our efforts are designed to make sure that whatever exposures there are are manageable.

Senator CHAMBLISS. Thanks, Madam Chair.

Chairwoman STABENOW. Thank you very much.

As we conclude the first panel, thank you very much for joining us today. We take our oversight responsibilities very seriously on

this issue, and we will continue to work with you. We appreciate all of the efforts and the responsibilities that have been given through the new statute. And we also know that we continue to have to work together on these international issues, which are very important, as we make sure that first and foremost we are focused on the American consumer, the American taxpayer, the American citizens in terms of how this system moves forward, but we are impacted about what happens around the globe. And as you can tell from the questions by the Committee, we are concerned about how this will proceed and the implications of it when we are involved in the challenges of harmonizing with various countries around the globe.

So thank you both very much. We look forward to working with you.

Mr. GENSLER. Thank you. We look forward to continuing working closely with you.

Chairwoman STABENOW. Thank you very much.

We will ask our second panel to come forward. I am very pleased to have two additional distinguished leaders with us to speak about this topic. And we will have a third panel today as well, so we ask the patience of the Committee. We have a lot of important information to be gathering from the hearing today.

Well, good morning. We are so pleased to have both of you with us this morning. Let me introduce our first witness on our second panel.

Brooksley Born, we welcome you to the Committee and appreciate your leadership over the years. Recently a member of the Financial Crisis Inquiry Commission, a group tasked with investigating the causes of the recent financial crisis, also a former Chair of the CFTC under President Clinton, and someone who has extensive experience with the derivatives markets and certainly the issues leading up to the crisis that our country faced. So we welcome you this morning and look forward to your testimony.

We also want to welcome Dan Roth. Mr. Roth is the president and CEO of the National Futures Association, where he has been for over 25 years. We all know that the NFA is a congressionally authorized organization intended to self- regulate and protect the integrity of the derivatives market.

So we welcome both of you, and we would ask Ms. Born to proceed.

STATEMENT OF HON. BROOKSLEY BORN, FORMER COMMISSIONER, FINANCIAL CRISIS INQUIRY COMMISSION; AND FORMER CHAIRPERSON, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Ms. BORN. Thank you very much, Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee. Thank you so much for inviting me to appear before you to discuss the implementation of the derivatives provisions of the Wall Street Reform and Consumer Protection Act. Effective and prompt implementation of these provisions is critically important to protect the American public and our financial system.

The Financial Crisis Inquiry Commission on which I served recently issued its report on the causes of the financial and economic

crisis in the United States. In that report the Commission concluded that profound failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were among the prime causes of the financial crisis. The Dodd-Frank Act addresses a number of the causes of the financial crisis found by the Commission, including the unregulated over-the-counter derivatives market.

The Commission in its report specifically concluded that OTC derivatives contributed significantly to the financial crisis. The Commission found that this enormous market was characterized by uncontrolled leverage, lack of transparency, lack of capital and margin requirements, speculation, interconnections among firms, and concentrations of risk.

The Commission concluded that derivatives known as credit default swaps fueled the securitization frenzy and the housing bubble by encouraging investors in mortgage- related securities to believe that they were protected against default and also were used to create synthetic CDOs, which were merely bets on real mortgage securities and amplified the losses from the collapse of the housing bubble.

Insurance giant AIG's sale of the credit default swaps on mortgage-related CDOs without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the Government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system.

In addition, the existence of millions of OTC derivatives of all kinds, not merely credit default swaps, created interconnections among a vast web of systemically important firms through counterparty credit risk, exposing the financial system to contagion and helping to precipitate the massive Government bailouts.

The financial regulatory reforms in Title VII of the Dodd-Frank Act are vital to strengthening the financial system and reducing systemic risk posed by this unregulated market. However, there now appears to be a concerted effort by some large financial institutions and their trade associations to prevent full implementation and enforcement of Title VII and other provisions of the Dodd-Frank Act. Bills are pending in Congress that would weaken or repeal the act. Efforts to persuade or require agencies to issue watered-down regulations or to delay or otherwise fail to fully implement provisions of the act are underway. The CFTC is threatened with funding cuts that will impair its ability to implementation and enforce Title VII.

The political power of the financial sector is still enormous, and policymakers in Congress and the executive branch must have the political will to resist these efforts to derail regulatory reform. If we as a country do not learn from the financial crisis and put in place the regulatory reforms needed to address its causes, we may be doomed to suffer future financial crises. The American people deserve better.

Thank you.

[The prepared statement of Ms. Born can be found on page 47 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Roth, welcome.

STATEMENT OF DANIEL ROTH, PRESIDENT AND CEO, NATIONAL FUTURES ASSOCIATION, CHICAGO, ILLINOIS

Mr. ROTH. Thank you, Madam Chair. For the last 30 years or so, NFA has acted as the self-regulatory organization, the industry-wide self-regulatory organization for the U.S. futures industry. Now, though, it looks like we may be taking on some significant additional responsibilities in light of the CFTC's Dodd-Frank rule-making.

What I wanted to do today, if I could, would just be to spend a little bit of time talking about the new responsibilities that may be coming NFA's way and what we are doing to prepare for those responsibilities.

The first involves the registration process. The CFTC has proposed that NFA handle the registration process for all swap dealers and major swap participants. Frankly, for the last 25 years we have handled the registration process for every category of registration under the Commodity Exchange Act, so this is not anything that is particularly new to us. We have already made the changes necessary to our Web-based registration system to accommodate these new categories of registration, and we can begin accepting and processing applications and conducting the necessary background checks whenever the CFTC asks us to do that.

The trickier part of the registration process is going to come as the CFTC's new rules under Section 4s of the Act are implemented. What the Commission has proposed is that each firm would become provisionally registered as a swap dealer or major swap participant, but then as each of the new rules kicks in, the applicant would have to submit to NFA its policies and procedures that are reasonably designed to demonstrate that they will be in compliance with the new rule, and NFA will then have to review those fairly voluminous submissions in a thorough and meaningful and timely manner. So this is going to require us to really bring on additional staff from outside of NFA. We are going to have to redeploy some of our existing resources temporarily to handle that charge. And we are going to have to develop very clear guidance for our staff to review those submissions. And on all of that we will be working very closely with the CFTC, but we cannot really complete that process and develop the guidance for our staff until the rules themselves are adopted in their final form.

In addition to the registration process, the CFTC has proposed that all swap dealers and major swap participants become members of National Futures Association, and our responsibility, our basic responsibility, would be to monitor those firms for compliance with the applicable regulations, though obviously for some of the major bank firms that have prudential regulators, our responsibilities might be somewhat more limited.

In order to take on that additional responsibility, we have got to accomplish three basic undertakings that I have described in my written testimony.

First, we have to revamp our governing structure at NFA to ask sure that our board structure has enough checks and balances to deal with the issues that I described in my written testimony. We

have a committee that is working on that. We have made significant progress on that. We cannot complete that process, though, until we have final definitions of the terms “swap dealer” and “major swap participant.”

Secondly, we have to work out a funding mechanism to make sure that NFA recovers its costs of performing these regulatory functions. And, again, we cannot say for certain what those costs are. You do not know until you know. You do not know until you see how many firms walk through the door and how many members you actually have. We are working under the assumption that we will have to almost double the size of our compliance department and generate somewhere in the neighborhood of $25 million a year in order to recover our costs.

The third thing we have to do is just prepare to do the work itself. We have to recruit and hire and train staff that have experience in these markets. We need to train the existing staff at NFA to perform some of these functions, and we need to prepare audit modules and audit programs so that when our staff goes out into the field they can monitor for compliance with the rules in a manner that is very effective and yet very efficient and a smart way to approach the work. So we have to develop those audit modules. We cannot, obviously, complete that work, again, until the 4s guidance is complete.

One final thing I wanted to make a third area of responsibility for NFA will involve swap execution facilities. Dodd-Frank imposes certain self-regulatory functions and surveillance responsibilities on swap execution facilities. The CFTC has proposed allowing those SEFs to outsource that function to an organization like NFA. This is something we have been doing for the last 10 years with respect to some of the smaller contract markets. We know this is a very different sort of business model than the contract markets. We are going to have to revise our surveillance programs to accommodate those changes. We have been working very closely with SEFs and with the CFTC to try to determine the exact audit trail of information we will need to perform that function, and we will continue to work with SEFs and with the Commission to try to make sure we can take on that responsibility when the time comes.

So it is a very different time for NFA, a lot of new responsibilities coming our way, but we look forward, as we have for the last 30 years, to working very closely with the Commission and the industry to find solutions that hopefully work for everybody.

Thank you.

[The prepared statement of Mr. Roth can be found on page 95 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Ms. Born, when we look back at the year 2000 and we look at your position with the CFTC at the time, you were a lonely voice expressing concern about deregulation at that time and what could happen, and we fast-forward to see, unfortunately, what did happen. I wonder if you might talk about what you believe are the most important reforms or authorities in Dodd-Frank that could have prevented the financial crisis.

Ms. BORN. Well, as the Financial Crisis Inquiry Commission found, the statute in 2000, the Commodity Futures Modernization

Act, that deregulated the over-the-counter derivatives market was, we believe, a key turning point in the process going toward the financial crisis. I think the most important reforms in Title VII are the central clearing provisions and the exchange trading provisions.

What we saw in the financial crisis in 2008 was an enormous market of more than $670 trillion in notional amount worldwide that was not transparent. It was opaque. Regulators, market participants, traders in the marketplace did not have a picture of the market itself. They did not know the amount of exposure of their counterparties.

Transparency is provided by exchange trading. Price discovery was also lacking in many aspects of the market. There was an inability to price many transactions. Exchange trading provides price discovery in a meaningful way.

Counterparty credit risk was what added to the panic in the fall of 2008. It is the reason that the derivatives market froze up, that the credit markets froze up, and we were on the brink of being plunged into another Great Depression. Central clearing provides protection against counterparty credit risk in a significant way and will make a big difference.

Chairwoman STABENOW. Thanks very much. I wonder, again, with your experience at the CFTC if you might speak a bit about what is happening in terms of the debate around the budget for the CFTC. There is a lot of debate about defunding, about reducing the budgets, and I am concerned that this will actually create more delays or more uncertainty or potentially more damage to financial markets if they are not able to fully address the concerns in a timely manner and move forward in a way where the implementation is done in the right way. But I wonder if you might speak to whether or not from your judgment you think that the current budget is sufficient to implement the reforms, to oversee the global market issues that we have been talking about, and what impact it would have on our ability to protect consumers if we were to see what the House passed, which I believe was a 44-percent cut in funding for the CFTC. If that actually were to happen, how would that impact what we are all concerned about in terms of implementing these changes in the right way?

Ms. BORN. Well, I believe that the CFTC needs more resources in the next fiscal year than it has in this fiscal year, and that it should have a substantial increase rather than any decrease.

The size and resources of the CFTC are not that much bigger than they were in the late 1990s when I was Chair. There was a 10-year period where there was little or no expansion of staff. Indeed, the staff fell below the staffing levels in the late 1990s.

The staffing level is now back up to about what I had or slightly above it, but, of course, the regulated futures and options markets have grown exponentially in the 10 to 12 years since I was Chair. And the responsibility for the over-the-counter derivatives market, which approaches $300 trillion in notional amount just in the United States, is an enormous new responsibility.

I think that to be really effective in full implementation and enforcement of the act, the CFTC needs more resources.

Chairwoman STABENOW. Thank you very much.

Senator Roberts?

Senator ROBERTS. Mr. Roth, regarding the registration of swap dealers and major swap participants, in your testimony you mention that the CFTC's proposed rules allow provisional registration for swap dealers and major swap participants before all the rules are finalized. As each rule is finalized, the NFA would review compliance with the new rule by each provisional swap deal and major swap participant. Do you think this process, this provisional registration process, is the most effective means of registering new swap dealers and major swap participants? Could there be a better or more efficient process in your view?

Mr. ROTH. Yes, I think the provisional registration process is actually workable in that it is an opportunity for firms to begin the registration process while allowing the CFTC to phase in the 4s requirements over a period of time. The provisional registration process provides that those submissions have to be made at NFA. There is not a specific clock or deadline by which those submissions have to be reviewed and approved. So I think there is some flexibility built into that system that will allow the registration process to occur while these rules are being phased in. So I actually thought it was a fairly workable approach.

Not to minimize the effort that is going to be involved for the firms to make the submission.

Senator ROBERTS. I am glad you added that last part.

I noticed that your testimony suggested a phased-in approach to regulatory requirements for swap execution facilities—everything has to be an acronym in this town, so that is a SEF so that NFA would not have to attempt to begin to perform regulatory services for all interested SEFs on the same day. Do you have any indication that the CFTC will agree with your suggestion? In the absence of a phase-in, how would one determine which SEF would receive your regulatory services first, thus perhaps providing a competitive advantage to the earliest SEF?

Mr. ROTH. In its rule proposal regarding SEFs, the CFTC proposed to avoid exactly the sort of competitive advantage that we were talking about in our testimony by providing that all SEFs that had their applications by a certain date would be able to continue to operate while their applications were being reviewed.

I think the approach that we are suggesting with our testimony is completely consistent with that, which is, again, that the SEFs should be allowed to continue to operate while—to the extent that they are contracting with NFA for us to perform those services, while we phase in that operation, they should be allowed to continue to operate to avoid an artificial competitive advantage for those that are there first.

So I think the Commission is—based on its rule proposal, I think they are sympathetic with our view, and I would certainly hope that they would be.

Senator ROBERTS. I appreciate that.

Thank you, Madam Chairman.

Chairwoman STABENOW. Thank you very much.

Senator GILLIBRAND.

Senator GILLIBRAND. Thank you, Madam Chairwoman, for holding this hearing. Thank you for your testimony, both of you. I have two areas of questions.

The first is the issue of extraterritorial application of margin. I do not know if you have seen it, but a number of Senators, we sent a letter to Chairman Gensler and to other agencies and regulators asking them specifically about whether they intended to have the same margin requirements on U.S. subsidiaries operating abroad in non-U.S. firms because obviously the concern is it creates an enormous competitive edge for competitors if we have to satisfy those margin requirements in those markets. I would like your thoughts on that issue.

Ms. BORN. Well, I have not done much thinking specifically on that issue. You know, it was a foreign subsidiary of a U.S. company that brought down AIG. Most of AIG Financial Products' activities were in London, and they entered into an enormous portfolio of credit default swaps without putting forth collateral, without putting forth margin, without putting aside capital reserves.

So one should keep in mind about this issue that this can threaten the U.S. parent; it can threaten the U.S. financial system.

Mr. ROTH. Can I just mention that regulatory arbitrage is always going to be an issue, and Chairman Gensler alluded to this. If you look at the CFTC's previous experience in dealing with its Part 30 regulations, the Part 30 regulations create exemptions for certain foreign intermediaries if they are subject to a regulatory regime that is comparable to the U.S. regulatory regime. That Part 30 regime has been in place for a long time and has worked extraordinarily well, I think. But a key ingredient of it is, again, assessing the overall comparability of regulation. And to the extent that a particular jurisdiction, for example, had margin requirements that were far less stringent than ours, then I think it would not qualify for that sort of reciprocal recognition.

Senator GILLIBRAND. Further to that question, in the AIG example a lot of their contracts were with U.S. counterparts, so that was one of the reasons why—and, granted, they had all contracts in one direction, assuming that the real estate industry would never go down in value. Bad assumption. But some of those contracts were with the U.S. counterparts, and under the regulatory framework that we have talked about in Dodd-Frank, those U.S. counterparts would have capital requirements as well and 100 percent disclosure.

So if you know enough details about the AIG example, do you see those protections as being sufficient if we did not have capital requirements for the non-U.S.-based entities?

Ms. BORN. Well, AIG Financial Products also had enormous credit default swap commitments to European banks. I do agree with Mr. Roth, however, that international discussions, international harmonization, can be a solution here. Certainly when I was at the CFTC, we worked very closely with European regulators to try to, number one, harmonize derivatives regulation but also, secondly, to recognize equivalent regulatory schemes abroad. And we entered into a number of memoranda of understanding with European countries' regulators that recognized that their regulatory scheme was essentially comparable. And I think that that is what the

United States regulators and Secretary Geithner are working toward today.

Senator GILLIBRAND. I agree that that is what they said, and I also agree that we have made efforts with memorandums of understanding. But, unfortunately, we have also heard from foreign regulators that they think that they are skeptical of the U.S. approach, that they do not necessarily follow the approach or that they are skeptical about the pace of reform. And so my concern is that if we do not make it a priority—because I really believe we have to have international harmonization, because if we do not there will be immediate regulatory arbitrage, and that will be very devastating to the U.S. economy. If you have billions of dollars of transactions that would normally originate in the U.S. being conducted abroad, that is an enormous amount of—or less investment in the U.S. and I our economy at a time when everything we are trying to do here in Washington is to create a greater opportunity for job creation, to make a greater landscape for economic growth.

So what should our regulators be doing now or what should the administration be doing now to make it more likely that we will have harmonization in a timely fashion? Because even Chairman Gensler said this morning he expects the regulatory reform to take an additional 6 months from his July deadline, but how do we expect to have harmonization within the next 6 months? And what could we do to make that more likely?

Chairwoman STABENOW. And I will ask you to be brief in your answer.

Senator GILLIBRAND. Sorry. Thank you, Madam Chairwoman.

Ms. BORN. Well, from my view—and I have talked to both U.S. regulators who are working on this, and I have met with a number of EU personnel who are involved—I think there is a very good-faith, strong effort going on right now, and I believe that there will be adequate harmonization. Of course, as Chairman Gensler said, some countries are ahead of us, for example, Canada.

Chairwoman STABENOW. Senator Lugar.

Senator LUGAR. Thank you, Madam Chairman.

Chairman Born, in testimony before our Committee at the time the Dodd-Frank bill was being drafted, we had many persons coming in and saying we are just regular businesses in the United States doing manufacturing, trying at least to get some pricing of commodities, or we are wheat farmers or corn farmers or what have you, we are not AIG or we are not very sophisticated people. And as a matter of fact, they were attempting to draw a distinction between persons in the back room at AIG or very sophisticated bankers trying to figure out how to game the system and in due course, as you pointed out, brought it to a crashing halt.

Was there any way of drafting Dodd-Frank in ways that recognized these more modest uses of swaps and derivatives as opposed to some defensive mechanism toward the cleverest of all, who may still be thinking even as we are talking today, about how to outsmart Dodd-Frank or the system we are talking about? In other words, the idea of transparency is very important, trading on exchanges, but is there any potential differentiation between the sophisticated bankers and regular businesses and farmers?

Ms. BORN. Well, I think Dodd-Frank Title VII actually recognizes the difference with the end-user exemption, Senator. You know, commercial entities that are using these contracts for hedging purposes should be treated somewhat differently, but they, too, need transparency; they need protection against counterparty credit risk. So that I think it is very important that the market as a whole should come under the regulatory regime.

Senator LUGAR. The end-user situation, in other words, you believe does make this differentiation so that this is not quite so onerous to other people.

Ms. BORN. Indeed. Yes, not only does it allow them an exemption if they wish from clearing, but also both the SEC and the CFTC Chairs have said that margin will not be imposed on those contracts as well.

Senator LUGAR. Mr. Roth, you have described the work of your organization and the great amount of additional application paperwork that folks will be involved in. Does this create such a burden that U.S. firms are likely to be competitively affected? In other words, have we imposed, by attempting to do the right thing in the United States as we see it, such substantial costs that we really are not competitive? With regard to people abroad, leaving aside any desire of evasion, it just simply would be easier to do business in some other country that did not have the regulations and the forms.

Mr. ROTH. To discuss that in sort of general terms, any form of regulation imposes additional costs, and the balancing act obviously is always that in a long-term perspective, the more well regulated—not overregulated but well-regulated jurisdictions are the ones that thrive over time, and that is a very difficult balancing act, and there is always a temptation, I think, to move one way or the other and miss the mark by overregulating or underregulating. But, clearly, additional regulation imposes additional costs. The question that everybody has to answer is whether over a long period of time those additional costs are a good investment.

Senator LUGAR. Are you going to be able to identify, as we have future hearings, which I am certain we will, be able to quantify those costs or offer us some metrics so we understand this is reasonable, excessive, or out of reach?

Mr. ROTH. We certainly can provide updated information on what the costs are. Frankly, the problem that we have— just at NFA, when we do a little—sometimes when you are trying to do a cost/benefit analysis, it is hard to measure the impact of something that you prevented. You know, how many firms did not go under? How many customers were not defrauded? There is an inherently difficult process of trying to measure a negative, and that complicates the process. But we can certainly provide additional data as it becomes available on the costs.

Senator LUGAR. Thank you very much.

Thank you, Madam Chair.

Chairwoman STABENOW. Thank you.

Senator Boozman?

Senator BOOZMAN. Thank you, Madam Chair.

Mr. Roth, I want to follow up on Senator Lugar's line. A lot of our agribusinesses, a lot of our—I am thinking of a manufacturing

business that makes motors and, you know, hedges on the materials that they use for that. I do not think right now that they really understand the impact of what is going to happen.

I guess my question to you would be: Do you think there is enough clarity at this point, is there enough information out that that is a correct statement?

Mr. ROTH. Senator, I certainly think that until the final definitions of the terms "swap dealer" and "major swap participant" are promulgated, certain firms are not going to know which side of the line they are on and, therefore, do not know what additional costs they will be taking on or not taking on.

So I think to the extent that if the question is how much can people assess the impact——

Senator BOOZMAN. How they are going to be impacted.

Mr. ROTH. —of the regulations on them, I think it is hard to do that until you know what the final definitions are.

Senator BOOZMAN. I guess the next question then is: If that is true, how can they make the necessary changes that they are going to need to do for compliance?

Mr. ROTH. And I think the approach there has to be— that is why I think it is important to phase in regulations in a time that gives—a rule that people cannot comply with is a bad rule. And I know that from personal experience because I have written some of them.

[Laughter.]

Mr. ROTH. And that is why I think the phase-in approach is so important, and I think the Commission is very consistent with that and very supportive of the concept of phasing these regulations in, and they have to be phased in where it takes into account both their importance to the public policy and the difficulty of coming into compliance. Firms have to have that time. But you lose credibility of a regulatory system if you have rules that cannot be complied with.

Senator BOOZMAN. Thank you, Madam Chair.

Chairwoman STABENOW. You are welcome.

Senator Thune?

Senator THUNE. Thank you, Madam Chair, and I want to thank you and the Ranking Member for holding this important hearing today, and I appreciate the panels that are testifying.

You know, we have a lot of concerns about Dodd-Frank and hope to correct some of those. I think it is important that this Committee here work together to try and monitor the work that is done by the CFTC, the Fed, and the SEC to make sure that these troubles with the bill, the concerns that we have, are not compounded. And I am in particular concerned about the limited definition the CFTC is looking to instate for the de minimis exemption when defining "swap dealers." I understand there has been some discussion of this already with the first panel, with Chairman Gensler, but, you know, there are a lot of elevators and local co-ops that provide important risk management opportunities for producers. They are hardly the large and systemically important entities that Congress intended to be regulated by this law, and including them in the definition of "swap dealers" will only raise prices for producers and limit their chances to engage in bona fide hedging.

So I say that just as sort of a prefatory remark, but I am interested in knowing—I think this was perhaps answered by the previous panel, but if you could shed some light on whether you think that farm cooperatives pose a systemic risk to our economy and should they be regulated in the same way.

Ms. BORN. Well, I certainly think that they should be trading in regulated markets and that it is important to have the Dodd-Frank derivatives reforms in place to protect them by providing more transparency, protection against counterparty credit risk, open and fair access to markets.

Senator THUNE. Mr. Roth, would you comment on that?

Mr. ROTH. I certainly agree with what the former Chair said. If there is a farmers co-op out there that poses a systemic risk to the economy, I have not bumped into it yet.

Senator THUNE. Okay. Well put.

I would like to ask you a little bit about the factors that the CFTC ought to consider, or at least you think ought to consider when making these new capital and margin requirements. Obviously, should they consider whether an institution is systemically important, I think that is probably a given. But should they consider the economic cost of tying up capital and margin requirements?

Ms. BORN. Well, I think that there should be some cost/benefit analysis done, but I think in terms of assessing the benefits of having margins and collateral requirements, we need to focus on what happened in 2008 when the lack of such requirements played a significant role in bringing the financial system to a standstill.

Senator THUNE. Do you think they ought to consider the benefit of price discovery that comes from having many investors in a liquid market?

Ms. BORN. Absolutely, and that is why transparency is necessary, and price discovery is best effectuated through exchange trading. So I think the higher the percentage of transactions that actually go on exchange where everybody, all market participants, all commercial entities, can see what the prices are, the better.

Senator THUNE. Should end users who are hedging financial risk be given an exemption?

Ms. BORN. An exemption from clearing?

Senator THUNE. Yes.

Ms. BORN. They have been given the exemption. If it had been up to me—and it was not—I would have been concerned because, of course, they will not have the protections of central clearing, which reduces counterparty credit risk. They will not have the advantages of transparency, which would reduce their costs. But Congress and the President of the United States made that decision, and I accept it.

Senator THUNE. Will users who are not or should users who are not systemically important be allowed to front less capital?

Ms. BORN. To have less capital themselves?

Senator THUNE. To front less capital, right.

Ms. BORN. Well I think you need to distinguish between capital requirements and margin requirements. I think they need to put up margin. I do not think the capital requirements of small participants is a significant——

Senator THUNE. A final question. My time is running out. I would direct this to either one of you. But do you believe that the position limits that are being proposed by the CFTC will raise costs for smaller investors who have money in commodity mutual funds?

Ms. BORN. I have not thought of it in those terms. I do think that the position limits are critically important to stem excessive speculation, which I think we have seen in a number of commodity markets. Recently we certainly saw it—and the Financial Crisis Inquiry Commission discusses this. We saw it in the summer of 2008, and it certainly made the financial system much more fragile.

Senator THUNE. Mr. Roth?

Mr. ROTH. I would assume that the imposition of new regulations generally increases costs for someone. The question is always: Is there an offsetting benefit to that regulation? And in this case the judgment is whether there is excessive speculation and whether it is hurting the overall economy.

Senator THUNE. Okay. Thank you, Madam Chairwoman.

Chairwoman STABENOW. You are welcome.

Thank you very much to both of you. We will excuse you and ask our third panel to join us.

[Pause.]

Chairwoman STABENOW. Well, good morning, and thanks very much to each of you for coming and for your patience. It is always a challenge being the third panel of witnesses, so we appreciate your patience this morning. Let me introduce our witnesses.

Mr. Chuck Conner is the president and chief executive officer of the National Council of Farmers Cooperatives. He has worked at the USDA as Deputy Secretary, at the White House as a Special Assistant to President Bush, and as president of the Corn Refiners Association, and we welcome you this morning.

Mr. Adam Cooper is the senior managing director and chief legal officer at Citadel LLC in Chicago, and he is here today on behalf of the Managed Funds Association, an organization he knows well, having served two terms as the chairman. At Citadel Mr. Cooper is responsible for the firm's global legal compliance transaction management and regulatory affairs function. We welcome you.

I should also mention just on the side that Mr. Cooper is a graduate of the University of Michigan, so even though I went to Michigan State, I will welcome you.

[Laughter.]

Chairwoman STABENOW. And then last, certainly not least, is John Damgard, who has been president of the Futures Industry Association for nearly 30 years. Mr. Damgard also has a record of public service with stints at the USDA and the White House, and while at the USDA served as Deputy Assistant and Acting Assistant Secretary of Agriculture, was responsible for major marketing and regulatory functions at the USDA.

So we welcome all three of you, and we will ask Mr. Conner to go first.

STATEMENT OF HON. CHARLES CONNER, PRESIDENT AND CEO, NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, DC

Mr. CONNER. Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee, thank you for holding this hearing today to review the implementation of the Dodd- Frank Act. I appreciate the opportunity to be here to discuss the role of the over-the-counter derivatives market in helping farmers and, more specifically, farmer-owned cooperatives manage commodity price risks, which is such an important factor today.

Before proceeding further with my testimony, Chairwoman Stabenow, I just do need to say that while my remarks express some degree of criticism against the Commodity Futures Trading Commission and the direction they are taking, as an organization we have been given unprecedented access to them as well and certainly given full opportunity to make our views known throughout that process, both to the Commissioners as well as to the staff members at the CFTC, and for that we are very, very appreciative to them.

NCFC is here today to ask for your continued help in ensuring that the implementation of the Dodd-Frank Act does indeed preserve the management tools available for farmers and their cooperatives. We were pleased to hear your own remarks, Chairwoman Stabenow, and those of Senator Klobuchar at the earlier hearing on March 3rd on Dodd-Frank implementation.

Due to market volatility in recent years, co-ops using more and more over-the-counter products to better manage their risk exposure by customizing what are known as commercial hedges, and more producers are depending upon their cooperatives to provide them with these tools to manage price risk and to assist them in locking in these margins.

As I indicated earlier, and as others have noted, volatility is probably one of the most difficult challenges that we face in American agriculture today. American farmers and ranchers must continue to have access to these new and innovative risk management products if they are to survive.

NCFC supports elements of the Dodd-Frank Act that bring more transparency and oversight to the over-the-counter derivatives markets. However, the uncertainty created by the "definitions" rules is our greatest concern at this time. While the CFTC has proposed regulations for swaps and swap dealers, it is unclear to us who will be subjected to these additional regulations. Further, some activities of co-ops would appear to be swept into the "swap dealer" definition category.

The two main issues in the proposed rule are the application of the so-called interpretive approach for identifying whether a person is a swap dealer and the very low thresholds on the de minimis exception. The proposed rule would likely capture a number of entities that were never intended by this Committee to be regulated as swap dealers, including farmer cooperatives.

Additionally, some cooperatives are at risk of being designated as swap dealers due to their unique structure. For example, a federated grain or farm supply co-op is owned by many local cooperatives which are separate business entities. Unlike a traditional cor-

porate structure where risk can be transferred and consolidated internally, cooperatives look to transfer risk from the local level to an affiliated federated co-op. Using swaps as a tool to transfer that risk should not lead them, we believe, to be designated as dealers. Under the draft rules, they simply would be.

These rules were intended for large, systemically important institutions, and to answer an earlier question, we are not in that category by any means. Imposing them on co-ops would mean increased financial requirements and other regulatory costs. This in turn would make offering these services to our farmer members simply uneconomical. Such action would result in the unintended consequence of increasing risk in the agriculture sector and to farmers— the exact opposite of what this Committee, I believe, would have happen. We do not believe this was your intention.

So I thank you again for the opportunity to testify before the Committee. We appreciate your role, your very active role, in ensuring that farmer co-ops will continue to be able to support the viability of their member farmers and for the cooperatives that we own, and we look forward to answering any questions you may have.

[The prepared statement of Mr. Conner can be found on page 54 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. COOPER.

STATEMENT OF ADAM COOPER, SENIOR MANAGING DIRECTOR AND CHIEF LEGAL OFFICER, CITADEL LLC ON BEHALF OF MANAGED FUNDS ASSOCIATION (MFA), CHICAGO, ILLINOIS

Mr. COOPER. Thank you, Chairman Stabenow, Ranking Member Roberts, members of the Committee. I am here on behalf of the Managed Funds Association and its members, but also on behalf of Citadel, which is a global financial institution that provides asset management services and a range of capital markets activities from our headquarters in Chicago and offices in financial centers such as New York, San Francisco, Boston, London, and Hong Kong.

MFA appreciates the opportunity to provide its views on the implementation of Title VII of the Dodd-Frank Act, and we commend the Committee for its diligent oversight of the new regulatory framework affecting derivatives. MFA is the voice of the global alternative investment industry, and our members help pensions, endowments, and other institutions diversify their investments, manage their investment returns, and generate reliable returns to meet their obligations to their beneficiaries.

Our members are active participants in the OTC derivatives markets. We have a strong interest in promoting the integrity and the proper functioning of these markets through the increased transparency, competition, and systemic risk mitigation. MFA recognizes the efforts of the CFTC and the SEC in promulgating numerous new regulations called for under Dodd-Frank.

We believe it is imperative that the regulators implement the rules in a straightforward, common-sense, and workable manner. To assist in these efforts, we have provided regulators and we have submitted in connection with our testimony here today a blueprint

which contains a detailed plan for adopting and implementing all Title VII rules. By properly ordering priorities and establishing defined milestones, the OTC derivatives market could achieve substantial progress towards key regulatory forms, including central clearing, sooner rather than later.

MFA supports policymakers' efforts to reduce systemic risk by requiring central clearing and data gathering about swaps. We believe that a straightforward and workable phased implementation, starting with central clearing, will play an essential role in reducing systemic, operational, and counterparty risk; will enhance market transparency, competition, and regulatory efficiencies; and will fulfill the primary goal of Title VII of Dodd-Frank. We are confident that good clearing—and, that is, clearing with open access and real-time processing—will become the foundation for competitive execution facilities and significant improvements in transparency.

Clearing of OTC derivatives is not new. Extensive dealer-to-dealer clearing happens today. The buy side has also undertaken significant preparations. For example, a number of buy-side firms, Citadel included, have negotiated clearing agreements, tested margin methodologies, tested straight-through processing, and worked through a wide range of operational and reporting issues necessary to clear at scale. It makes good sense from a policy perspective to capitalize on this momentum and facilitate greater buy-side access—great buy-side access to clearing now.

We urge regulators to move promptly and to ensure that all market participants that want access to clearing have access to clearing. The success of central clearing and data gathering will depend on the structure, governance, and the financial soundness of the clearinghouses, the data repositories, and the other institutions in this marketplace. We strongly believe there is a need for those entities to have transparent and replicable risk models and straight-through clearing processes that enable fair and open access that incentivize competition and that reduce barriers to entry. It is important to have customer representation on the governance and risk committees of the clearinghouses and for no one group to constitute a controlling majority. As financial end users, MFA's members regularly exchange margin with their counterparts.

The prudential regulators' proposed capital and margin requirements for swap dealers and for major swap participants do not require those entities to post variation margin to their non-dealer counterparts. This will undermine market discipline. In fact, the absence of this two-way margining discipline and regime is the central lesson to AIG's failure.

We are also concerned that the CFTC's proposed margin and segregation rules may impair arrangements that permit netting across customers' cleared and uncleared positions. We believe this will increase systemic and settlement risk and will restrict the efficient use of capital.

MFA remains concerned about the efficacy of position limits. We are particularly concerned about the workability of the CFTC's proposed rules, which depart from its longstanding policy on disaggregation of independently controlled accounts. Inappropriately formulated limits would impair the ability of markets to serve

their essential risk allocation function, which would increase the cost of managing risk and harm hedgers and ultimately consumers of these products.

Lastly, we are aware that in Europe and throughout the world, regulators are working on proposed OTC derivatives regulations to align with the Dodd-Frank Act. We are concerned about the extraterritorial application of these regulations; however, we very much appreciate the ongoing efforts of U.S. and non-U.S. policymakers and regulators to coordinate and ensure the harmony, the efficacy, and the alignment of derivatives reforms.

On behalf of Citadel and the MFA, I very much thank you for the opportunity to testify and stand available to answer any questions. Thank you.

[The prepared statement of Mr. Cooper can be found on page 58 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Damgard, welcome.

STATEMENT OF JOHN DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, DC

Mr. DAMGARD. Thank you. Chairwoman Stabenow, Ranking Member Roberts, Senator Lugar, I am John Damgard, president of the Futures Industry Association. On behalf of the FIA and its members, I want to thank you for the opportunity to appear before you today.

FIA is the leading trade association for the futures, options, and over-the-counter cleared derivatives markets. Its membership includes the world's largest derivatives clearing firms, as well as the leading derivatives exchanges from more than 20 countries, including Citadel.

We take justifiable pride that throughout the financial crisis, the futures markets continued to function exactly well. The futures regulatory system passed the test with flying colors. And I would like to say, in contrast to what Mrs. Born said, our trade association has no interest in stonewalling or undermining this process. Our members have spent hundreds and hundreds of millions of dollars in their efforts to make sure that they are ready for these changes, and I think I speak for all other trade associations that are in the financial world.

One of our greatest concerns with the Dodd-Frank Act is the potentially adverse effect on competition. As the president of the FIA, I can assure you that the global derivatives marketplace is becoming more and more competitive every year. Just last week, I was in London for our annual international derivatives expo, and I heard a lot of discussion about the potential impact of these new regulations. Our competitors in London and in other financial centers around the world are watching what we do here very closely indeed. While our regulators are making a strong and sustained effort to consult with their counterparts abroad, there are some significant differences emerging in our respective approaches, and we need to do our utmost to preserve a level playing field.

In my written testimony, I have attached a six-page summary of more than two dozen comment letters that the FIA has filed on various Dodd-Frank rulemakings. I doubt that any of us realized

last year just how complicated this process would be. Yes, the futures regulatory system provided Congress with an excellent model for regulating swaps, but cleared swaps are not the same as futures. One size does not fit all. To get this right, the new regulatory framework must be carefully designed and sensibly implemented.

I commend the leadership of the CFTC and the SEC for their determination to carry out the monumental rulemaking mandate assigned them by Dodd-Frank. But through no fault of their own, it has become obvious to everyone that the July 16th deadline was simply too ambitious.

Just yesterday, the CFTC issued a proposed order providing temporary regulatory relief for several important provisions of the Dodd-Frank Act that are due to take effect on July 15th, and I think Chairman Gensler went over that fairly carefully. But this is only a temporary measure. Of far more importance is the substance of the many rulemakings now under consideration and the overall impact of the proposed regulations as a whole. The CFTC has not yet made decisions on a host of critical issues that will have an important influence on the structure of this industry and the costs that my members must bear.

The CFTC confirmed yesterday that the final definitions of "swap, "swap dealer," and "major swap participants" will be among the very last rules adopted, and yet many of the new regulatory requirements will hinge on these core definitions; and until they are finished, it is hard to know for sure who and what will be covered.

Chairman Gensler has correctly observed that the proposed rules fit together in a mosaic. Mosaics, however, are nothing more than chips of colored stone until they have been pieced together into a work of art. The Commission has shown us the individual chips, but it has not shown its vision on how they will fit together. The industry and the public deserve an opportunity to analyze and comment on this regulatory mosaic before it is set in concrete.

In conclusion, I would like to circle back to my opening theme, namely, the international dimension of Dodd- Frank. When Congress was considering this legislation, many in the financial services industry and in Congress cautioned that the extraterritorial reach of the regulatory such being established here would inhibit the ability of U.S. market participants to compete internationally. Today there is increasing evidence that last year's fears will be this year's reality.

We were pleased to learn that the Chairman and Ranking Member of this Committee recently wrote to their colleagues in the European Parliament expressing their concern. As the Senators emphasized, "a key objective of the [Dodd-Frank] Act was to 'consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards' for the regulation of derivatives transactions." The FIA welcomes your pledge to work with your European colleagues to harmonize these rules and stands ready to help in any way we can.

In our experience, the CFTC's Part 30 rules provide a successful model for limiting the extraterritorial impact of Dodd-Frank. The Part 30 rules, which govern the offer and sale of foreign futures and options to U.S. participants, were promulgated in 1987, as Dan

Roth said, and have promoted international trade for nearly 24 years without sacrificing customer protections. CFTC's Part 30 rules recognize we cannot expect other countries to implement regulations identical to ours. Instead, it provides a mechanism for providing exemptions to exchanges and clearinghouses that are subject to comparable regulations in their home countries.

The swaps markets, even more than the futures markets, are international in scope. This is in part because swaps have been traded in bilateral transactions, and there have been no trading platforms or central clearing organizations that would focus trading in certain locations. As regulations around the world develop rules, it is essential that they be coordinated and comparable, both with respect to substance and timing.

Thirty years ago, the CFTC determined that given the agency's limited resources, it is appropriate this time to focus the Commission's customer protection activities upon domestic firms and upon firms soliciting or accepting orders from domestic users of the futures markets. This same policy should govern the regulation of swaps.

In particular, we urge the CFTC to use its authority under Dodd-Frank to provide an exemption for swap clearinghouses located outside the United States that clear swaps for U.S. participants, provided that they are subject to comparable regulations in their home country. Such an exemption would facilitate international competition, provide more choice in clearing for U.S. entities, and free the CFTC staff to focus on transactions that more directly affect U.S. market participants, and I thank you very much for the opportunity to testify.

[The prepared statement of Mr. Damgard can be found on page 71 in the appendix.]

Chairwoman STABENOW. Thank you very much, and, Mr. Damgard, you answered the first question I was going to ask you in terms of what is happening abroad. Senator Roberts and I have sent a letter, and we will be working together with our European counterparts, and I appreciate your comments on that. As you can tell from the Committee discussion today, we are very concerned about how all this fits together and making sure it is done in the right way.

Mr. Cooper, being part of a firm that is very active in these markets, I would like to hear more about your perspective on phasing in implementation of financial regulatory reform and any potential delays. Would delaying the bill create additional legal or market uncertainty, in your opinion? And what sort of information or certainty from the regulators would be ideal to help your firm meet the changes required by reform?

Mr. COOPER. Thank you, Chairwoman. I think that I approach it really from the fundamental premise that we are today maybe literally 1,000 days from the demise of Lehman. We still do not have meaningful central clearing of derivatives. One of the greatest goals of Dodd-Frank was to reduce systemic risk that built up from the daisy chain of interconnectedness.

Phasing-in represents a common-sense approach to—we do not subscribe to a big bang theory. There are a lot of rules. There are a lot of issues. But what we do know is that today the infrastruc-

ture for clearing exists. I think as Mr. Damgard alluded to, we have been clearing derivatives for nearly a century in this country. Clearing takes place today between the dealers. The buy side is ready. We are asking for mandatory access to clearing for those firms that are ready to clear. Most of the risk that exists in the system today is derived from the largest firms and those that are capable and desirous of clearing.

Certainty is key. Once we launch clearing and the related data that will be available to the regulators from reporting the swap data repositories, the regulators can then be much more thoughtful about phasing in and providing specificity about the subsequent aspects of implementation of Dodd-Frank. So we think the launch of clearing will, in fact, provide a range of data that will help our regulators make more informed decisions, smarter regulation, and greater certainty for the marketplace.

Chairwoman STABENOW. Thanks very much.

Mr. Conner, we appreciate your testimony today and for highlighting what is certainly an important responsibility of this Committee as we look at the importance of risk management for farmers and co-ops and end users in general. But I wonder if you might go into more detail about the impact of increased volatility in the commodity markets, how it has impacted your members, why it is critical to preserve the relationship between the farm and the co-op, and also if you might have any specific examples on the impact of farmers or co-ops in terms of additional regulations that are coming, such as swap dealer requirements, that kind of thing.

Mr. CONNER. Thank you, Senator Stabenow. Let me just say the costs are substantial, we feel, and, you know, the volatility in today's marketplace is really just unprecedented. I mean, this is not theory. This is not, you know, hypothetical "what if's." I mean, we are living in the midst of, you know, the most volatile commodity times that we have ever seen in our Nation's history. Last week USDA's crop report and immediately, you know, prices are locked up, the maximum daily limits, you know, there are consequences associated with these kind of price moves, and you have both producers and buyers out there on any given day, you know, you are not looking to limit your exposure over the course of a day or a couple of days. I mean, you are trying to limit your exposure over the course of hours and minutes because there is that kind of volatility in this marketplace.

You know, for our producers, obviously, you know, they just simply cannot withstand that kind of volatility. They cannot be sitting on a commodity that is worth something one day and the next day it may be worth 50 percent less—or 50 percent more. And if you are a livestock guy, you know, how do you deal with that that on any given day there can be that kind of change in your input cost?

So this is a huge, huge issue for American agriculture. Co-ops did not get into this business, you know, because we saw opportunities out there. We got in there because our farmer owners came to us and said, you know, this may well be the number one issue we are facing, and as our co-op, what can you do to help us manage these kinds of risks?

Individual farmers, despite, you know, the presence of a very strong futures market there for hedging, in many cases individual

farmers simply do not have the ability to hedge their commodities on the futures market and withstand the kind of margin calls that you could get in that daily price movement. They do not have access to that kind of capital to lock up, you know, to handle those margin calls. They have looked to the co-ops to say, you know, what can you do for me to basically absorb some of that margining kinds of requirements so that you can offer me a forward price at some point? You know, once I have my crop in hand, I will take that price, but I cannot handle the margin of then hedging that particular price on our futures exchanges.

Co-ops, one of the functions we have done is we have assumed that. We have taken over that price risk function. We have taken over the responsibility for margining, if you will, those kinds of transactions. Some of that margining has involved over-the-counter swaps in order to limit our own exposure.

The example I use, Madam Chairman, is I have had one co-op that on one given day, as a result of change in the corn and soybean market, had a $100 million margin call in one day. That is one transaction. So, I mean, you know, these are not small numbers, and the impact of trying to capitalize yourself to be able to withstand that kind of action on a given day—you know, you walk into the office and someone is on the phone saying, "I need $100 million of your capital." You know, you cannot sustain that kind of thing. And we have used, I think effectively, been forced to use these over-the-counter transactions to try and manage that on behalf of our producers.

Mr. DAMGARD. Which in turn finds its way to the exchange. As a corn and soybean producer, I certainly sympathize and agree with everything Chuck says. And ye clearinghouses are very, very complicated organizations. I mean, they are very, very capital intensive, and to your point, Adam, the clearinghouses have to be very careful about establishing standards about who can be members of that clearinghouse and how much money it requires to be a member. You cannot let the local corner shoe store guy become a clearing member without running the other people that have substantial capital deciding to get out of the clearinghouse.

So the clearinghouses have worked exactly well, but they do not eliminate risk. They mutualize it among the people that have the deep pockets.

Chairwoman STABENOW. Thank you very much.

Senator Roberts?

Senator ROBERTS. Madam Chairman, once when I was Chairman of the Emerging Threats Subcommittee of the Armed Services Committee, I made it mandatory that every panel member be shackled to their chair so that they could hear all panels, and I just think it would be appropriate here, shackling.

[Laughter.]

Senator ROBERTS. But at any rate, it would be interesting to have a panel here with Mr. Conner and then have Ms. Born and then Mr. Cooper, and then I would like to place Chairman Gensler right next to John Damgard, and then have at it and have about a 15—you know, a roundtable discussion, and I think it would be very helpful.

Chuck, welcome back. Thank you for your contribution. Thank you for that last statement. What are you going to tell your membership as a result of this hearing? Are you going to say that you have every confidence that a farmer cooperative is free in regards to some of the CFTC rulings that you are worried about? What are you going to tell them?

Mr. CONNER. Well, that is a great question, Senator Roberts. You know, again——

Chairwoman STABENOW. I am just going to say, he is going to start by saying it was chaired brilliantly.

[Laughter.]

Senator ROBERTS. I think that is a given, Madam Chairwoman.

Mr. CONNER. We have had unprecedented access to Chairman Gensler and the Commissioners and the staff at CFTC, and so we——

Senator ROBERTS. Well, now, Chuck, wait a minute.

Mr. CONNER. —have been given the opportunity——

Senator ROBERTS. Wait a minute, wait a minute.

Mr. CONNER. All right.

Senator ROBERTS. The Chairwoman has held a hearing. We sent a letter, three of us, down to the CFTC saying, "What is the legal standing after July 16?" And it was not until yesterday that they met. There were several 3–2 votes, which were obvious, in regards to deadlines and what was going on. And then we had the order. I guess that is the order. I said regulations. I was chastised by staff saying it is an "order," and it is 23 pages long with two appendixes. I have not read it all. I am supposed to digest it. As I said before, I will probably get indigestion.

Now, you cannot tell me that you have had access to the 31 working groups and the 51 regulations and the thousand pages of regulations. You may be able to tell me as to your specific concern that you have had some access and have had some guarantee or something like that.

Now, Senator Boozman indicated, "What am I going to tell a local manufacturer?" The Chairwoman does not know, I do not think. She is awfully good and awfully brilliant in conducting a hearing, but I doubt if she has had time because we did not get these things until 7 o'clock in the morning. The Wall Street Journal had more than we had. At any rate she does not know. Senator Klobuchar does not know. Senator Gillibrand does not know. Senator Thune does not know. Senator Johanns does not know. Senator Boozman does not know. Senator Chambliss does not know. Senator Lugar does not know. And I certainly do not know. We have staff, one member, that does know, but we have not had time to really digest it.

I do not think that Chairman Gensler knows what all these 31 working groups and 51 regulations are going onto the detail that we would like to know, and so they have simply delayed it until December 31, and we are in another state of swap purgatory, although there are some exceptions that we have been advised not to worry, you know, we are going to take care of this.

Now, I am being a little harsh here, but the way that this has been handled, having a hearing the day before they come up and then regs showing up at 7 o'clock in the morning, I do not like that

at all. I do not think that is the way to be treated. I do not think the Chairwoman should be treated like that, or me or, for that matter, any other Senator. So I am sort of being obstreperous about this.

Mr. Cooper, what are you going to tell your membership, John, what are you going to tell your membership in terms of what you found out at this hearing?

Mr. DAMGARD. Well, Senator, we also——

Senator ROBERTS. How about another hearing a little bit later on?

Mr. DAMGARD. We welcome that very much. We know that this mosaic that I spoke of is going to be very, very difficult to put together. I have great sympathy for Chairman Gensler. I think you are right. I think that, you know, he is working as hard as he can for coordination, but, I mean, somebody handed me this today, which he could not have known. Simon Lewis, who is the chairman of the Association of Financial Markets in Europe, was quoted as saying yesterday, "'There remains the risk of poorly calibrated, rushed, inconsistent, or unclear regulation,' Lewis told the Brussels audience." So it is not easy for these things to be coordinated in a way that is going to make sense.

Senator ROBERTS. Mr. Damgard, you said in your testimony the European Parliament is considering regulatory retaliation against the United States clearing organizations unless the U.S. allows mutual recognition of equivalent foreign regulatory regimes. It is not follow along or get in line. It is basically equivalent foreign regulatory regimes.

What should the CFTC do to address this possibility? And what would be the consequences if the CFTC does not act in regards to a retaliatory kind of situation here in regards to what you heard over there in the European Parliament?

Mr. DAMGARD. Well, in my testimony I talk about Part 30 initial recognition, and I think that really is the answer. And I think sometimes Secretary Geithner's remarks about, you know, whatever, the light touch in London was the reason for this terrible tragedy, that was not constructive. I happened to be over there at the time, and people were not happy with that. They were saying, "Well, you did not have any regulation on these products at all, so why can you criticized us for light regulation?" It tends to make it more difficult to reach any accommodation, and my sense last week was that if the United States goes it alone, we would be risking an awful lot of not only retaliation but damaging U.S. participants in the market.

Senator ROBERTS. Well, I thank you for your comment. I am over time by a minute and 40, typically, but at any rate—and I have been rather unpleasantly irascible this morning, but I am irascible because of the situation, and I am just trying to figure out what you are going to tell your people. And I think what you are going to tell them is, well, it was a pretty darn good hearing, we had some pretty good pertinent questions, Chairman Gensler did the best that he could, Ms. Born was reliving the thrilling days of yesteryear in 2008, et cetera, et cetera, et cetera. But I am not sure if you got any specific, concrete answer that can put you at ease that you can tell your membership do not worry about this. It is

a situation where I think this Committee has to continue our strong oversight responsibility, and when things clear up a little bit—and Lord know, you know, Chairman Gensler has a tremendous challenge ahead because of the budget restrictions and what he is forced to do, mandated to do, what he wants to do under Dodd-Frank.

So I do not know. Do you have any specific positive thing that you could go back to your membership and say, hey, you know, we think we are going to be all right?

Mr. COOPER. Senator, if I may, I do think there is something encouraging that I can report to my members, and, that is, I have not heard anything that would detract from the regulators' opportunity to announce a date certain by which clearinghouses will be open for business and that those who want access to clearing can have access to clearing so that we can phase in those rules, so that we can launch central clearing and reduce systemic risk today in a meaningful way.

Senator ROBERTS. That is a good thing, and with that I think I will yield back. Thank you.

Chairwoman STABENOW. Well, thank you very much.

Let me say as we conclude the hearing, we thank all the witnesses today. We certainly appreciate your comments, and as we have said since the beginning of the year, we take our oversight responsibilities very seriously, and we will continue to do that both through the Committee hearing process but also on a day-by-day communication that is happening at staff, and certainly Senator Roberts and I are very engaged at various levels in this.

So we thank you very much. Any additional questions for the record should be submitted to the Committee clerk within 5 business days, and the Committee hearing is adjourned. Thank you.

[Whereupon, at 12:01 p.m., the Committee was adjourned.]

A P P E N D I X

JUNE 15, 2011

Opening Statement
Senator Saxby Chambliss
Senate Committee on Agriculture, Nutrition & Forestry
One Year Later - The Wall Street Reform and Consumer Protection Act - Implementation of Title VII
June 15, 2011

Madam Chairwoman and Senator Roberts, thank you for providing this Committee the opportunity to review and discuss the implementation of Title VII, the derivatives title of the Dodd – Frank Act, of which this Committee has oversight. I would also like to thank the witnesses for being here and providing their testimonies, which I hope will be helpful as we discuss the rule making process of this legislation.

Last year, in the aftermath of the financial meltdown of 2008, Congress passed The Wall Street Reform and consumer Protection Act which required, according to published reports, 385 new rules to be written. The CFTC has several rule writing teams proposing a plethora of new regulations. And they still are not finished. After all these rules, regulations, and red tape I am still concerned that those who caused the financial crisis have not been held accountable and the American financial system will not be any safer. This legislation and the regulations that will be created under the authority of the legislation have created massive uncertainty, opportunities for international regulatory arbitrage, unnecessary and imprudent use of capital, loss of market liquidity, as well as huge

legal fees and giant costs related to compliance. For years farmers in Georgia and across the country have been able to hedge their risks against future commodities prices and the uncertainties of these regulations have left rural grain elevator owners and operators wondering if they will be allowed to enter into contacts with these farmers and continue their business.

In Georgia there are many companies – Home Depot, UPS, Coca Cola, Delta Airlines, Southern Company, and AGCO, just to name a few – that manage business risks with derivatives.

Also the requirement of those that provide credit to our nation's agricultural producers (like the Farm Credit System Banks) to clear their interest-rate derivatives will result in higher interest rates being charged to our farmers, ranchers, electric cooperatives and renewable fuel facilities for business and equipment loans.

I fear the unintended consequences resulting from applying complicated, one-size-fits-all regulations too broadly will subject our American businesses to more risk, not less, and will result in consumers paying more for goods and services.

In addition to the impact these regulations may have on end users, we must also ensure that new authorities within Dodd – Frank do not result in overly

burdensome regulations being applied to already regulated exchanges. The Commodity Exchange Act and its principled-based approach served the commodities market well and as a result the exchanges performed well during the recent crisis.

Again, I would like to thank the Chairwoman and ranking Member for holding this hearing and I look forward to the forthcoming testimonies.

Testimony
of
Brooksley Born

Former Commissioner,
Financial Crisis Inquiry Commission

Former Chairperson,
Commodity Futures Trading Commission

Concerning the Wall Street Reform and Consumer Protection Act -- Implementation of Title VII

Before the
United States Senate
Committee on Agriculture, Nutrition and Forestry

June 15, 2011

Chairwoman Stabenow, Ranking Member Roberts, and Members of the Committee:

Thank you for inviting me to appear before you to discuss the implementation of the derivatives provisions of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Effective and prompt implementation of those provisions is critically important to protect the American public and our financial system.

I recently served as a Commissioner on the Financial Crisis Inquiry Commission ("Commission"), which was created by statute in 2009 to examine the causes of the financial and economic crisis in the United States and to report to the President, Congress and the American people on those causes. The Commission issued its report ("Report") on January 27, 2011, after 18 months of investigation, including 19 days of public hearings, interviews with about 700 persons and review of millions of pages of documents.

The recent financial crisis and the economic crisis that has followed it have demonstrated how vital financial regulatory reform is to the welfare of the American people. As the Commission found, these crises have been devastating. Trillions of taxpayer dollars were committed to rescue large corporations and to support the financial system and the economy. Millions of Americans are out of work, cannot find full-time work or have given up looking for work. Millions of families have lost their homes to foreclosure, are in the foreclosure process, or are seriously behind on their mortgage payments. Trillions of dollars in household wealth vanished, with retirement accounts and life savings swept away. (Report, pp. xv-xvi.)

The Commission concluded that profound failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were among the prime causes of the financial crisis. (Report, pp. xv-xxviii.) The Dodd-Frank Act

addresses a number of the causes of the financial crisis found by the Commission, including the unregulated over-the-counter ("OTC") derivatives market. The Act's full and timely implementation and rigorous enforcement should go far toward protecting the American public.

The Commission in its Report concluded that widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. (Report, p. xviii.) The Commission found that policymakers and regulators failed in their responsibilities to protect the public in part because of a widely accepted belief in the self-regulating nature of financial markets and the ability of financial firms to police themselves. Former Federal Reserve Board Chairman Alan Greenspan championed deregulation and was joined by policy makers in successive Presidential Administrations and successive Congresses in supporting widespread deregulation of financial markets and institutions. As a result, gaps in government oversight of key parts of the financial system were created, including the enormous shadow banking system and the OTC derivatives market. Moreover, supervision of financial firms was weakened, and firms were able in many cases to select among supervisors, leading to a regulatory race to the bottom. The financial sector effectively pressed for this deregulation, spending almost $4 billion in federal lobbying expenses and campaign contributions in the decade leading up to the crisis.

The Commission specifically concluded that unregulated OTC derivatives contributed significantly to the financial crisis. (Report, pp. xxiv-xxv.) It found that the enactment of the Commodity Futures Modernization Act of 2000 "to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward financial crisis." (Report, p. xxiv.) Thereafter, the unregulated global OTC derivatives market grew exponentially to almost $673 trillion in notional amount on the eve of the crisis in June 2008. The Commission found that this market was characterized by uncontrolled leverage,

lack of transparency, lack of capital and margin requirements, speculation, interconnections among firms, and concentrations of risk. The Commission concluded that derivatives known as credit default swaps fueled the securitization frenzy and the housing bubble by encouraging investors in mortgage-related securities to believe they were protected against default. Credit default swaps were also used to create synthetic mortgage-related collateralized debt obligations ("CDOs"), which were merely bets on real mortgage securities. Such bets significantly amplified the losses from the collapse of the housing bubble by allowing multiple bets on the same securities. When the housing bubble burst, derivatives were at the center of the storm. Insurance giant AIG's sale of credit default swaps on mortgage-related CDOs without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system. In addition, the existence of millions of OTC derivative contracts of **all** types -- including interest rate swaps, foreign exchange swaps and commodity swaps -- created interconnections among a vast web of systemically important financial institutions through counterparty credit risk, exposing the financial system to contagion and helping to precipitate the massive government bailouts.

The financial regulatory reforms relating to OTC derivatives contained in Title VII of the Dodd-Frank Act are vital to strengthening the financial system and reducing systemic risk. Centralized clearing by regulated clearing operations will reduce the counterparty credit risk that created contagion during the financial crisis as the failure of financial institutions threatened their counterparties and the financial system as a whole. Trading on regulated exchanges or swap execution facilities will provide critically important transparency and price discovery to market participants and the public. Position limits will reduce excessive speculation on physical

commodities such as energy and agricultural products that distorts price discovery, impairs the use of the markets for hedging purposes, and imposes unfair prices on consumers. Swap dealers will have to meet minimum capital and collateral requirements and will be subject to business conduct rules. Rules against fraud, manipulation and other abuses will protect the marketplace and market participants. Swap data repositories will enable regulators to oversee OTC derivatives as well as those traded on exchange.

The CFTC and the SEC, which have the primary responsibility for implementing Title VII, have been acting responsibly and diligently to propose regulations and to prepare to undertake the enormous new task of regulating the OTC derivatives market -- estimated to approach $300 trillion in notional amount in the United States and more than $580 trillion globally. However, the Act's provisions must be fully implemented by the adoption of regulations and must be rigorously enforced to provide needed protection to the public. Despite all the efforts of the CFTC and the SEC to date, it is important to recognize that safeguards are not yet in place.

There now appears to be a concerted effort by some large financial institutions and their trade associations to prevent full implementation and enforcement of Title VII and other provisions of the Dodd-Frank Act. Alan Greenspan is warning about alleged dire consequences of some provisions of the Act and again advocating self-regulation. Bills are pending in Congress that would repeal or weaken the Act. Efforts to persuade the agencies to issue watered down regulations or to delay or otherwise fail to fully implement provisions of the Act are underway.

Substantial delay of Title VII implementation such as that recently proposed in the House of Representatives would be dangerous. As noted above, until regulations implementing Title VII are in effect, the financial system and the American people will have no protection against the unregulated OTC derivatives market and will continue to be exposed to the repercussions of large defaults which might be triggered by the European sovereign debt crisis, continuing problems in the housing or commercial real estate markets, the vulnerability of the municipal bond market or other significant financial risks. The CFTC has been acting responsibly to ensure that its regulations will be adopted in a timely manner after due consideration of public comments, and additional delay is unwarranted.

Some financial services firms are arguing that the rules will be too burdensome and costly and that they will be "job killers." Yet, any such impact of the rules will be miniscule compared to the trillions of dollars of lost wealth and taxpayer expenditures and the millions of lost jobs that the lack of regulation caused during the financial crisis. Failure to regulate OTC derivatives now would risk another crisis involving enormous costs to the public.

Firms are also arguing that U.S. regulation under the Dodd-Frank Act might cause them to conduct their derivatives transactions on foreign markets with less regulation than the United States. This argument merely underscores the importance of international cooperation in establishing comprehensive reform of the derivatives market as called for by Secretary of the Treasury Timothy Geithner in his speech on June 6, 2011 to the International Monetary Conference.

Moreover, Congressional threats to cut the funding of key regulators imperil regulatory reform. The CFTC has been threatened with cuts that would significantly impair its operations.

As noted above, it has greatly increased responsibilities under the Dodd-Frank Act -- responsibilities vital to financial stability -- and needs significantly more resources to meet those responsibilities. The reduction in the CFTC's fiscal year 2012 budget proposed in the House of Representatives would not only impede the CFTC's ability to implement regulations under Title VII but would stifle its ability to enforce them.

The political power of the financial sector is still enormous, and policy makers in Congress and the Executive Branch must have the political will to resist these efforts to derail regulatory reform. If we do not learn from the financial crisis and put in place the regulatory reforms needed to address its causes, we may well face future financial crises. The American people deserve better.

Thank you very much.

Statement of
Charles Conner
President and Chief Executive Officer
National Council of Farmer Cooperatives

SENATE COMMITTEE ON AGRICULTURE,
NUTRITION & FORESTRY
WASHINGTON, DC

June 15, 2011

Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee, thank you for the invitation to testify today on the role of the over-the-counter (OTC) derivatives market in helping farmer-owned cooperatives and their members manage commodity price risks.

I am Chuck Conner, President and Chief Executive Officer of the National Council of Farmer Cooperatives (NCFC). NCFC represents the nearly 3,000 farmer-owned cooperatives across the country whose members include a majority of our nation's more than 2 million farmers.

I appreciate the opportunity to discuss some of the key issues we see in implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I also wish to thank Sens. Amy Klobuchar and John Thune for their service as co-chairs of the Congressional Farmer Cooperative Caucus.

Farmer cooperatives – businesses owned, governed and controlled by farmers and ranchers – are an important part of the success of American agriculture. They are a proven tool to help individual family farmers and ranchers through the ups and downs of weather, commodity markets, and technological change. Through their cooperatives, producers are able to improve their income from the marketplace, manage risk, and strengthen their bargaining power, allowing individual producers to compete globally in a way that would be impossible to replicate as individual producers.

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

As such, we ask that the implementation of the Dodd-Frank Act preserve risk management tools for farmers and their cooperatives. We were please to hear your remarks, Chairwoman Stabenow, and those of Sen. Klobuchar at the March 3rd hearing on Dodd-Frank implementation. You echoed our concern that farmer co-ops will face additional regulations and encouraged the Commodity Futures Trading Commission (CFTC) to ensure the relationship between farmers

and co-ops will be preserved, allowing farmers to have affordable access to risk management tools.

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

- Treat agricultural cooperatives as end users because they aggregate the commercial risk of individual farmer-members and are currently treated as such by the CFTC;
- Exclude agricultural cooperatives and Farm Credit System lenders from the definition of a swap dealer; and
- Consider aggregate costs associated with the new regulations and the impact on the agriculture sector.

Cooperatives' Use of the OTC Market

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

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

Some examples include:

- Local grain cooperatives offer farmers a minimum price for future delivery of a specific volume of grain. The local elevator then offsets that risk by entering into a customized swap with an affiliated cooperative in a regional or federated system.

- Cooperatives facilitate hedging for dairy farmers by offering a fixed price for their milk and a swap to hedge their feed purchases.

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

- Since most individual farmers do not have the demand necessary to warrant a standard 42,000-gallon monthly NYMEX contract, individual farmers can hedge their fuel costs by entering into swaps in 1,000-gallon increments.

While our members could provide greater details on how the above programs work for those sectors, they are all similar in concept and purpose – to hedge the price risk inherent to the production and marketing of agricultural commodities.

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

For example, recent movements in grain and oilseed markets have caused a considerable amount of working capital to be used to cover daily margin calls. With the pending increase in the daily price limits on exchange-traded corn futures, those requirements will likely intensify. For farmers to continue to take advantage of selling grain forward during price rallies, cooperatives have to either increase their borrowing from their lenders or look for alternative ways to manage such risk. Using the OTC market has become that alternative. As was the case during the volatile markets in 2008, swaps today allow cooperatives to free up working capital and continue to forward contract with farmers.

Implementation of the Dodd-Frank Act

NCFC believes that as the Dodd-Frank Act is implemented federal regulators must preserve the ability of cooperatives to use the OTC market to manage commercial risks while also allowing them to meet the growing demand from their member-owners for hedging products.

NCFC supports elements of the Dodd-Frank Act that bring more transparency and oversight to the OTC derivatives markets. We also recognize the complexity involved in crafting the implementing rules. Additionally, we have had a number of opportunities to express our concerns to the CFTC. The Commission has been accessible and engaged on our issues.

The uncertainty created by the "definitions" rules is NCFC's greatest concern at this time. While the CFTC has proposed regulations for swaps and swap dealers, it is unclear to us who, and therefore what transactions, will be subjected to those additional regulations. Further, some activities of cooperatives would appear to sweep them into the "swap dealer" category.

The two main issues in the proposed rule are the application of the "interpretive approach for identifying whether a person is a swap dealer," and the very low thresholds on the "de minimis exception." As such CFTC would likely capture a number of entities, including farmer cooperatives, which were never intended to be regulated as swap dealers.

Taking this a step further, some cooperatives are at risk of being designated as swap dealers due to their unique structure. For example, a federated grain or farm supply cooperative is owned by many local cooperatives which are separate business entities. Unlike a traditional corporate structure where risk can be transferred internally, the ability to transfer risk from the local level to the federated cooperative – in this case in the form of a swap – looks to be treated as an external transaction under the draft rules.

Regulating farmer cooperatives as dealers would increase requirements for posting capital and margin on swaps it uses with other dealers to offset the risk of providing risk management products and services. This requirement, combined with the cost of complying with other regulatory requirements intended for large systemically important institutions, could make providing those services to their farmer-members uneconomical. Such action would result in the unintended consequence of increasing risk in the agricultural sector.

We do not believe this is what Congress intended and we urge the committee to once again reiterate that to the CFTC. Furthermore, we do not believe that any member of the committee would want any action taken that would reduce the price and risk management options available to farmers, especially during these highly volatile economic times. Unfortunately, that may well be the consequence of the rulemaking process unless the committee makes its wishes known.

Farmer-owned cooperatives and farmers also would face increased costs and have fewer risk management options if cooperative Farm Credit System lenders are made subject to the Dodd-Frank Act's mandatory clearing requirements or are defined as swap dealers. We are urging CFTC to provide farm credit lenders with an exemption from mandatory clearing and to recognize the swaps they provide to cooperatives in conjunction with loans should not result in them falling under the definition of a swap dealer.

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

Thank you.

MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

ADAM COOPER
SENIOR MANAGING DIRECTOR AND CHIEF LEGAL OFFICER,
CITADEL LLC

ON BEHALF OF
MANAGED FUNDS ASSOCIATION

For the Hearing
One Year Later - The Wall Street Reform and
Consumer Protection Act - Implementation of Title VII

BEFORE THE

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

JUNE 15, 2011

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WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

One Year Later - The Wall Street Reform and Consumer Protection Act - Implementation of Title VII

June 15, 2011

My name is Adam Cooper and I am Senior Managing Director and Chief Legal Officer of Citadel LLC, a global financial institution that provides asset management services and engages in a range of capital markets activities. Citadel oversees investments around the world for investors from across the world from its headquarters in Chicago and offices in other financial centers including New York, London, Hong Kong, San Francisco and Boston.

I am here today to speak on behalf of Managed Funds Association ("MFA") and its members. On their behalf, I am pleased to provide this statement in connection with the U.S. Senate Committee on Agriculture, Nutrition and Forestry's hearing held on June 15, 2011 to review implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") one year after enactment. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $2 trillion invested in absolute return strategies around the world. Our members serve pensions, university endowments, and other institutions to diversify their investments, manage risk and generate reliable returns to meet their obligations to their beneficiaries.

MFA's members are among the most sophisticated institutional investors and play an important role in our financial system. They are active participants in the commodity, securities and over-the-counter ("OTC") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. The growth and diversification of investment funds have strengthened U.S. capital markets and provided investors with the means to diversify their investments, thereby reducing overall portfolio investment risk. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

In addition, MFA members are active participants in the OTC derivatives markets, where they use swaps to, among other things, hedge risk. For example, an asset manager that has investments denominated in foreign currencies may engage in an FX swap to hedge against the risk of currency fluctuations and protect its portfolio from such related losses. As active participants in the derivatives markets, MFA members also play a critical role in enabling commercial and other institutional market participants to reduce

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their commercial or balance sheet risk through the use of swaps. For example, corporate end-users may purchase a credit default swap from a dealer to protect themselves from the default of another corporation, or a pension fund may purchase a variance swap from a dealer to protect against stock market volatility and to ensure that it can meet its future obligations to pensioners. In such scenarios, dealers generally look to balance their books by purchasing offsetting protection from market participants who may be better positioned to manage such risk, such as hedge funds. Dealers would be limited in the amount of protection they could offer their customers if there were no market participants willing to purchase or sell protection to mitigate a dealer's risk.

MFA members depend on reliable counterparties and market stability. As such, we have a strong interest in promoting the integrity and proper functioning of the OTC derivatives markets, and in ensuring that new regulations appropriately address interconnectedness and systemic risk, include adequate protections for customers' collateral and promote open and transparent markets. MFA is fully supportive of policymakers' goals to improve the functioning of the markets and protect customers by promoting central clearing of derivatives, increasing transparency and implementing other measures intended to mitigate systemic risk. MFA believes that moving to central clearing will yield immediate results by improving efficiency and competitiveness in the OTC derivatives markets as well as reducing interconnectedness and systemic risk. Such improvements in the financial markets in turn reduce the cost of capital and help drive job creation.

On behalf of MFA, I appreciate the Committee's review of the implementation of Title VII of the Dodd-Frank Act. MFA provided a number of comments to regulators, which it believes are consistent with the Committee's public policy goals and will further enhance the benefits of OTC derivatives regulation. We would like to work with the Committee, the CFTC and any other interested parties in addressing these issues, and we are committed in working towards regulations that will restore investor confidence, stabilize our financial markets and strengthen our nation's economy.

TIMELINE FOR IMPLEMENTATION OF TITLE VII RULEMAKINGS

MFA recognizes that the Dodd-Frank Act mandates that regulators promulgate a record number of new regulations within 360 days of its enactment. Throughout the legislative and regulatory processes, MFA has advocated for reform of the OTC derivatives markets. In this spirit, we have concrete recommendations that will facilitate prompt implementation of essential reforms, such as central clearing, and move the industry closer to our shared goal of reduced systemic risk and a more efficient market structure. In order to be a constructive part of the process, MFA submitted a letter to the CFTC and SEC Commissioners on March 24, 2011, providing recommendations and a detailed timeline for prompt adoption and implementation of all rules related to OTC derivatives reform. The letter is included as Annex A to this Written Statement.

As a general matter, MFA believes that by properly ordering priorities, establishing a series of defined milestones and implementing reforms in a practical manner that focuses on the ultimate goal (*i.e.*, reducing the risk to the global financial system), the OTC derivatives market could achieve substantial progress towards key regulatory reforms, including central clearing, sooner rather than later. To that end, we believe the first two priorities should be: (i) expanding the use of central clearing for liquid ("clearable") contracts by all relevant classes of market participants; and (ii) having trade repositories receive data on both cleared and bilateral swaps. These changes would provide immediate and substantial benefits to the markets by enhancing price transparency and competition for the most liquid swap transactions. In addition, reforms, such as broad industry clearing and trade repository data, will lay the groundwork for future reforms (*e.g.*, electronic trading and trade transparency) that will provide regulators the data they need (*e.g.*, regarding liquidity and pricing) to promulgate effective rules, oversee the markets and monitor for market risks.

We do not support a "big bang" approach to implementation where all rules take effect simultaneously and almost immediately after adopted as final. We think this approach could strain the structure and resources of the financial markets, might overwhelm the staff and financial resources of regulators and could become a barrier to overall progress on reform. Instead, we recommend implementing rules using a phase-in approach based on the type of product and not the type of market participant. For example, with respect to central clearing, we expect the most liquid and standardized classes of products to be available for clearing first and, at such time, all market participants ready to clear that class of products (including customers) should be initially permitted (but not required) to clear them, as a key step toward ensuring that all relevant participants are prepared for compliance with the clearing mandate when it becomes effective. In addition, in order to allow market participants to prepare for the effectiveness of each of these phased-in rules, we suggest that the SEC and CFTC promptly release their expected plans and timing for adoption and implementation of all rulemakings.

Although as a general matter, we support moving forward on critical Title VII reforms, we are concerned about provisions in Title VII that automatically will become effective on July 16, 2011 without any rulemaking. Without the benefit of additional, related or pending CFTC interpretive guidance or rulemakings, certain of these provisions will create operational and compliance issues for MFA's members or their swap counterparties (*e.g.*, the repeal of certain provisions in Part 2 of the CFTC regulations that provide legal certainty to swap transactions). We appreciate that the CFTC is holding an open meeting to discuss the issue and that the SEC announced that they would also be taking steps to resolve these concerns. We are supportive of their efforts, although we are still evaluating the solutions that they are proposing.

CENTRAL CLEARING AND ACCESS TO CLEARING SIGNIFICANT ENTITIES

MFA supports policymakers' efforts to reduce systemic risk by transitioning eligible markets to central clearing and by enhancing transparency. We believe that central clearing will play an essential role in reducing systemic, operational and counterparty risk. We are confident that "good" clearing (*i.e.*, clearing with objective, risk-based standards for participation and real-time trade acceptance), with open access and real-time processing, will become the foundation for competitive swap execution facilities ("SEFs") and consequent significant improvements in transparency. While we expect a bilateral market to remain for limited customized business and risk management needs, the vast majority of the volume in the OTC derivatives markets is concentrated in products that are appropriate and should be eligible for clearing.

We believe that mandatory clearing and gathering of data by swap data repositories ("SDRs"), to the extent practicable, are key first steps that will offer increased regulatory and market efficiencies, greater market transparency and competition. Since the beginning of this important debate, MFA has supported central clearing. In that vein, we urge regulators to move deliberately and promptly to ensure that *all* relevant participants in the market are afforded open access to clearing and are in a position to comply the clearing mandate as regulators phase it in.

With over three years of foundational work in OTC derivatives clearing behind us, the industry is in a good position to complete the remaining milestones to prepare for widespread clearing in the near term. Clearinghouses for credit default swaps ("CDS") and interest rate swaps ("IRS") have already been through extensive dealer-to-dealer clearing. Since 2009, IntercontinentalExchange has cleared CDS representing over $15 trillion in gross notional amounts and more than 400,000 transactions, primarily in dealer-to-dealer transactions. In addition, since 1999, LCH.Clearnet has cleared $295 trillion in gross notional amounts of dealer-to-dealer IRS in 14 currencies.

In addition, although a number of key impediments to buy-side clearing exist, buy-side participants have also undertaken significant steps to prepare for greater, open access to clearing. For example, a number of buy-side firms, including Citadel, have negotiated clearing arrangements, tested margin methodologies, tested straight-through processing and worked through a wide range of operational and reporting prerequisites to clearing in volume. Clearing members have also been working for several years now on structuring offerings to clients, including smaller clients with limited operational capacity themselves, to support widespread clearing. It makes good policy sense to capitalize on this momentum by moving forward with greater clearing generally and facilitating greater buy-side clearing.

As experienced and active market participants, we recognize that the success of central clearing and the gathering of data will depend on the structure, governance and financial soundness of derivatives clearing organizations ("DCOs"), SDRs, SEFs and

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designated contract markets ("DCMs"). Accordingly, we emphasize the need for DCOs, wherever applicable, to have transparent and replicable risk models and straight-through, real-time processing that enable fair and open access in a manner that incentivizes competition and reduces barriers to entry. Thus, from a customer protection perspective, we believe it is important to have customer representation on the governance and risk committees of DCOs because given the critical decisions such committees will make (*e.g.*, decisions about which classes of swaps the DCO is permitted to clear), they will benefit from the perspective of such significant and longstanding market participants. We also believe that to completely effectuate fair representation and balanced governance, it is critical that the CFTC adopt regulations that prohibit any one group from constituting a controlling majority of DCO boards or risk committees.

With respect to DCOs, DCMs and SEFs, MFA appreciates that the CFTC has proposed rules intended to ensure that these crucial entities are governed in a manner that prevents conflicts of interest from undermining the CFTC's mission to reduce risk, increase transparency and promote market integrity within the financial system. We very much appreciate that the proposed rules reflect the CFTC's detailed appraisal of market concerns, and we believe the rules are a critical step towards mitigating conflicts of interest at DCOs, DCMs and SEFs while preserving their competitiveness and ability to provide the best possible services to the markets.

With respect to SDRs, we emphasize that their role as data collectors is critical to providing transparency and greater information about the financial markets. We believe that the data received by SDRs and shared with regulators will form an essential component of the regulatory process by providing regulators with the information necessary to refine their regulations and to effectively oversee the markets and market participants. Such data collection efforts are an important first step towards the long-term goal of real-time public reporting.

CAPITAL AND MARGIN REQUIREMENTS

The Dodd-Frank Act requires the Prudential Regulators to impose capital and margin requirements on market participants that are subject to their regulation as swap dealers ("SDs") or major swap participants ("MSPs", and together with SDs, Covered Swap Entities). MFA strongly supports measures to reduce systemic risk in the swap markets, including the imposition of balanced, risk-based margin requirements, but we want to ensure that the Prudential Regulators' proposed capital and margin requirements for Covered Swap Entities' uncleared swaps promote a balanced approach between decreasing unnecessary risk and maintaining necessary liquidity in swap markets.

In particular, we are concerned that although the Prudential Regulators' proposed margin requirements do not prevent Covered Swap Entities from posting variation margin to their financial entity counterparties on their uncleared swaps, they also do not include an express requirement that Covered Swap Entities do so. Rather, the Prudential

Regulators' proposed requirements create a potential misperception that it is neither necessary nor important for a Covered Swap Entity to post variation margin. MFA is concerned that Covered Swap Entities may use the presumption created by the Proposed Rules to retreat from current market "best practice" of posting variation margin to their counterparties. The ability of market participants to accumulate an unlimited amount of unsecured obligations to counterparties was one of the primary causes of the recent financial crisis and was why entities such as AIG were "too big to fail". As a result, the failure to mitigate current counterparty credit exposures by requiring Covered Swap Entities to exchange variation margin could cause serious harm to the financial system. Moreover, we believe that it is important that bilateral markets be required to maintain the discipline of two-way variation margin as a step for them to transition, to the extent possible, to clearing.

We note also that proposed margin and segregation of collateral rules may, going forward, prohibit arrangements that currently allow netting of a customer's cleared and uncleared positions as well as swap and non-swap positions. We are concerned that such effects will: (i) increase systemic risk by eliminating netting offsets that reduce risk; (ii) restrict the ability of market participants to make efficient use of their capital; and (iii) increase complexity and settlement risk.

MFA is still reviewing and analyzing the Prudential Regulators' proposal as well as CFTC's similar proposed capital and margin requirements for SDs and MSPs subject to its regulation. Therefore, we would appreciate the opportunity to provide our written comment letters to the Committee as an addendum to our testimony once they are complete.

SEGREGATION OF CUSTOMER COLLATERAL

MFA supports measures aimed at increasing protections for customer assets posted as collateral for swaps. For cleared swaps, MFA applauds policymakers' decision in the legislation to prohibit futures commission merchants ("FCMs") from treating a customer's margin as its own and from commingling their proprietary assets with those of their customers. We agree that segregation of assets is a critical component to the effective functioning of the mandatory clearing regime and necessary to ensure that customer assets are protected in the event of the FCM's insolvency. The Dodd Frank Act provides critical support for clearing by expressly confirming that a clearing member must fully segregate its customer assets relating to a swap from its own assets under applicable bankruptcy rules.

MFA members have been active participants in the policy discussion about the best specific segregation model to apply to cleared customer assets. As a result, we applaud the CFTC for proposing to adopt the more protective Full Legal Segregation Model (over the Legal Segregation with Recourse Model or the Futures Model). We believe that the Full Legal Segregation model provides a high degree of protection to

customer collateral as well as increased assurance that customers will be able to promptly transfer their positions and collateral in the event of their clearing member's default, while hopefully avoiding the potentially substantial cost and delay that might be entailed in shifting to a model of complete legal and operational partitioning.

However, we are concerned that the CFTC's proposed segregation rules would prohibit an FCM from imposing, or permitting the imposition of, a lien on the collateral of a cleared swaps customer, even when the lien is imposed at the request of the customer itself. The purpose of this prohibition is to preempt the claim of an FCM's creditor against any customer's collateral in the event of the FCM's insolvency, and thereby, help ensure the portability of such collateral. While we support the efforts of the CFTC to protect customers and the portability of their assets, we think it critical that the CFTC eliminate this restriction and preserve customers' ability to initiate negotiated arrangements that permit such liens.

DEFINITION OF MAJOR SWAP PARTICIPANT

The legislation provides a definition for the term "major swap participant", which is a new category of market participant. Because entities that become MSPs will be subject to significant regulatory obligations, including new capital requirements as well as a number of business conduct and other requirements, the way in which regulators define this important term will significantly affect the evolving markets for swaps and the conduct of participants in these markets. MFA believes that the MSP designation should capture non-dealer market participants whose swap positions may adversely affect market stability. In addition, we strongly support the need for enhanced market standards and consistency to prevent anomalous and dangerous practices, such as AIG's, and which mitigate the excessive build-up of counterparty and systemic risk.

The legislation gives the CFTC, jointly with the SEC, (together with the CFTC, the "Commissions"), the authority to define certain important terms that form part of the MSP definition, such as "substantial position", "substantial counterparty exposure" and "highly leveraged". The Commissions have jointly issued a proposed rule providing different tests and threshold levels for these terms in order to clarify which entities are MSPs.

MFA supports the Commissions' general approach to the MSP definition and the tests for the different terms. However, we think it would be useful for the Commissions first to conduct an informal survey to determine which types of market participants will likely meet the definition and whether the proposed definitional thresholds are appropriate as proposed. We think the Commissions can conduct such a survey without incurring significant costs or delaying the progression of the regulations. In addition, we would appreciate more clarity around the tests, such as on (i) the effects of over-collateralization or cleared swap positions on the calculations, and (ii) the treatment of cleared swaps for purposes of the potential future exposure test. We think clarity is

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essential to ensure that there is a bright line where market participants have certainty as to whether they need to register as an MSP. Lastly, to be effective going forward, the Commissions need to ensure that their proposed rules take into account reasonable projections about market activity and growth, so that the rules capture the intended market participants, consistent with the goal of monitoring and overseeing entities that could pose systemic risk to the United States financial markets.

SWAP EXECUTION FACILITIES

The legislation defines a "swap execution facility" (a "SEF") as "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that—(A) facilitates the execution of swaps between persons; and (B) is not a designated contract market." However, we are concerned that the CFTC is interpreting the definition too narrowly because its proposed rule requires that to qualify as a SEF a company must offer a "many-to-many" quote platform (*i.e.*, a trading platform where a market participant must transmit a request for a buy or sell quote to no less than five market participants). We believe that the mandated minimum number of request-for-quote recipients is unnecessary and could harm customers' ability to execute these transactions efficiently.

MFA believes that each SEF trading platform needs to be appropriate for the product type it will execute, as the characteristics and corresponding trading needs vary. In addition, we believe that permitting a broad range of swap trading platforms (subject to the requirements under the legislation) would benefit investors and the markets by increasing regulatory and market efficiencies, promoting market-based competition among providers and enabling greater transparency over time and across a variety of products. Therefore, we would appreciate it if policymakers could provide guidance to the CFTC on Congress's intended interpretation of the definition, so that the CFTC's final rules will preserve flexibility and opportunity for variety and organic development among SEF trading platforms to the benefit of all market participants and consistent with the approach in other markets.

In addition, the CFTC's proposed rules relating to SEFs also raise a number of issues related to block trade sizes. The CFTC's proposed definition of block size has such a high threshold that only very large trades would qualify as block trades. We believe that it is important that the CFTC define the notion of block size in a way that allows a sufficient number of block trades and illiquid and bespoke swaps to continue to take place. As a result, MFA believes that with respect to the determination of block trade sizes for swaps, regulators should obtain empirical evidence before establishing block trade levels for each swap class (*e.g.*, relating to duration, underlying reference entity, etc.), so as to ensure that the CFTC's final rules on block trades do not disrupt markets or reduce liquidity. In addition, once the CFTC has the evidence to proceed, we believe that the CFTC's determinations relating to block size should take into account the

varying characteristics of liquidity of the market for a particular instrument and the characteristics of the relevant class or product.

In this context, we refer again to our proposed implementation timeline, which sequences broad access to and utilization of clearing ahead of requirements to trade on SEFs and requirements for individual real-time trade reporting. We believe that by first prioritizing clearing and reporting to regulators, regulators will obtain valuable information regarding trade volumes, pricing and liquidity, which they can then use to determine subsequent transparency requirements and to create the foundation for SEFs to offer their facilities on an open and competitive basis. As leading buy-side participants, we currently see considerable preparation by a range of existing and start-up SEFs seeking to capitalize on the opportunities created by Dodd Frank, which will become concrete once suitable clearing models become available that set out the requirements for open access.

POSITION LIMITS

MFA recognizes that the Dodd-Frank Act expanded the CFTC's authority to set position limits, as the Commission finds necessary to deter and prevent excessive speculation that causes sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity. Academic and governmental studies[1] and real world examples have not found excessive speculation to be the cause of recent market volatility and show that policies restricting investor access to derivatives markets impair commercial participants' ability to hedge and restrict the use of risk management tools. Nevertheless, concerns with the effectiveness of position limits aside, we have strong concern with the

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[1] *See* CFTC Inter-Agency Task Force on Commodity Markets—Interim Report on Crude Oil (July 2008); GAO Briefings to the House Committee on Agriculture on Issues Involving the Use of Futures Markets to Invest in Commodity Indexes (Dec. 2008); International Organization of Securities Commission's Technical Committee (IOSCO) Final Report (Mar. 2009); IMF World Economic Outlook (Oct. 2008); HM Treasury Global Commodities: A long term vision for stable, secure and sustainable global markets (June 2008); CME Group white paper "Excessive Speculation and Position Limits in Energy Derivatives Markets," available at http://cmegroup.com/company/files/PositionLimitsWhitePaper.pdf; *Dr Evil, or drivel? The charge-sheet against commodity speculators is flimsy*, Economist, November 11, 2010 ("In fact there is little empirical evidence that investors cause more than fleeting distortions to commodity prices. The most persuasive explanation for the rises and falls of commodities is demand and supply."); Irwin, Scott. H., and Sanders, Dwight R. (2010), The Impact of Index and Swap Funds on Commodity Futures Markets: Preliminary Results, OECD Food, Agriculture and Fisheries Working Papers, No. 27, OECD Publishing; "With Better Data, Better Understanding" (Jan. 27, 2009); Lawrence Eagles, J.P. Morgan; CFTC Staff Report on Commodity Swap Dealers & Index Traders (Sept. 2008); "Commodity Price and Futures Positions" (Dec. 16, 2009), Ruy Ribero, Lawrence Eagles and Nicholas von Solodkoff, J.P. Morgan; "We can safely say there is no indication in this data of the fact speculators are pushing the price of oil," Christophe Barret, global oil analyst at Credit Agricole, quoted in Energy Risk (Apr 13, 2010), available at http://www.risk.net/energy-risk/news/1600919/cftc-speculators-influence-commodity-markets; Prepared Testimony of Philip K. Verleger, Jr., Haskayne School of Management, University of Calgary, PKVerleger LLC, to Commodity Futures Trading Commission on The Role of Speculators in Setting the Price of Oil (Aug. 5, 2009); "Speculators Cleared in U.K. Oil Volatility" (July 28, 2009), *The Wall Street Journal*; CFTC Interagency Task Force on Commodity Markets, Interim Report on Crude Oil, *supra* note 11; and Büyükşahin, Haigh, Harris, Overdahl and Robe, Fundamentals, Trader Activity and Derivative Pricing (December 4, 2008), available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/marketreportenergyfutures.pdf.

workability of the CFTC's currently proposed rules on position limits ("Proposed Rules") in many respects.

The CFTC's Proposed Rules depart from its longstanding policy of aggregating positions based on ownership, control of trading decisions and trading in concert. With respect to position limits, Section 4a(a) of the Commodity Exchange Act provides:

> In determining whether any person has exceeded such limits, the positions held and trading done by any persons directly or indirectly controlled by such person shall be included with the positions held and trading done by such person; and further, such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the positions were held by, or the trading were done by, a single person.

Under current regulation, the CFTC provides relief from having to aggregate accounts or positions based on ownership where discretion over trading is granted to an independent third party, because the beneficial owners in these cases do not directly or indirectly control the trading of the accounts or positions involved, and they are often unaware of the specific orders.

The CFTC has given no reason to depart from its longstanding disaggregation policy for independent account controllers, nor do we believe it is consistent with the spirit of the law. The Proposed Rules' elimination of the disaggregation policy for independent account controllers would generally eliminate the ability of firms to disaggregate different parts of their business or different passive accounts that follow different investment strategies. The ability to invest in a variety of strategies and obtain access to a variety of independent managers is particularly important to larger passive investors, such as pension plans.

If asset managers cannot disaggregate independent account controllers for purposes of position limits, asset managers and/or independent account controllers to whom they allocate assets may be compelled to reduce their participation in the futures markets, and/or shift their business to other venues, resulting in a significant reduction of market liquidity on U.S. futures exchanges. We also note that the Proposed Rules would effectively require otherwise independent trading operations of commonly owned enterprises to communicate with each other as to their trading positions and intentions so as to avoid violating position limits. A trader, such as a pension plan, also would be required to signal to its independent managers the positions of its other independent managers to ensure that the trader does not exceed the position limits. Such communications would raise confidentiality issues and the potential for trading in concert, which is precisely the sort of behavior that the Proposed Rules seek to avoid.

MFA believes that, when the CFTC exercises its regulatory oversight authority, it must be cognizant of the effect of the proposed federal limits on the ability of futures markets to perform their fundamental price discovery, risk transfer and risk management

functions, which depend on the existence of liquid, fair, and competitive markets. In this way, position limits regulation is less likely to unintentionally reduce market liquidity and the ability of market participants to appropriately diversify and hedge risk. Accordingly, we recommend that the Committee encourage the CFTC to maintain its longstanding disaggregation policy for independent account controllers with respect to position limits.

INTERNATIONAL

As the Committee is aware, European, Asian and other policymakers are currently working on their proposed regulation with respect to OTC derivatives to complement the market reform occurring in the U.S. However, considerable uncertainty exists with regard to the extraterritorial application of those proposed regulations, particularly the European regulation. MFA respectfully urges U.S. policymakers and regulators to enhance their coordination with their European and other counterparts to ensure that any regulatory reform is consistent, where applicable, and addresses counterparty and systemic risk, while permitting access to, and competition among, central counterparties organized in countries outside of the relevant jurisdiction.

In particular, it is important that approval of third country central counterparties not become unreasonably difficult to obtain. Otherwise, there is potential that the derivatives market will become fragmented along jurisdictional lines, which could cause significant harm to the markets by, among other things, impeding competition, impairing portability and eventual interoperability, limiting participant access to clearing and their ability to operate in certain jurisdictions, and ultimately creating artificial barriers across a global marketplace and instrument type.

While we recognize that the regulatory regimes of different countries may need to diverge to a certain extent, inconsistent regulations will be costly, burdensome and, in some cases, make it impossible for market participants to comply with both regimes. We are appreciative of the ongoing joint efforts of U.S. and non-U.S. regulators to avoid any disharmony between the regulations, to the extent possible, as well as the imposition of duplicative regulation and encourage continued efforts in this regard.

CONCLUSION

On behalf of MFA, I appreciate the Committee's review of the implementation of Title VII of the Dodd-Frank Act one year after enactment. As discussed, MFA believes that OTC derivatives regulation has the potential benefits of reducing systemic and counterparty risk, and enhancing market efficiency, competition and investor protection. We recommend that critical OTC derivatives reforms, such as central clearing, move

forward promptly by ordering priorities, using defined interim milestones and implementing reforms using a product-by-product phase in approach. We believe that smart regulations that parallel market practice will enhance oversight and compliance, support the risk management needs of market participants and further promote innovation and competition.

MFA is committed to working with Members and staff of the Committee and regulators to restore investor confidence, enhance our regulatory system, stabilize our financial markets and strengthen our nation's economy. Thank you for the opportunity to appear before you today. I would be happy to answer any questions that you may have.

SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

ONE YEAR LATER — THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

STATEMENT OF JOHN M. DAMGARD, PRESIDENT FUTURES INDUSTRY ASSOCIATION[1]

JUNE 15, 2011

Chairwoman Stabenow, Ranking Member Roberts, members of the Committee, I am John Damgard, president of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today as we approach the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms, as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearing organizations (DCOs), our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearing organizations and commit a substantial amount of their own capital to guarantee customer transactions. Our member firms, along with the DCOs of which they are members, take seriously their responsibility to manage carefully the significant financial risks that they assume on a daily basis.

We take justifiable pride that throughout the financial crisis, the futures markets operated well; no FCM failed and no customer lost money as a result of a failure of the futures regulatory system.

Guidance on the Extraterritorial Scope of the Commission's Rules is Essential

When Congress was considering the Dodd-Frank Act, many in the financial services industry — and in Congress — cautioned that the extraterritorial reach of the regulatory structure being established in the U.S. would unnecessarily interfere with the regulatory programs being established in the European Union and Asia and would inhibit the ability of U.S. market participants to compete internationally. As we approach the effective date of the Dodd-Frank Act, there is increasing evidence that last year's fears will be this year's reality.

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1 This statement is written prior to the Commission's scheduled meeting on June 14, at which it is expected to consider effective dates of the several provisions of the Dodd-Frank Act. The Commission's actions at that meeting may help resolve some or all of the questions that have arisen regarding the interpretation of the effective date provisions, and the legal uncertainty arising therefrom, discussed herein.

We were pleased, therefore, to learn that Ms. Stabenow and Mr. Roberts recently wrote to their colleagues in the European Parliament, in which they acknowledged "that there are significant questions about the legal and jurisdictional reach of U.S. regulation" and pledged to work with the European Parliament and U.S. regulatory authorities to resolve these questions. As the Senators emphasized, "a key objective of the [Dodd-Frank] Act was to 'consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards' for the regulation of derivatives transactions."

Although we understand that consultation among the Commission and international regulators has been considerable, coordination appears to have been lacking. To the contrary, the message that has been received — publicly, at least — is that "consistent international standards" can only be assured by adopting the same rules that the Commission has proposed. We respectfully submit that "coordination" requires a willingness to compromise for the sake of achieving a common goal. These are qualities that any successful Senator understands and for which this Committee, with its long tradition of bipartisanship, is known and respected. FIA, therefore, welcomes the Senators' pledge to work closely with their European colleagues "to harmonize rules on trade reporting, execution and other issues that affect the global markets." Having just returned from London, where FIA co-sponsored the International Derivatives Expo, I am confident that your involvement will be welcomed in Europe as well. The potential extraterritorial reach of the Dodd-Frank Act, and the legal uncertainty such reach would engender, was a constant theme among participants.

The failure of the Commission to provide clear guidance on the extraterritorial scope of the Dodd-Frank Act prior to its effective date, and the resultant legal and regulatory uncertainty to which market facilities and participants both here and abroad will be exposed, will require such participants to incur significant costs to comply with the Dodd-Frank Act or assume the regulatory risk that they will be found to be in violation of one or more provisions of the Dodd-Frank Act and, perhaps, ordered to cease business activities until they are in compliance. No market facility or participant can afford to take this risk.

For example, the Dodd-Frank Act makes it unlawful for a clearing organization "directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a derivatives clearing organization with respect to . . . a swap," unless that clearing organization is registered with the Commission as a clearing organization. Under this provision, it appears that a foreign clearing organization would be required to be registered as a DCO, if it clears just one swap for a U.S. participant. This is the case even if the Commission has not determined that the swap is required to be cleared.

Concurrently, however, Congress has provided that the Dodd-Frank Act should not apply to activities that do not have "a direct and significant connection with activities in, or effect on, commerce of" the U.S. The Commission, therefore, has authority to exempt a clearing organization with limited U.S. participation from registration. An exemption would permit such clearing organizations to offer clearing services to U.S. participants without having to incur the costs of applying for registration and, thereafter, meet duplicative and potentially conflicting, regulatory requirements of the Commission and its home country regulator.

The Dodd-Frank Act also makes it unlawful for a clearing member to accept money or securities from a swaps customer without being registered as an FCM. This provision caused FIA to file a petition for a temporary exemption from registration as an FCM on behalf of our members' non-U.S. affiliates that are clearing members of ICE Clear Europe, and similarly situated clearing members. (A copy of the petition is attached to this statement, and we respectfully request that it be made a part of the record.) ICE Clear Europe is the clearing organization for over-the-counter energy derivatives executed through the IntercontinentalExchange. We filed this petition for temporary exemption as a precautionary measure in order to assure that U.S. customers would be able to continue to clear trades without disruption after the July 16 effective date of the Dodd-Frank Act.

As the Committee is aware, one of the principal purposes of the Dodd-Frank Act is to encourage competition among clearing organizations and clearing members. Requiring each foreign clearing organization that clears swaps for or on behalf of U.S. participants to become registered as a DCO and each clearing member that, directly or indirectly, clears for U.S. participants to become registered as an FCM will almost certainly restrict rather than encourage competition. Requiring U.S. FCMs to become registered with multiple foreign DCOs may also enhance systemic risk, by exposing such FCMs to the risks of being members of clearing organizations that are subject to different regulatory regimes and bankruptcy laws.

Two of the more active swaps clearing organizations registered with the Commission, ICE Clear Europe and LCH.Clearnet Ltd., are located outside of the U.S., and we fully expect that other foreign clearing organizations may elect or be required to be registered with the Commission as DCOs. Certainly, any foreign clearing organization that elects to apply for registration as a DCO should be permitted to apply. However, we do not believe every foreign clearing organization that clears swaps, where U.S. participants are involved, should be required to be registered simply because it clears for U.S. participants.

An exemption from registration would relieve the Commission of the substantial costs of overseeing such foreign clearing organizations and free staff to focus on transactions that more directly affect U.S. market participants. In his testimony before the Senate Appropriations Subcommittee on Financial Services and General Government in May, Chairman Gensler stated that the Commission currently oversees 14 registered DCOs and anticipates that the Dodd-Frank Act will result in an additional six or seven clearing organizations applying for registration as a DCO. The Commission is requesting a 30 additional staff "to address the significant increase in the number of DCOs."

A Successful Model for the Oversight of Foreign DCOs

This does not need to be the result. As noted above, Congress determined to limit the application of the Dodd-Frank Act on activities outside of the U.S. The statute should not apply to a foreign clearing organization, unless such activities have "a direct and significant connection with activities in, or effect on, commerce of" the U.S. We believe the Commission has authority to interpret this provision to exclude from its jurisdiction certain entities and transactions that do not have a significant impact on U.S. commerce. Elsewhere in the Dodd-Frank Act, the Commission has specific authority to exempt a foreign clearing organization from registration,

subject to conditions, if the Commission determines that the foreign clearing organization is subject to comparable, comprehensive supervision and regulation by government authorities in its home country.

The Commission's Part 30 rules, which govern the offer and sale of foreign futures and options transactions to U.S. participants, is a tested, successful model for the regulation of international transactions that could serve as a starting point for exempting foreign clearing organizations and other market participants from the Commission's registration requirements. The Commission's Part 30 rules were first promulgated nearly 24 years ago in 1987. Under these rules, foreign clearing organizations are not required to be registered with the Commission to clear futures contracts executed on foreign exchanges on behalf of U.S. participants. In addition, a foreign clearing member is not required to be registered with the Commission as an FCM, if the foreign clearing member carries only a customer omnibus account on behalf of a U.S. FCM and does not carry an account directly for a U.S. customer.

These rules assure that the accounts of U.S. participants are carried by U.S. FCMs, subject to the Commission's rules regarding the protection of foreign futures and options customer funds, as well as the Commission's sales practice and other requirements to which FCMs are subject. Customers that trade on non-U.S. markets also receive prescribed risk disclosure, which assures that they understand the additional risks of trading outside of the U.S.

Further, the rules provide that a foreign clearing member may deal directly with FCMs and their affiliates without having to be registered with the Commission as FCMs. Having determined that a foreign clearing member is not required to be registered as an FCM to carry a U.S. FCM's customer omnibus account, the Commission concluded that registration would not be required to clear the U.S. FCM's proprietary accounts. The Commission concluded that U.S. FCMs are able to assess the risks of trading on foreign markets.

Finally, under the Part 30 rules, the Commission has granted exemptions from registration to non-U.S. firms that deal with U.S. customers and that the Commission determines are subject to comparable regulation in their home country.

Exemptive Relief Will Facilitate Coordination Among International Regulators

By granting appropriate exemptive relief, we believe the Commission will facilitate greater coordination among international regulators and the establishment of consistent standards with respect to the regulation of swaps among regulatory authorities in the U.S., Asia and the European Union. An example of the need for such coordination has been brought into sharp relief with recent reports that the European Parliament is considering amendments to the EU's European Market Infrastructure Regulation ("EMIR"), which would effectively prohibit a third-country clearing organization from providing clearing services to EU entities, unless the clearing organization is authorized by each EU member state. A third country clearing organization could be authorized only if the European Commission recognized that the legal and supervisory arrangements of its home jurisdiction were "equivalent" to those contained within EMIR. We have been advised that European Securities and Markets Authority (ESMA) anticipates that it will be able to recognize US DCOs, but would expect that such recognition would be reciprocal.

If the European Parliament adopts these amendments, we believe it would be extremely difficult for U.S. DCOs to offer their clearing services to entities within the EU, unless U.S. regulation is determined to be "equivalent" to the standards contained in EMIR. The potential "balkanization" of derivatives clearing in this way benefits no one, denying market participants access to clearing, reducing competition and increasing global systemic risk. Yet, the Commission's ability to work with ESMA will be severely constrained if the Dodd-Frank Act is interpreted to require EU clearing organizations to be registered here to offer clearing services to U.S. participants.

The Commission has been a leader in developing standards for mutual recognition among international regulators for more than 20 years. The Dodd-Frank Act should not be interpreted in a manner that requires the Commission to surrender this leadership role.

Legal and Regulatory Uncertainty Creates Substantial Financial Risk

Legal uncertainty is a domestic as well as an international concern. When Congress determined that the provisions of the Dodd-Frank Act would generally become effective on July 16, it no doubt assumed that the bulk of the regulations necessary to implement its provisions would have been adopted. Despite the best efforts of the Commission and its staff, however, that is not the case.

Importantly, the Commission only recently proposed rules to establish a segregation scheme for cleared swaps customer collateral. The proposed rules would create a regulatory regime for the segregation of cleared swaps customer collateral that differs substantially from the regulations governing the segregation of customer funds held in connection with futures and options on futures transactions executed on U.S. designated contract markets. The Commission has also requested comment on alternative segregation schemes and has made clear that the final rules may look significantly different from the rules the Commission has proposed. The rules governing cleared swaps customer collateral are a linchpin of the Commission's customer protection regime. Until such rules become final, the extent to which other customer protections can be implemented will be limited.

Whichever segregation scheme is ultimately selected, FCMs and end-users alike would need to make substantial changes to their back office systems. At a June 3, 2011 Commission roundtable on the proposed rules, several representatives of investment managers also anticipated that, once the segregation rules are adopted, they would need two years before they would be ready to engage in cleared swaps transactions. In addition to implementing changes to their back office systems, they would have to undertake a significant educational process with their clients to explain their respective rights and obligations under the rules. They would then need to obtain written authorization from each client to engage in cleared swaps transactions on their behalf. This process cannot begin until the rules have been adopted.

Moreover, the Commission has not yet made decisions on other critical issues that will determine the Commission's view of the full scope of its jurisdiction. The basic definitions of a "swap dealer", "major swap participant" and "swap" have not been adopted. Similarly, rules relating to capital and margin requirements have not been finalized. As a result, many swap market

participants may not be aware, or may be uncertain, whether they will be required to be registered with the Commission in some capacity or otherwise be affected by the proposed rules. Until these issues and the extraterritorial scope of the Commission's jurisdiction are resolved, holding companies with multiple affiliates will be unable to determine the appropriate entity (or entities) that should be registered as swap dealers.

Consequently, there is substantial uncertainty concerning the ability of market participants to conduct a broad range of activities after July 16 as well as the continued legality of transactions entered into prior to that date. Such legal uncertainty benefits no one and exposes all market participants to substantial financial risk.

On Friday, June 10, FIA joined with other financial services trade associations to request the Commission to adopt appropriate interpretative and exemptive relief necessary to assure an orderly implementation of the amendments to the Commodity Exchange Act made by the Dodd-Frank Act and avert severe market disruption. FIA respectfully requests the Committee to encourage the Commission to exercise its interpretative and exemptive authority to this end.

Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you may have.

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. SENATE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY

WASHINGTON, DC

June 15, 2011

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

I am pleased to testify alongside Michael Gibson from the Federal Reserve.

Financial Crisis

It has been nearly one year since the President signed the Dodd-Frank Act into law. It is important to remember why the Dodd-Frank Act's derivatives reforms are necessary.

The 2008 financial crisis occurred because the financial system failed the American public. The financial regulatory system failed as well. When AIG and Lehman Brothers

faltered, we all paid the price. The effects of the crisis remain, and there continues to be significant uncertainty in the economy.

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

Derivatives Markets

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

With notional values of more than $300 trillion in the United States – that's more than $20 of swaps for every dollar of goods and services produced in the U.S. economy – derivatives

markets must work for the benefit of the American public. Members of the public keep their savings with banks and pension funds that use swaps to manage their interest rate risks. The public buys gasoline and groceries from companies that rely upon futures and swaps to hedge their commodity price risks.

That's why oversight must ensure that these markets function with integrity, transparency, openness and competition, free from fraud, manipulation and other abuses. Though the CFTC is not a price-setting agency, recent volatility in prices for basic commodities – agricultural and energy – are very real reminders of the need for common sense rules in the derivatives markets.

The Dodd-Frank Act

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

Broadening the Scope

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

The Dodd-Frank Act also broadened the CFTC's oversight to include authority to register foreign boards of trade (FBOTs) providing direct access to U.S. traders. To become registered, FBOTs must be subject to regulatory oversight that is comprehensive and comparable to U.S. oversight. This new authority enhances the Commission's ability to ensure that U.S. traders cannot avoid essential market protections by trading contracts traded on FBOTs that are linked with U.S. contracts.

Promoting Transparency

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

The more transparent a marketplace is, the more liquid it is, the more competitive it is and the lower the costs for hedgers, borrowers and their customers.

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

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

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

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

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

Lowering Risk

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

Oversight of swap dealers, including capital and margin requirements, business conduct standards and recordkeeping and reporting requirements will reduce the risk posed to the economy by these dealers.

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

Enforcement

Effective regulation requires an effective enforcement program. The Dodd-Frank Act enhances the Commission's enforcement authorities in the futures markets and expands them to the swaps markets. The Act also provides the Commission with important new anti-fraud and anti-manipulation authority based upon similar authority that the SEC, Federal Energy Regulatory Commission and Federal Trade Commission have for securities and certain energy commodities.

By expanding the CFTC's arsenal of enforcement tools, the Act strengthens the ability of the Commission to effectively deal with threats to market integrity. We will use these tools to be a more effective cop on the beat, to promote market integrity and to protect market participants.

Position Limits

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

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

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

Rule-Writing Process

The CFTC is working deliberatively, efficiently and transparently to write rules to implement the Dodd-Frank Act. At this point, we have substantially completed the proposal phase of our rule-writing.

The public had an opportunity to comment on the entire mosaic of proposed rules in a supplemental comment period of 30 days, which closed last Friday, June 3.

We will begin considering final rules only after staff can analyze, summarize and consider comments, after the Commissioners are able to discuss the comments and provide feedback to staff, and after the Commission consults with fellow regulators on the rules.

The Commission yesterday scheduled public meetings in July and August to begin considering final rules under Dodd-Frank. We envision having more meetings in September and into the fall to take up final rules.

The Dodd-Frank Act has a deadline of 360 days after enactment for completion of the bulk of our rulemakings – July 16, 2011. The Commission had a public meeting yesterday to address issues related to the transition period between July 16 and the effective dates of CFTC rulemakings. The Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. We are coordinating closely with the SEC on these issues.

The Dodd-Frank Act made many significant changes to the CEA. Section 754 of the Dodd-Frank Act states that Subtitle A of Title VII – the Subtitle that provides for the regulation of swaps – "shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provisions of this subtitle."

Thus, those provisions that require rulemakings will not go into effect until the CFTC finalizes the respective rules. Furthermore, they will only go into effect based on the phased implementation dates included in the final rules. During yesterday's public Commission meeting, the CFTC released a list of the provisions of the swaps subtitle that require rulemakings.

Unless otherwise provided, those provisions of Title VII that do not require rulemaking will take effect on July 16. The Commission voted to issue a proposed order that would provide relief until December 31, 2011, or when the definitional rulemakings become effective, whichever is sooner, from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This includes provisions that do not directly rely on a rule to be promulgated, but do refer to terms that must be further defined by the CFTC and SEC, such as "swap" and "swap dealer."

The order proposed by the Commission also would provide relief through no later than December 31, 2011, from certain CEA requirements that may result from the repeal, effective on July 16, 2011, of some of sections 2(d), 2(e), 2(g), 2(h) and 5d.

The proposed order will be open for public comment for 14 days after it is published in the Federal Register. We intend to finalize an order regarding relief from the relevant Dodd-Frank provisions before July 16, 2011.

Phasing of Implementation

The Dodd-Frank Act gives the CFTC and SEC certain flexibility to set effective dates and a schedule for compliance with rules implementing Title VII of the Act. The order in which the Commission finalizes the rules does not determine the order of the rules' effective dates or applicable compliance dates. Phasing the effective dates of the Act's provisions will give market

participants time to develop policies, procedures, systems and infrastructure needed to comply with the new regulatory requirements. It will lower risk and costs of compliance.

In early May 2011, CFTC and SEC staff held a roundtable to hear directly from the public about the timing of implementation dates of Dodd-Frank rulemakings. Prior to the roundtable, on April 29, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. We also opened a public comment file last month that closed on Friday, June 10, to hear specifically on this issue. The roundtable and 291 public comment letters help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time.

One concept that the CFTC is considering with regard to phasing of effective dates is phasing in effective dates over time rather than all at once. Those rules that could be implemented sooner should be so as to lower risk.

A second is that we are looking at whether there are certain requirements that should be met soon than others. For market infrastructures, such as clearinghouses, trading platforms and data repositories, for example, registration with the Commission and development of new policies, procedures and rulebooks should be completed before compliance with those policies, procedures and rulebooks by market participants could be required. More specifically, clearinghouses, for example, may be required to be registered and provide for client clearing at an effective date in advance of any determinations of clearing mandates.

Conclusion

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

The CFTC must be adequately resourced to police the markets and protect the public. The CFTC is taking on a significantly expanded scope and mission. By way of analogy, it is as if the agency previously had the role to oversee the markets in the state of Louisiana and was just mandated by Congress to extend oversight to Alabama, Kentucky, Mississippi, Missouri, Oklahoma, South Carolina, and Tennessee.

With seven times the population to police, far greater resources are needed for the public to be protected. Without sufficient funding for the agency, our nation cannot be assured of effective enforcement of new rules in the swaps market to promote transparency, lower risk and protect against another crisis. It would hamper our ability to seek out fraud, manipulation and other abuses at a time when commodity prices are rising and volatile.

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

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

For release on delivery
9:30 a.m. EDT
June 15, 2011

Statement by

Michael S. Gibson

Senior Associate Director

Division of Research and Statistics

Board of Governors of the Federal Reserve System

before the

Committee on Agriculture, Nutrition, and Forestry

U.S. Senate

June 15, 2011

Chairwoman Stabenow, Ranking Member Roberts, and other members of the Committee, I appreciate this opportunity to provide the Federal Reserve Board's views on the implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Board's responsibilities with respect to over-the-counter (OTC) derivatives fall into three broad areas: consultation and coordination with other authorities, both domestic and international; efforts to strengthen the infrastructure of derivatives markets; and supervision of many derivatives dealers and market participants.

Consultation and Coordination

The Dodd-Frank Act requires that the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) consult with the Board on the rules they are crafting to implement several provisions of title VII. Immediately after passage of the act, the staff from the commissions and the Board met to fashion a process for this consultation; at the Board, we identified members of the staff with relevant expertise, both here and across the Federal Reserve System. Our staff have commented on proposed rules of the commissions at each stage of the development process to date. In providing feedback, we have tried to bring to bear our experience from supervising dealers and market infrastructure as well as our familiarity with markets and data sources to assist the commissions.

Important coordination activities related to derivatives regulation also are occurring within international groups. Most prominently, the Group of Twenty (G-20) leaders have set out commitments related to reform of the OTC derivatives markets that, when implemented by national authorities, will form a broadly consistent international regulatory approach. Work on the G-20 commitments is being done by numerous groups of technical and policy experts, and staff members from the Federal Reserve are actively participating in these groups.

More generally, the Board participates in many international groups that serve as vehicles for coordinating policies related to the participants and the infrastructure of derivatives markets. These groups include the Basel Committee on Banking Supervision (Basel Committee), which has recently enhanced international capital, leverage, and liquidity standards for derivatives, and the Committee on Payment and Settlement Systems, which is working with the International Organization of Securities Commissions to update international standards for systemically important clearing systems, including central counterparties that clear derivatives instruments, and trade repositories. Public consultation on these revised international standards is currently under way.

The goal of all of these efforts is to develop a consistent international approach to the regulation and supervision of derivatives products and market infrastructures as well as to the sound implementation of the agreed-upon approaches. Our aim is to promote both financial stability and fair competitive conditions to the fullest extent possible.

Infrastructure Issues

The Dodd-Frank Act addressed both the infrastructure of the derivatives markets and the regulation and supervision of its dealers and major participants. Central counterparties are given an expanded role in the clearing and settling of swap and security-based swap (hereafter referred to as "swap") transactions, and the Board believes benefits can flow from this reform. Since 2005, Federal Reserve staff members have worked with market participants to strengthen the infrastructure for OTC derivatives, including developing and broadening the use of central clearing mechanisms and trade repositories. Market participants have already established central counterparties that provide clearing services for some OTC interest rate, energy, and credit derivatives contracts. If properly designed, managed, and overseen, central counterparties offer

an important tool for managing counterparty credit risk, and thus they can reduce risk to market participants and to the financial system. Both central counterparties and trade repositories also support regulatory oversight and policymaking by providing more-comprehensive data on the derivatives markets. The Board is committed to continuing to work with other authorities, both in the United States and abroad, to ensure that a largely consistent international approach is taken to central counterparties and trade repositories and that their risk-reducing benefits are realized.

Title VIII of the act complements the role of central clearing in title VII through heightened supervisory oversight of systemically important financial market utilities, including systemically important facilities that clear swaps. This heightened oversight is important because financial market utilities such as central counterparties concentrate risk and thus have the potential to transmit shocks throughout the financial markets. The Financial Stability Oversight Council is responsible for designating utilities as systemically important. Through its role on the council, the Board participated in the development of the proposed designation process that was released for comment in March. Separately, the Board recently sought comment on proposed risk-management standards that would apply to those designated utilities supervised by the Board under title VIII.[1] We are working closely with the CFTC and the SEC, who will also supervise utilities under title VIII, to develop a cooperative framework to inform and coordinate our respective supervisory authorities. As part of title VIII, the Board was given new authority to provide designated utilities with access to Reserve Bank accounts, payment services, and emergency collateralized liquidity in unusual and exigent circumstances. We are carefully considering ways to implement this authority in a manner that protects taxpayers and limits any rise in moral hazard.

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[1] Board of Governors of the Federal Reserve System (2011), "Federal Reserve Seeks Comment on Proposed Rule Related to Supervision of Designated Financial Market Utilities," press release, March 30, www.federalreserve.gov/newsevents/press/other/20110330a.htm.

Supervisory Issues

Although central counterparties will provide an additional tool for managing counterparty credit risk, enhancements to the risk-management policies and procedures for individual market participants will continue to be a high priority for supervisors. As the reforms outlined in the act are implemented, the most active firms in bilateral OTC markets likely will become active clearing members of central counterparties. As such, the quality of risk management at these firms importantly affects the ability of the central counterparty to manage its risks effectively and to deliver risk-reducing benefits to the markets.

Capital and margin requirements are central to the prudential regulation of financial institutions active in derivatives markets as well as to the internal risk-management processes of such firms. Title VII requires that the CFTC, the SEC, and prudential regulators adopt capital and margin requirements for the noncleared swap activity of swap dealers and major swap participants. The Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration are responsible for adopting capital and margin requirements for swap dealers and major swap participants that are banks or other prudentially regulated entities. The commissions are responsible for adopting capital and margin requirements for swap dealers and major swap participants that are not supervised by a prudential regulator. The prudential regulators and the commissions are consulting in developing the rules, and all agencies must, to the maximum extent practicable, adopt comparable standards. The Board and the other prudential regulators have released for public comment a proposed rule on capital and margin requirements. Our proposal is open for public comment, and we welcome the public's views.

For capital, our proposal relies on the existing regulatory capital requirements, which already specifically address the unique risks of derivatives transactions. Beyond the current requirements, the Board and the other U.S. banking agencies played an active role in developing the recent Basel III enhancements to capital requirements agreed to by the Basel Committee in December 2010. Basel III will, among other things, strengthen the prudential framework for OTC derivatives by increasing OTC derivatives' risk-based capital and leverage requirements and by requiring banking firms to hold an additional buffer of high-quality, liquid assets to address potential liquidity needs resulting from their derivatives portfolios.

Our proposal for margin imposes initial and variation margin requirements on the noncleared swaps held by swap dealers or major swap participants that have a prudential regulator. For swaps with a nonfinancial end-user counterparty, the proposed rule would not specify a minimum margin requirement. Rather, it would allow a banking organization that is a dealer or major participant to establish a threshold, based on a credit exposure limit that is approved and monitored as part of the credit approval process, below which the end user would not have to post margin. The proposed rule would not impose any caps on the credit exposure limits for nonfinancial end-user counterparties. In contrast, for swaps with other counterparties, the proposal would cap the allowable threshold for unsecured credit exposure on noncleared swaps. In addition, the proposal would only apply a margin requirement to contracts entered into after the new requirement becomes effective.

A much-discussed part of the act is the requirement that banks push portions of their swap activity into affiliates or face restrictions on their access to the discount window or deposit insurance. Under the push-out provisions, banking organizations with deposit insurance or access to the Federal Reserve's discount window will have to reorganize some of their

derivatives activity, pushing certain types of swaps out of subsidiary banks and into distinct legal entities that will require their own capitalization and separate documentation of trades with existing customers. The act permits domestic banks to continue to engage in derivatives activities that have been a traditional focus of banks, including hedging activities and dealing in interest rate swaps, currency swaps, certain cleared credit default swaps, and other swaps that reference assets that banks are eligible to hold. However, because of the specific language contained in the act, this exemption for traditional bank derivatives activities does not apply to foreign banking firms that have access to the Federal Reserve's discount window through their U.S. branches. A possibly unintended effect of the act's push-out provision may be to require some foreign firms to reorganize their existing U.S. derivatives activities to a greater extent than U.S. firms. Proposed rules to implement this section are still under development by the banking agencies.

Conclusion

As the implementation process for the act continues, the challenge facing the Board is to enhance supervision, oversight, and prudential standards of major derivatives market participants in a manner that promotes more-effective risk management and reduces systemic risk, yet retain the significant benefits of derivatives to the businesses and investors who use them to manage financial market risks. The Board is working diligently to achieve these goals.

TESTIMONY OF DANIEL J. ROTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
UNITED STATES SENATE

JUNE 15, 2011

My name is Daniel Roth and I am the President and Chief Executive Officer of National Futures Association. NFA is the industry wide self-regulatory organization for the U.S. futures industry. Basically, any firm doing business with the public on a U.S. futures exchange is required to be a member of NFA. Our 4000 member firms include Futures Commission Merchants, Introducing Brokers, Commodity Pool Operators and Commodity Trading Advisors. We also regulate the activities of the 50,000 account executives that are registered as associated persons of our member firms. NFA adopts rules to require members to deal fairly with their customers; we monitor members for compliance with those rules through investigations, surveillance and examinations; and we take disciplinary action against members that fail to comply with those rules. In all of these areas we work very closely with the CFTC as our oversight agency. Over the years, this partnership has led to extraordinary results. Since NFA began operations in 1982, volume on U.S. futures exchanges is up by over 2000% but during that same period of time customer complaints in the futures industry have actually dropped by over 70%.

Now it seems likely that NFA's responsibilities could be expanded significantly as a result of the CFTC's Dodd-Frank rule making. Specifically, the CFTC has proposed regulations that could expand NFA responsibilities in three areas:

- The CFTC has proposed delegating to NFA the responsibility for processing applications for registration as swap dealer and major swap participant, conducting the background checks on those applicants and their principals and, as appropriate, granting or denying those applications;

- The CFTC has also proposed requiring all registered swap dealers and major swap participants to become members of NFA and requiring NFA to monitor those members for compliance with regulatory requirements; and

- Under Dodd-Frank, swap execution facilities will have certain surveillance and self regulatory responsibilities. The CFTC has proposed allowing SEFs to outsource those functions to other registered entities, such as NFA.

In my testimony today I would like to discuss each of these areas and describe the challenges facing NFA and the steps we have taken and are taking to meet those challenges.

Registration of Swap Dealers and Major Swap Participants

Over the years the CFTC has delegated to NFA virtually all of the registration responsibility for all of the categories of registration under the Commodity Exchange Act. All applications for registration as FCMs, CPOs, CTAs, IBs, associated persons, floor brokers or floor traders must be filed with NFA. NFA performs an extensive background check on each application based on the qualification standards set forth in Sections 8a(2) and (3) of the Act and, as appropriate, either grants or denies the application. All of NFA's adverse registration actions are subject to review by the CFTC. It was not surprising, then, that the CFTC has proposed delegating the registration responsibility for swap dealers and major swap participants to NFA as well. When the CFTC first proposed the delegation, NFA began working on the changes to our web based registration system to accommodate these new categories of registration. Those programming changes have been completed and NFA is now in a position to begin accepting and processing applications as soon as the CFTC adopts final rules regarding registration and the definitions of "swap dealers" and "major swap participants."

The trickier part of the registration process will involve the submissions each applicant firm must make as the CFTC's rules promulgated under Section 4s of the Act become effective. The Commission's proposed registration rules contemplate that firms may apply for registration before all of the Section 4s requirements have become effective. In these situations, firms can be granted a "provisional registration." As each Section 4s requirement becomes effective, the firm would be required to submit to NFA written policies and procedures designed to ensure that the firm will be in compliance with the applicable Section 4s requirement. Once all of a firm's Section 4s submissions have been reviewed and approved, the firm would be granted a full registration. If NFA determines that the submissions are not adequate the firm's provisional registration would be withdrawn.

As each Section 4s requirement is phased in, NFA will be receiving fairly voluminous submissions from each firm applying for swap dealer or major swap participant registration. To review these submissions in a timely and meaningful way NFA will need to augment its existing staff, prepare detailed guidance for the NFA staff conducting the reviews and temporarily divert resources from other compliance functions to the review of the submissions. Obviously, we cannot complete the guidance for NFA staff reviewing the Section 4s submissions until the Commission adopts rules in their final form. We have, though, begun preparing the guidance based on the proposed rules and will work closely with the Commission staff in that process. I should also point out that a number of swap dealer firms have been most generous with their time to provide training to both NFA and CFTC staff regarding some of the nuts

and bolts aspects of their operations, which will be a great help in developing the Section 4s guidance for our staff.

Regulation of Swap Dealers and Major Swap Participants

Before NFA can undertake the regulation of swap dealers and major swap participants, we have to address three basic issues: governance, funding and audit modules.

Governance

NFA cannot begin regulating swap dealers and major swap participants until those firms become NFA members and they cannot become NFA members until NFA amends its articles of incorporation to create those categories of membership. We cannot amend the articles of incorporation until we determine the necessary changes to our governing structure to ensure the fair and adequate representation of swap dealers and major swap participants on NFA's Board of Directors. Boiled to its essence, the governance issue involves devising a system of checks and balances to ensure that the futures industry representatives on NFA's board cannot adopt rules to place OTC derivatives at a competitive disadvantage and that the OTC derivative representatives on the Board cannot adopt rules to, in effect, give themselves a free pass.

NFA's Board has appointed a Swap Dealer Advisory Committee to work with NFA's Special Committee on Governance to develop recommended changes to NFA's governing structure. Any amendments to NFA's articles of incorporation must be approved first by NFA's Board, then by NFA's membership and, finally, by the CFTC. We are hopeful that we can present the proposed changes to NFA's Board this summer. That will depend, however, on the CFTC's adoption of final definitions of the terms "swap dealer" and "major swap participant," since it would be impossible to determine issues on board representation until we know the actual definitions of the appropriate categories.

Funding

NFA now has three main areas of regulatory responsibility: regulation of intermediaries involved with exchange traded futures, trade practice and market surveillance on behalf of certain futures exchanges and the regulation of off exchange retail forex dealers. We have consistently applied three basic principles regarding the funding of our activity in each of these areas:

- Each regulatory activity has to pay its own way. We do not, for example, want fees generated by exchange traded futures to subsidize our regulation of off exchange retail forex dealers. Each area must generate sufficient revenue to cover NFA's direct expenses, an allocated share of NFA's overhead and a pro rata contribution to NFA's reserves.

- We try not to take any more money out of the market than necessary. NFA's Board approves our budget each year and tries to maintain reserves at between 10 and 14 months of operating expenses. When reserves climb above 14 months of operating expenses, we cut fees; when they fall below ten months we raise fees. Thankfully, over the years we have been able to cut fees more often than we have had to raise them.

- In addition to being fair and equitable, any structure of fees and dues must be easy for members to administer.

We expect to apply these same principles with respect to OTC derivatives. Representatives of our Swap Dealers Advisory Committee will be working with NFA's Finance Committee to develop recommendations regarding dues and fees. Obviously, we will not know for certain the actual cost of performing these regulatory activities until we know how many firms actually become registered, how often they need to be audited and how long those examinations might take. As a starting point for our discussions, however, we are assuming that over time we will need to nearly double the size of our compliance department, bring on over 100 additional employees and incur costs of over $25 million each year.

Audit Modules

At some point NFA will be conducting examinations of swap dealer members. For swap dealers that do not have a prudential regulator NFA will be monitoring those members for compliance with the full range of CFTC regulations, including recordkeeping, margin, capital requirements and business conduct standards. For those that do have prudential regulators we will not be monitoring for compliance with capital and margin requirements but would still be doing so for other Section 4s requirements.

To do this job we will, as described above, need to hire individuals with extensive experience with these products and train teams of auditors to conduct the examinations. It is not just a question of building a staff, however. We also need to construct the audit modules that examiners can use in the field to test for compliance with each of the substantive areas of regulation. Building the modules is a significant undertaking in and of itself and obviously cannot be completed until the rules themselves are in final form. As the rules are adopted we will develop the necessary audit modules, working closely with the CFTC in that process.

Finally, I should note that our regulation of OTC derivatives will involve other categories of registration beyond swap dealers and major swap participants. Dodd-Frank amended the definitions of commodity pool operators, commodity trading advisors, introducing brokers and futures commission merchants to include activities regarding swaps in each definition. It remains to be seen how many firms will have to

apply for registration as a result of these definitional changes, but these new members will be engaged in business that is quite different in some ways than traditional CPOs, CTAs and IBs. We will need to carefully consider how both our rules and our audit modules will need to change to reflect that reality.

Surveillance Activities on Behalf of Swap Execution Facilities

Dodd-Frank establishes certain core principles for swap execution facilities, including obligations to perform certain self regulatory responsibilities. Many potential SEFs have no self regulatory infrastructure in place. Therefore, the CFTC proposed allowing SEFs, like designated contract markets, to outsource certain self regulatory responsibilities to registered futures associations. NFA has been performing trade practice and market surveillance functions on behalf of futures exchanges for over ten years. During that time the CFTC has performed numerous reviews of NFA's surveillance functions and has always been fully satisfied with NFA's performance.

NFA has been contacted by numerous potential SEFs that are interested in outsourcing certain self regulatory responsibilities to NFA. We recognize that swap execution facilities will operate on a much different business model than contract markets and that significant changes to our surveillance programs will be necessary for NFA to perform that function. The first step in making those changes is to identify the data elements that NFA will have to receive from the SEFs in order to perform a meaningful surveillance function. After internal meetings, extensive discussions with several SEFs and meetings with the CFTC staff, we have identified 170 data elements that need to be built into our system. We have hired additional help in our information systems department so that we can make the necessary changes to our surveillance programs and are in the process of doing so.

Depending on how many SEFs contract with NFA, we anticipate that we will have to dramatically increase the size of our current surveillance staff, though the timing of that expansion will depend on CFTC implementation dates for SEFs. We have also begun to develop a formal schedule of the regulatory services NFA could provide to SEFs and a schedule of fees designed to ensure that NFA recovers its costs. Once NFA has signed agreements with SEFs, it might be difficult logistically to ensure that NFA could start performing regulatory services for all of the SEFs that seek NFA services on the same day. We are hopeful that a phased in approach to SEF regulatory requirements will ensure that the order in which NFA begins performing regulatory services for SEFs does not create a competitive advantage for any particular SEFs.

One of the difficult issues that still needs to be addressed involves cross market surveillance. NFA may conduct surveillance for some SEFs but probably not all. Certain types of abuses could be perpetrated across multiple SEFs. Detecting those types of abuses will require close coordination between the regulators, the swap data repositories and the SEFs. At this time, it is unclear exactly how that coordination will be accomplished and who will have both the ability and responsibility to detect those

abuses. We will work closely with the Commission in any way we can to address this issue.

Conclusion

Over the last 29 years, NFA's primary mission has been to partner with the CFTC in creating a robust and efficient regulatory environment for the U.S. futures industry. These are challenging times for both regulators and the derivatives industry. We are confident that we can continue our tradition of working closely with the Commission and with the industry to be part of the solution for many of the vexing problems that lie ahead.

/ckm(Testimony Senate Ag 6-11)

DOCUMENTS SUBMITTED FOR THE RECORD

JUNE 15, 2011

Concurrence of Commissioner Scott D. O'Malia to Testimony of Chairman Gary Gensler
before the U.S. Senate Committee on Agriculture, Nutrition and Forestry

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

FINANCIAL SERVICES AGENCY
GOVERNMENT OF JAPAN

3-2-1 Kasumigaseki Chiyoda-ku Tokyo 100-8967 Japan

Mr. Gary Gensler
Chairman
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
USA

1 April 2011

Dear Mr. Gensler,

I am writing this letter to request your Commission's consideration concerning the rules on Over-the-Counter (OTC) derivatives trading, as applied to Japanese financial institutions. We have a concern regarding the extraterritorial application of rules relating to US Dodd-Frank Act (DFA), which are shared by Japanese financial institutions, and seek your consideration on this issue.

Following the agreement reached at the G20 Pittsburgh summit, we the financial regulators of the World are in the process of creating an internationally consistent regulatory framework. In Japan, Financial Instruments and Exchanges Act (FIEA) was amended last year, and we are now drafting a regulation to mandate central clearing for liquid and standardized types of OTC derivatives. We understand that your Commission and the Securities and Exchange Commission are also working day and night to prescribe the rules on OTC derivatives by the deadline of 15 July 2011.

As DFA is an US law, naturally we expect this law to be applied to US entities incorporated in the US. For Japanese financial institutions, laws and regulations of Japan, which are consistent with the internationally agreed framework such as G20 and IOSCO, should apply. Therefore, we believe that Japanese financial institution should not be asked to register as Swap Dealer (SD) or Major Swap Participant (MSP) under the framework of DFA. If these institutions were also to be regulated under US DFA framework, this will create an undesirable and redundant effect on these Japanese institutions.

Given the above, we should be grateful if you would confirm that:

1. For a Japanese financial institution including its branches located in the US, as it is incorporated in Japan, the institution is regulated under FIEA. In such circumstances, naturally, there should be no requirement for it to register as a SD or MSP, as stipulated under DFA.
2. For a US subsidiary of a Japanese financial institution, as it is incorporated in the US, it will naturally be regulated under DFA. Conversely, a Japanese subsidiary of a US financial institution will be regulated under the Japanese law, and therefore should not be required to register as SD or MSP under DFA.

Another concern is the different timing of OTC clearing requirement implementation. Japan is currently in the process of creating an infrastructure to facilitate central clearing and other obligations by end-2012 the deadline agreed by G20. In the interim period, if a swap trade between a Japanese financial institution and an US financial institution is

required to be cleared centrally under DFA, this could have the following unintended consequences:

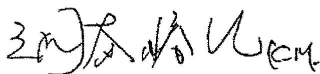
1. Japanese institutions might have to avoid trading with US institutions, having no choice other than to dealing with non-US financial institutions.
2. For certain swap trades that need to take place with US institutions, they would be forced to use the incumbent CCP – LCH.Clearnet. This would inadvertently strengthen the LCH's current dominant status in the interest rates swap market.

Therefore, we should be grateful if you could confirm that, as you phase in the central clearing requirement, it would only be applied if both parties of such swaps are US institutions. If this treatment could not be made permanent, at the very least we would formally request that such a transitional arrangement be made until end-2012. We trust that a mutually satisfactory permanent arrangement could be agreed between us by then.

We are fully committed to implementing an internationally consistent OTC derivative regulation as agreed by the G20 and FSB. In this regard, we think it is very important to coordinate among national regulators so that the regulations will be introduced in a consistent and effective manner.

Thank you very much in advance for your kind assistance. Should you have any questions concerning the above, or any questions concerning the OTC derivatives regulation in Japan, please do not hesitate to contact me.

Yours sincerely,



Katsunori Mikuniya
Commissioner & Chief Executive
Financial Services Agency
Government of Japan

Cc: Commissioner Bart Chilton, CFTC
Commissioner Michael Dunn, CFTC
Commissioner Scott D. O'Malia, CFTC
Commissioner Jill E. Sommers, CFTC

Chairman Mary L. Schapiro, SEC
Commissioner Luis A. Aguilar, SEC
Commissioner Kathleen L. Casey, SEC
Commissioner Troy A. Paredes, SEC
Commissioner Elisse B. Walter, SEC

Testimony of the Honorable Glenn English, CEO
National Rural Electric Cooperatives Association

Submitted to the

United States Senate
Committee on Agriculture, Nutrition and Forestry

June 15, 2011

Madam Chairwoman, Ranking Member Roberts, and Members of the Committee. Thank you for holding this hearing to address the implementation of the Dodd-Frank Wall St. Reform and Consumer Protection Act of 2010, and the role of over-the-counter (OTC) derivatives in helping end-users such as electric cooperatives keep electric bills affordable for our consumer-members.

The National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing over 900 not-for-profit, member-owned, rural electric utilities, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools (and other establishments) in 2,500 of the nation's 3,141 counties. Our member cooperatives serve over 17.5 million member owners in the states represented on this Committee.

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

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

NRECA's electric cooperative members, primarily generation and transmission members, need predictability in the price for power, fuel, transmission, financing, and other supply resources if they are to provide stable, affordable rates to their members, including farmers in your state. As not-for-profit entities, we are not in the business of making money. Rural electric cooperatives use derivatives to keep costs down by reducing the risks associated with those necessary inputs. It is important to understand that electric co-ops are engaged in activities that are pure hedging, or commercial risk management. We DO NOT use derivatives for speculation

or other non-hedging purposes. We are in a difficult situation, but OTC derivatives are an important tool for managing risk on behalf of our members.

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

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

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

Our Concerns with Implementation of the Dodd-Frank Act are as follows:

The July 16, 2011 Issue

As this Committee is aware, 30 days from now, certain provisions of the Dodd-Frank Act will become automatically effective -- without final rules being in place for a definitive new market structure for "swaps." This is problematic because a number of those automatically effective provisions delete the exclusions and exemptions upon which commercial entities rely to transact in the OTC markets for nonfinancial commodities like power, natural gas, electric transmission and other common commercial risk transactions. Congress made such provisions automatically effective on the unrealistic assumption that the new market structure for the diverse global swaps markets would take shape within a one-year time frame. As of July 16, 2011, many of the transactions that rural electric cooperatives use to manage our commercial risk may be of questionable legal and regulatory status. Financial counterparties may decide not to transact with us due to our relatively small size, and the requirement under Dodd-Frank that transactions with entities who are not "eligible contract participants" are illegal unless executed on a CFTC-regulated exchange.

NRECA, along with four other electric trade associations, filed a petition on May 23rd with the CFTC urging the Commission to grant "grandfather" exemptions contemplated by the Act to those who rely on the OTC markets, and to provide other exemptions as well for up to one year

after the effective date of the Dodd-Frank Act. We asked the CFTC to do this to prevent market disruption as the Commission works with other regulators to finalize and implement the new market structure. These petitions were provided for specifically in Section 723(c) of the Dodd-Frank Act -- the "grandfather provisions" to allow market participants to continue to operate with legal certainty during the transition to new regulations. We asked for an extension of all necessary exemptions, for electric end-users and their counterparties, to ensure stability and legal certainty in nonfinancial energy commodity derivatives markets which are necessary to our public service mission. These markets are a tiny fraction of the global derivatives markets –and such interim relief would not delay creation of the new market structure or be at odds with the goals of the legislation to provide transparency and stability in the vast $600 trillion global swap markets.

It is our hope that Chairman Gensler will be able to address this issue before the Committee today to provide some guidance for energy end-users who need legal certainty and the ability to continue to use OTC derivatives to provide affordable and reliable power for American consumers while the regulators finalize their new markets.

The Definition of "Swap Dealer"

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

The Definition of "Swap"

The most important term in the Dodd-Frank Act -- because it defines the scope of the CFTC's regulatory authority -- is "swap." NRECA is concerned that if the CFTC defines that term too broadly, it could bring under the CFTC's jurisdiction numerous commercial transactions that cooperatives and others in the energy industry have long used to manage electric grid reliability and to provide long-term price certainty for electric consumers. It is our belief that the CFTC must acknowledge in its rules that a "swap" does not include physical forward commodity contracts, "commercial" options that settle physically, or physical commodity contracts that

contain option provisions, including full requirement contracts that even the smallest cooperatives use to hedge their needs for physical power and natural gas. Further, CFTC should acknowledge that a "swap" excludes long-term power supply and generation capacity contracts, reserve sharing agreements, transmission contracts, emissions contracts or other transactions that are subject to FERC, EPA, or state energy or environmental regulation.

These instruments are non-financial transactions between non-financial entities that have never been considered "products" or "derivatives" or employed for speculative purposes. They were not created to "trade", they were developed to protect the reliability of the grid by ensuring that adequate generation resources will be available to meet the needs of consumers. These transactions do not pose any systemic risk to the financial system. Yet, if they were to be regulated by the CFTC as "swaps," such regulation could impose enormous new costs on electric consumers and could undermine reliability of electric service if the costs forced utilities to abandon these long-term arrangements.

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

Margin and Clearing Requirements

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

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

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

The problem is that requiring cooperatives' hedges to be centrally cleared or subjected to margin requirements would be unaffordable for most co-ops and would provide no value to the markets or to the nation. That is because our hedging transactions do not impose any of the systemic risk Dodd-Frank was intended to address. Yet any "initial margin" or "variance" margin requirements on our transactions under broad CFTC rules could force our members to post hundreds-of-millions of dollars in idle collateral that our consumers cannot afford to provide.

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

Reporting Requirements

Madam Chairwoman, the Dodd-Frank Act quite properly requires the CFTC to require reporting of those swaps traded on regulated exchanges. That information is critical to providing transparency to those markets. Unfortunately, the CFTC is proposing to move far beyond the reporting requirements in the Act to also require utilities to report a significant volume of information for those end-user transactions that Congress exempted from Dodd-Frank's central clearing requirements. In our energy markets, many utility-to-utility transactions are entered into between two end-users, and there are no swap dealers or major swap participants to bear the reporting burdens that these types of dealer entities are accustomed to.

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

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

Exemptions for FERC-regulated and 201(f) transactions

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

No entity has yet sought such an exemption because the rules from which they would be seeking exemption have not yet been written. Because the industry does not yet know what the CFTC will consider to be a "swap" or whether utility hedging efforts will be exempted from central clearing and margining requirements as end-user transactions, it does not yet know how critical it will be to pursue these additional avenues for relief. We certainly hope that the CFTC will choose to write its rules in a manner that minimizes potential conflicts with FERC regulation

and that minimizes potential costs for transactions between cooperatives or government owned utilities.

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

Treatment of Cooperative Lenders

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

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

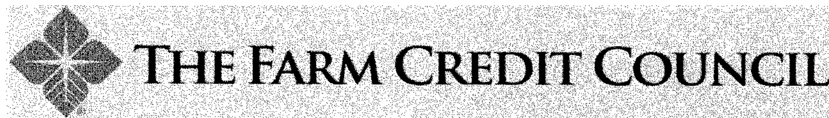
Conclusion

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

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

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

Thank you.



June 15, 2011

The Honorable Debbie Stabenow
Chairman
U.S. Senate Committee on
Agriculture, Nutrition and Forestry
328A Senate Russell Office Building
Washington, D.C. 20510

The Honorable Pat Roberts
Ranking Member
U.S. Senate Committee on
Agriculture, Nutrition and Forestry
328A Senate Russell Office Building
Washington, D.C. 20510

Re: One Year Later -- The Wall Street Reform and Consumer Protection Act -- Implementation of Title VII

Dear Chairman Stabenow and Ranking Member Roberts:

On behalf of its members, the Farm Credit Council appreciates the opportunity to submit this letter regarding the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "Act").[1] We commend the Committee for its leadership in overseeing the rulemaking process as the Commodity Futures Trading Commission ("CFTC") and prudential regulators implement this important new regulatory scheme.

The Farm Credit Council is the national trade association for the Farm Credit System, which comprises five banks and 87 associations that currently account for 40% of agricultural lending in the United States. We submit this letter because new derivatives regulation has the potential to affect the Farm Credit System's ability to offer cost-effective, dependable financing to farmers, farm-related businesses, and rural America. The Farm Credit System supports Congress's goal of making the financial system safer. We believe, however, that new regulation should not impose unwarranted costs on Farm Credit System institutions, which would ultimately raise the costs of loans to our member-borrowers and diminish rural America's access to credit, without making the financial system safer.

In explaining how proposed regulations will affect the Farm Credit System and what steps we believe regulators should take in implementing Dodd-Frank, we would like to make the following points:

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

- The Farm Credit System already has in place important protections for safety, soundness, and consumer protection. These attributes illustrate that many of Dodd-Frank's regulatory concerns do not apply with equal force to the Farm Credit System. In passing the Act, Congress concluded that the Farm Credit System did not pose a systemic threat and specifically excluded Farm Credit System institutions from oversight by the new systemic risk regulatory agency.

- Farm Credit System banks and associations should qualify for the end-user exception to Dodd-Frank's clearing requirement. Congress authorized and instructed the CFTC to consider exempting Farm Credit System institutions, regardless of size, from mandatory clearing since they do not pose a systemic risk to the financial system and they were not the cause of the problems that resulted in the recent financial crisis. Imposing higher costs on Farm Credit System institutions, through unnecessary derivatives regulation, ultimately leads to higher credit costs for farmers and ranchers, their agricultural cooperatives, rural infrastructure providers, and others in rural America. While Dodd-Frank places special emphasis on exempting institutions with less than $10 billion in assets, Congress also made it clear that it should not be viewed as a limit by CFTC. If the CFTC adopts an asset test, it must be applied in a manner that appropriately recognizes the unique cooperative structure of the Farm Credit System to "look through" Farm Credit banks to the smaller Farm Credit associations that own them. Alternatively, the CFTC should adopt a risk-based approach to mandatory clearing in a manner similar to the definition of major swap participant.

- Consistent with our understanding of the end-user clearing exception, Farm Credit System institutions should not be required to post initial or variation margin on swaps they use to hedge or mitigate risk. Congress created the end-user exception to preserve end users' ability to hedge risk without incurring these significant new costs. We therefore believe that Congress did not intend to impose costly margin requirements on end users for uncleared, as well as cleared, swaps. Further, the special rules proposed by the Farm Credit Administration and Federal Housing Finance Agency should not apply to low-risk end users of swaps. These proposed requirements are not contemplated by Dodd-Frank, they would raise the costs of derivatives we use for hedging, and they would make Farm Credit System institutions burdensome counterparties. We fear that special regulations for our members will make swap dealers less likely to transact with us and diminish our ability to hedge risk necessary for providing dependable, cost-effective financing to farmers, ranchers, and rural America.

- No Farm Credit System institution should be considered a swap dealer. Farm Credit System institutions enter into customer derivative transactions that are linked to the financial terms of the loans they issue. All customer derivative transactions are non-speculative in nature with risk immediately eliminated through appropriate risk management activities and controls. These customer derivative transactions pose no systemic risk to the financial system and are critical to helping our customers economically manage interest rate and foreign currency risk. In this way, the Farm Credit System's customer derivatives activity is the same as the customer derivatives activity of commercial banks, which Congress has exempted from designation as a swap dealer. There is no reason that the same exemption should not apply to the Farm Credit System.

Background

Congress created the Farm Credit System "to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations."[2] Congress also intended "to encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture which will be responsive to the credit needs of all types of agricultural producers having a basis for credit."[3] Today, the Farm Credit System is safe, sound, and responsive to its customer-owners. This is due, in part, to the following aspects of the Farm Credit System.

The Farm Credit System uses safe, non-speculative swaps and already effectively addresses counterparty credit risk. Farm Credit System institutions primarily use plain vanilla, fixed-for-floating interest rate swaps, and virtually all of our derivatives qualify for hedge accounting treatment. Farm Credit System institutions do not use swaps to speculate, and do not use the credit default swaps that contributed to the financial crisis. And Farm Credit System institutions already effectively manage counterparty credit risk. We deal with counterparties that have an investment grade or better long-term credit rating, and we monitor the credit standing of and levels of exposure to individual counterparties. Substantially all of our derivative contracts are supported by credit support agreements requiring the two-way posting of collateral in the event certain dollar thresholds of exposure are reached. These thresholds are small relative to the Farm Credit System capital.

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[2] 12 U.S.C. § 2001(a).

[3] *Id.* § 2001(b).

Specifically, as of March 31, 2011, the Farm Credit System's total derivatives exposure net of collateral ($204 million) represented approximately 11 to 12 basis points of the System's total loan volume ($177.5 billion). We believe that such limited exposure does not rise to the level of current concerns related to systemic risk and interconnectivity.

Farm Credit System institutions are regulated by the Farm Credit Administration, an independent federal agency that effectively mitigates the risk of Farm Credit System institutions to the United States financial system. The Farm Credit Act gives the Farm Credit Administration broad powers "for the purpose of ensuring the safety and soundness of System institutions."[4] These powers include suspending or removing directors or officers of Farm Credit System institutions who engage in unsafe or unsound practices and the ability to place unsafe or unsound institutions in conservatorship or receivership.

The Farm Credit Administration also effectively oversees the capital adequacy and derivatives activity of Farm Credit System institutions. The Farm Credit Administration sets minimum capital standards and rates the safety and soundness of each Farm Credit System institution, and it requires Farm Credit System institutions to limit their exposure to single or related counterparties and to establish policies that ensure that counterparty risks are consistent with the institution's risk-bearing capacity.

The Farm Credit System is not so interconnected with other financial entities to raise systemic risk concerns. Because Farm Credit System institutions do not take deposits, Farm Credit System banks and associations cannot experience a "run on the bank." And the Systemwide Debt Securities used to fund the Farm Credit System are (1) insured by the Farm Credit System Insurance Corporation, a government-controlled, independent entity, that administers a more than $3 billion insurance fund paid by premiums required of System institutions, and (2) issued by the five Farm Credit System banks, which are jointly and severally liable for these Systemwide debt obligations. In short, these layers of investor protection ensure that the Farm Credit System will not cause a run on the funding of other entities.

The Farm Credit System is a cooperative enterprise. Farm Credit System associations are cooperatives owned by their borrowers, and Farm Credit System banks are cooperatives primarily owned by their affiliated associations and other borrowers organized as cooperatives. Borrowers purchase equity in the institutions with which they do business, and Farm Credit System institutions return a portion of their earnings to their borrower-owners in the form of patronage distributions. Farm Credit Administration regulations further govern our standard of conduct, requiring, among other things, that Farm Credit System institutions monitor and avoid conflicts of interest.

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[4] *Id.* § 2252(a)(10).

Finally, Farm Credit System institutions are uniquely well suited to provide derivatives to their customers. To the extent that a System institution is a customer's only lender, that customer will likely be unable to enter into a swap with another party that would not have access to the loan collateral. New regulation would raise the costs of derivatives to the Farm Credit System's customers and could cause System institutions to stop offering these products. This would deprive some farmers, farm-related businesses, and rural America of the ability to manage risk, and drive others to Wall Street swap dealers that are less familiar with their unique needs.

In sum, Farm Credit System institutions are safe and sound, and they operate with high standards of conduct for their customers. Before determining that new regulation is warranted, regulators must therefore consider the Farm Credit Administration's effective current regulation of safety and soundness, the low risk profile of Farm Credit System institutions, and the unique relationship those institutions have with their borrower-owners.

With these principles in mind, we would like to discuss three significant areas of potential new regulation: (1) whether Farm Credit System institutions will qualify for the end-user clearing exception as we believe Congress, and this Committee, intended; (2) whether, even if they are exempt from clearing, Farm Credit System institutions would nevertheless be subject to costly new margin requirements, which we believe Congress, and this Committee, did not intend; and (3) whether Farm Credit System institutions will be designated as swap dealers, which we believe Congress, and this Committee, did not intend and which, if it occurred, would be unfair and unnecessary.

End-User Clearing Exception

Dodd-Frank exempts end users entering into swaps to hedge or mitigate commercial risk from mandatory clearing. Although Dodd-Frank generally defines end users as non-financial entities, Congress also directed the CFTC to "consider whether to exempt small banks, savings associations, farm credit system institutions, and credit unions."[5] As the statutory text and legislative history make clear, Congress gave the CFTC broad authority to permit Farm Credit System institutions, including those with total assets of more than $10 billion, to use the end-user exemption. Because the Farm Credit System is already safe and sound, and because our derivatives are already collateralized, we have urged the CFTC to clarify in its final rules that Farm Credit System institutions will qualify for the end-user clearing exemption.

First, we believe that the CFTC has maximum flexibility to adopt an equitable solution for exempting Farm Credit institutions from mandatory swaps clearing if they do not pose a systemic risk to the U.S. financial institutions. Consistent with what we believe to be

[5] Pub. L. No. 111-203, § 723(a)(3), 124 Stat. at 1680 (CEA § 2(h)(7)(C)(ii)).

Congress's intent, Dodd-Frank authorizes CFTC to exempt any sized Farm Credit System institution from mandatory clearing requirements, which is appropriate given that Farm Credit System institutions' derivatives use does not pose a risk to the financial system. We are concerned, however, that the CFTC may take a narrower approach and interpret Dodd-Frank's reference to the $10 billion asset size as a limit. This would make it critical that the CFTC recognize the unique cooperative structure of the Farm Credit System, where the cooperative district banks are generally owned by cooperative lending associations, which in turn engage in most of the System's retail lending. One consequence of our unique structure is that each bank centrally funds loans for its district. Centralized funding enables the associations to benefit from lower administrative and operational costs. Swaps that hedge risk on behalf of Farm Credit System associations are executed by the district bank to gain hedge accounting, to minimize administrative costs, and to minimize counterparty credit risk and margin requirements via district-wide netting of offsetting exposures. This is more cost effective and strengthens the liquidity of the System. As a result, Farm Credit System associations have a lower risk profile than the small commercial banks.

Under this structure, the cooperative lending associations are smaller than their affiliated banks that provide them funding and use derivatives to manage liquidity and other balance-sheet risks. For example, AgriBank, FCB, is the largest district bank, and its assets exceed $10 billion. But the 17 associations that own 99% of AgriBank have average assets of $3.6 billion. This is well below the $10 billion threshold that some have suggested.[6] Congress did not intend the $10 billion as a size limitation for exempting Farm Credit institutions from mandatory clearing. If, however, the CFTC decides to implement an exemption test that included asset size, the agency must then also recognize the unique cooperative structure of the Farm Credit System and "look through" Farm Credit banks to the smaller Farm Credit associations that own them.

We believe the increased costs of mandatory clearing will ultimately be borne by farmers and ranchers because of the higher cost of credit, and will put our cooperative lending associations at a disadvantage with respect to the small commercial banks with which they compete. The increased costs of mandatory clearing will be passed on from the banks to their associations, reducing their capital and liquidity, which in turn will either reduce the funds available for loans or increase borrowing costs. That result would be unfair and unnecessary

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[6] As the Farm Credit Council noted in its February 22 comment on the CFTC's proposed end-user exception rules, although the majority of Farm Credit System associations have assets of less than $10 billion, the few associations with greater assets do not present risk requiring mandatory clearing. Even the failure of a large association would have no material impact on the Farm Credit System's ability to meet its debt obligations because the five Farm Credit System banks are jointly and severally liable for the System's notes and bonds. Thus, no association is so large that it would impact System debt holders if it were placed in receivership. By contrast, if a standalone bank fails, its bondholders will likely face losses.

given that Congress intended to give regulators maximum flexibility in implementing the end-user exception.

Second, we have asked the CFTC to consider the risk of an institution's derivatives activity instead of simply its total assets. To the extent clearing is designed to address credit risk, large institutions may in fact be less risky than smaller institutions. Risk is a function of the type and amount of derivative activity after netting offsetting positions and collateral, not simply of total assets. Accordingly, we have urged the CFTC to consider a risk-based measure of which financial entities should be eligible for the end-user clearing exemption.

One such approach could draw on the framework proposed by the CFTC and the Securities and Exchange Commission ("SEC") for determining whether an entity has a "substantial position" in a major swaps category warranting regulation as a major swap participant. A similar test measuring uncollateralized current exposure or current exposure plus potential future exposure would also be appropriate for determining which financial institutions pose enough risk to warrant mandatory clearing. Specifically, we have proposed that current uncollateralized exposure of $2 billion in rate swaps and $1 billion in other categories of swaps -- or current uncollateralized exposure and potential future exposure of $3 billion for rate swaps or $1 billion for other swaps -- would be appropriate. These proposed thresholds, which are lower than the thresholds the CFTC has proposed for identifying major swap participants, would address risk among financial entities and would more accurately capture financial institutions whose swap exposure poses risk to the financial system. We are convinced that implementing a risk-based test using current and potential exposures is more equitable and appropriate way to determine when financial institution derivative activities, including Farm Credit System institutions, may pose a systemic risk to the financial system and, therefore, require mandatory clearing of derivative transactions.

Alternatively, the CFTC could adopt a test based on an institution's uncollateralized exposure to swaps as a percentage of capital. The Farm Credit System has suggested to the CFTC that appropriate risk limits would be current uncollateralized exposure to swaps of 10% of capital, or current uncollateralized exposure plus potential future exposure to swaps of 20% of capital. These limits would appropriately identify which small financial institutions pose systemic risk warranting mandatory clearing.

Finally, we preliminarily estimate that, conservatively, mandatory clearing would impose new costs on Farm Credit System institutions ranging from *$6 million to $27.2 million per year*. This estimate depends on the direction and volatility of interest rates, which in some scenarios, may require Farm Credit System institutions to post additional margin and thereby to incur costs exceeding even the high end of our estimate. For example, our estimate would have to be raised if a central counterparty's clearinghouse were to increase initial margin requirements in response to changes in interest rates. These new costs represent new transaction and operational fees, including fees to clearinghouses, futures commission merchants, and swap execution facilities, as well as the cost of developing new systems to process cleared trades.

More significantly, our cost estimates include the financing costs associated with posting initial and variation margin at clearinghouses. These financing costs are more difficult to predict because they depend on both the value of the Farm Credit System's swap positions, which may trigger variation margin requirements, and the level of interest rates, which will govern the cost of meeting margin calls. We believe that the negative carry associated with financing margin calls could easily exceed the assumptions we used to arrive at our estimates, pushing the annual cost of mandatory clearing above $27 million each year.

In the end, it is critically important that Farm Credit System banks, associations, and their members can make use of the end-user clearing exemption. Clearing will raise costs for Farm Credit System institutions that will ultimately be borne by our agricultural borrowers in the form of higher interest rates. We do not believe that new costs on agricultural borrowers are justified.

Margin Requirements

Margin requirements for uncleared swaps are closely related to the end-user clearing exception. Congress created the end-user clearing exception, so that end users would not have to bear the costs associated with posting initial and variation margin.[7] Recognizing that Congress did not intend to impose margin requirements on end users with respect to uncleared swaps, the CFTC has not proposed to impose margin requirements on non-financial entities that use swaps to hedge or mitigate risk.[8] By contrast, the prudential regulators have proposed to require that swap dealers and major swap participants collect margin from end users. We believe that this proposal is not consistent with Dodd-Frank or Congressional intent. Because we believe that Farm Credit System institutions should be eligible for the end-user exception, we further believe that it is not appropriate for regulators to impose margin requirements on Farm Credit System institutions. Accordingly, we plan to ask regulators to treat Farm Credit System institutions as non-financial end users and to clarify that they will not be subject to maximum credit thresholds above which they would have to post initial or variation margin.

The Farm Credit Administration and the Federal Housing Finance Agency have also proposed additional margin requirements for entities they regulate. These special rules would require Farm Credit System institutions to collect margin from swap dealers and major swap participants. They would further require both initial and variation margin posted by Farm

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[7] *See* Letter from Sens. Dodd and Lincoln to Reps. Frank and Peterson (June 30, 2010), *in* 156 Cong. Rec. S6192 (daily ed. July 22, 2010) ("The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk.").

[8] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732, 23,736 (proposed April 28, 2011) (to be codified at 17 C.F.R. pt. 23).

Credit System institutions to be segregated and subject to restrictions on rehypothecation and reinvestment. We estimate that these special requirements -- which are not contemplated by Dodd-Frank -- would impose millions of dollars in new costs each year that would not be justified by additional safety and soundness benefits. Because swap dealers typically rehypothecate variation margin -- that is, they use variation margin collected from one counterparty to post variation margin on an offsetting trade -- these special requirements would make Farm Credit System institutions burdensome counterparties. Given the cumbersome new regulation, we fear that swap dealers will no longer want to transact with Farm Credit System institutions and that Farm Credit System institutions will therefore be less able to hedge risk. Any such result would be inconsistent with Congress's intent to preserve end users' ability to hedge risk, and it would impact the availability of dependable, cost-effective credit for our farmer and rancher borrowers. Accordingly, we plan to ask regulators to clarify that these special requirements will only apply to large, high-risk financial entities -- not to low-risk financial end users of swaps with total assets below $250 billion.

Swap Dealer Regulation

Finally, we would like to address whether any Farm Credit System institution will be defined as a "swap dealer" and therefore will be forced to register with the CFTC and comply with potentially costly new capital, margin, and business conduct standards.

Farm Credit System institutions do not use swaps speculatively, and we are not market makers. One Farm Credit bank -- CoBank -- does enter into swaps with customers as a service that enables them to modify or reduce their interest rate and foreign currency risk related to their loans with the bank or its related associations. For example, a floating-rate loan agreement may require the customer to hedge fluctuations in interest rates. The most efficient way for the customer to do so is to enter into an interest rate swap or cap. By requiring the customer to hedge against changing interest rates and by providing the customer a swap for that hedge, CoBank reduces the risk that higher interest rates may cause excessive interest expense that the customer cannot afford. Thus, the hedging requirement mitigates risk for both the bank and the customer.

All of the Farm Credit System's customer derivatives transactions are non-speculative, and Farm Credit System institutions offset the risk associated with them. For example, CoBank concurrently enters into offsetting agreements with approved counterparties, and customer derivatives are secured under the related loan agreements with CoBank or its related association. CoBank's customers -- which include agricultural cooperatives; rural energy, communications, and water companies; farmer-owned financial institutions including agricultural credit associations; and other businesses that serve rural America -- depend on these swaps to hedge risk and allow them to access credit. Indeed, because CoBank is the only lender to many of its borrowers, it may be the only counterparty able to enter into a swap backed by the loan collateral.

We believe that Congress intended to clarify that "community banks aren't swap dealers or major swap participants"[9] -- at least not when they enter into a swap with a customer that is linked to the financial terms of the customer's loan. To accomplish this objective, Dodd-Frank states that "in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."[10] Although the statute says "insured depository institution," we believe Congress intended to exclude swaps offered in connection with loans and did not intend to confer a peculiar market advantage on commercial banks. To effectuate the intent that community banks not be designated swap dealers, the members of the Farm Credit System have urged the CFTC to clarify that this exemption applies equally to Farm Credit System institutions when they offer derivatives to customers in connection with loans, even though our institutions do not accept deposits.

First, the Farm Credit System's customer interest rate derivatives are identical to swaps offered by community banks in connection with loans. For example, CoBank customizes customer swaps to match the terms of loans and to ensure that the customer is effectively hedged against changes in interest rates. Because the swaps are connected to the financial terms of the loan, CoBank's customer interest rate swaps are consistent with the CFTC's preliminary interpretation of the community banks exemption.

Second, Farm Credit System institutions are subject to similar regulatory requirements as insured depository institutions. As an example, the Farm Credit Administration uses the same FIRS, or CAMELS, rating system for Farm Credit System institutions that the Federal Deposit Insurance Corporation uses for commercial banks.

Third, although Farm Credit System institutions do not accept deposits, the Systemwide Debt Securities they use to finance loans are insured, just as deposits of commercial banks are insured. If a bank cannot pay principal or interest on an insured debt obligation, the investors are paid from an independently administered insurance fund supported by premiums paid by Farm Credit System institutions. In the event that the entire insurance fund is exhausted, investors have further recourse to the five Farm Credit System banks, which are jointly and

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[9] 156 Cong. Rec. S5922 (daily ed. July 15, 2010) (statement of Sen. Lincoln) ("The definition of swap dealer was adjusted in a couple of respects so that a community bank which is hedging its interest rate risk on its loan portfolio would not be viewed as a Swap Dealer. In addition, we made it clear that a bank that originates a loan with a customer and offers a swap in connection with that loan shouldn't be viewed as a swap dealer. It was never the intention of the Senate Agriculture Committee to catch community banks in either situation. We worked very hard to make sure that this understanding came through in revised statutory language which was worked out during conference.").

[10] Pub. L. No. 111-203, § 721(a)(21), 124 Stat. at 1670 (adding CEA § 1a(49)(A)).

severally liable for Systemwide Debt Securities. All of the Farm Credit System's debt financing is insured in this manner.

Finally, unless Farm Credit System institutions were able to use it, the community bank exemption would give commercial banks an unwarranted competitive advantage in the market for agricultural lending. In determining whether an entity is a swap dealer, the rules currently proposed by the CFTC and the SEC do just that. The proposed rules exempt derivatives offered by commercial banks, while counting the same derivatives offered by the Farm Credit System, simply because System institutions do not accept deposits. This is unfair, and we do not believe that Congress intended this result in exempting community banks from additional regulation. Accordingly, we have urged the CFTC to provide this same exemption to the Farm Credit System in its final rules.

* * * *

On behalf of the members of the Farm Credit System, we thank the Committee for its leadership on these very important issues. Farm Credit System institutions rely on the safe use of derivatives to manage interest rate, liquidity, and balance sheet risk. These instruments, in turn, allow us to provide cost-effective, dependable financing to farmers, farm-related businesses, and rural America. It is essential that, in implementing Dodd-Frank, regulators do not impose unwarranted, duplicative, and costly regulation on the Farm Credit System. Mandatory clearing, new margin requirements, or swap dealer regulation would raise costs of financing for our borrowers.

We look forward to working with the Committee, as well as with regulators, to strike the appropriate balance between improving the safety of the financial system and preserving rural America's access to credit. Again, we thank the Committee for its leadership on these important matters.

Sincerely,

Kenneth E. Auer
President and CEO
Farm Credit Council

QUESTIONS AND ANSWERS

JUNE 15, 2011

Senate Committee on Agriculture, Nutrition & Forestry
One Year Later-Wall Street Reform and Consumer Protection Act-Implementation of Title VII
Questions for the record
June 15, 2011
Chairman Gary Gensler

Chairwoman Debbie Stabenow

1. Is the CFTC taking any steps to differentiate among traders who may be subject to position limits?

Response: **The CFTC's proposal on position limits takes steps to differentiate among traders. A significant differentiation under the proposal is that bona fide hedgers, and swap dealers to the extent that they are accommodating bona fide hedgers, would be exempt from position limits. As part of the rulemaking process, the Commission will consider whether other traders can qualify for tailored exemptions. The proposal also differentiates among traders in connection with the aggregation of accounts. For example, under specified conditions, account disaggregation is available for certain positions in pools, certain futures commission merchants, and certain independently owned and managed non-financial entities. The Commission will consider all comments from the public in developing final rules.**

2. Proposed business conduct standards for swap dealers dealing with special entities in effect may give a swap dealer the right to veto a special entity's advisor. Do you think this rule could give dealers power over the special entity's choice of an advisor and make advisors hesitant to negotiate aggressively with dealers?

Response: **The Commission's proposed business conduct standards rules track the statutory directive under the provisions of the Dodd-Frank Act that create a higher standard of care for swap dealers dealing with Special Entities. The proposed rules were designed to enable swap dealers to comply with their new duties in an efficient and effective manner, while adhering to the new protections for Special Entities. The Commission is reviewing the comments it has received on the proposed rules to ensure that the final rules protect market participants.**

3. In your proposal regarding capital requirements for nonbank swap dealers, you plan to recognize risk-based, Basel-consistent capital models recognized by the SEC and the Federal Reserve. Do you envision recognizing international, comparable capital-approved models under some sort of mutual recognition agreement with foreign regulators?

Response: **As required by the Dodd-Frank Act, the CFTC has proposed capital requirements for swap dealers (SDs) and major swap participants (MSPs) that are not subject to the oversight of the prudential regulators. The CFTC has consulted with the prudential regulators as well as with the Securities and Exchange Commission in**

developing the proposed capital rules. Under the proposed rules, an SD or MSP may apply for Commission approval to use internal models for purposes of its capital calculations. Initially, only SDs and MSPs whose internal models are approved and subject to ongoing review by the Federal Reserve Board or, as applicable, the SEC, would be permitted to apply for such Commission approval. The proposed rules also provide that the Commission may at any time determine by written order to accept applications requesting approval of internal models used by other SDs and MSPs that are not subject to review by the Federal Reserve Board or the SEC.

If an SD or MSP is subject to the tangible net equity requirement and has not received approval to use internal models, it would be required to calculate its market risk and over-the-counter credit risk exposures based upon certain internationally recognized standardized methodologies under the Basel Accord. The comment period on this proposal closed on July 11, 2011, and the Commission will consider the public's comments in developing final rules.

4. Should there be express exclusions from the definition of "swap" for commercial commodity contracts that utilities use every day -- such as forward contracts for physical power, natural gas, coal and other fuels, and for commercial options, such as capacity contracts, reserve sharing agreements, and all-requirements contracts?

<u>Response</u>: In May 2011, the CFTC and the SEC jointly published proposed rules and interpretive guidance to further define the term "swap" (among other terms). The release included proposed interpretive guidance regarding the exclusion of forward contracts in nonfinancial commodities from the swap definition. The CFTC is proposing that this forward exclusion be interpreted in a manner that is consistent with the existing forward contract exclusion with respect to futures contracts. The CFTC also proposed to treat commodity options embedded in forward contracts under the Dodd-Frank Act consistently with prior interpretations regarding such embedded options. The Notice of Proposed Rulemaking specifically requested comment on how the proposed interpretive guidance would affect full requirements contracts, capacity contracts, reserve sharing agreements, tolling agreements, energy management agreements, and ancillary services, and whether such agreements, contracts, and transactions should be excluded from the swap definition. The comment period for the proposed rule closed on July 22, 2011. The Commission will carefully consider the comments received in developing the final rule.

5. Do you think that cooperatives that use derivatives solely to help their members manage price volatility should be considered "swap dealers"? If so, why?

<u>Response</u>: In December 2010, the CFTC and the SEC jointly issued a proposed rulemaking to further define the term "swap dealer" (among other terms). The proposal specifically requested comment with respect to cooperatives. Many of the commenters addressed how the swap dealer definition should apply to cooperatives that enter into swaps with their members. After taking the public's comments into account, the application of the rule to cooperatives will be addressed in the final rule.

6. Recently, the CFTC provided an additional comment period on a number of proposed regulations. Does the Commission plan to allow the public to comment on the entirety of the rules once they have been modified? Does the Commission plan to give the public time to comment on final rules before they are voted on by the Commission?

<u>Response</u>: In May 2011, the Commission reopened many of its comment periods that had closed with respect to various proposed rules, and extended some open comment periods so that the public could comment in the context of the entire mosaic of proposed rules. This was an opportunity for the public and market participants to comment on the proposed new regulatory framework for swaps, including compliance costs, and to make recommendations regarding the schedule of implementation. Final rules will be developed only after staff can analyze the comments; after the Commissioners are able to consider the comments and provide feedback to staff; and after consultations with fellow regulators on the rules. If the Commission determines to adopt a final rule that is modified from the proposal and that triggers the notice and comment requirement of the Administrative Procedure Act, the Commission will provide the public with an additional opportunity to comment on the rulemaking.

7. I appreciate your response to the letters Senator Roberts and I sent to our colleagues in the European Union on the subject of global harmonization. As U.S. end users rely upon these global markets, it is important that these regulations are consistent and inspire confidence in the regulators responsible for their oversight. Is the Commission utilizing "mutual recognition" or "equivalence agreements" with foreign regulators, and if so how?

<u>Response</u>: Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce" of the United States. We are developing a plan for application of 722(d) and expect to receive public input on that plan. Mutual recognition or equivalence agreements with foreign regulators would be among the mechanisms discussed.

8. Does the Dodd-Frank Act limit your legal options in terms of a response to the issues addressed in our letter, issues such as indemnification and data security?

<u>Response</u>: The CFTC is working to provide sufficient access to information maintained by registered swap data repositories (SDRs) to appropriate domestic and foreign regulatory authorities. On August 4, 2011, the CFTC adopted final rules relating to the registration, regulation and oversight of SDRs. Recognizing that a confidentiality and indemnification agreement may be difficult for other regulators to execute, the CFTC's rules identify circumstances where domestic and foreign regulators may be provided access to swap information maintained by SDRs without being subject to the notice and indemnification

requirement. Access would be provided to regulators with existing Memorandum of Understanding or similar information-sharing arrangements with the CFTC, or in the case of a foreign regulator, as determined by the CFTC on a case-by-case basis.

The indemnification requirement applies only to regulators that desire direct access to the information maintained by an SDR. Under the CEA, the CFTC may, upon request, share confidential information in its possession obtained in connection with its administration of the CEA to any federal department or agency, individual state or any foreign futures authority, or department or agency of any foreign government or any political subdivision acting within the scope of its jurisdiction.

With respect to data security, the Dodd-Frank Act requires that SDRs maintain the privacy of any and all swap transaction information received from a swap dealer, counterparty, or any other registered entity. The CFTC's recent final SDR rules require that SDRs establish written policies and procedures to protect the privacy or confidentiality of information they receive and safeguard against the misappropriation or misuse of swap information that is restricted from disclosure under Section 8 of the CEA

9. The CFTC recently proposed rules that would require registration of certain mutual funds and private funds with that agency. What is the added benefit of registering these entities with the CFTC if they have already registered with the SEC?

Response: The CFTC recently proposed changes to its regulation, which currently permits investment companies registered under the Investment Company Act of 1940 to claim an exclusion from the definition of "commodity pool operator" under the Commodity Exchange Act. The Commission's proposed rule is intended to ensure that it can adequately oversee the commodities and derivatives markets and assess market risk associated with pooled investment vehicles under its jurisdiction.

Some registered investment companies have offered commodity pool interests to customers claiming the exclusion from CFTC regulations. The National Futures Association (NFA) submitted a petition for rulemaking that suggested revisions to relevant Commission regulations.

To prevent the practice of registered investment companies offering futures-only investment products without appropriate oversight, the Commission has proposed operating criteria consistent with the language proposed by NFA in its petition. The Commission's proposed rule is intended to ensure consistent treatment of commodity pool operators regardless of registration status with other regulators.

The Commission is reviewing the comments received on the proposal. Commission staff continues to collaborate with SEC staff. On July 6, 2011, CFTC staff held a public roundtable to discuss issues related to the registration and compliance regime for commodity pool operators and commodity trading advisors.

10. Dodd-Frank excluded forward contracts from CFTC regulation, namely ''any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." In a Notice of Proposed Rulemaking on May 23, the CFTC asked whether the forward exclusion from the swap definition should apply to certain environmental commodities. Many states have Renewable Portfolio Standards (RPSs) that use these environmental commodities – Renewable Energy Certificates (RECs) – for compliance. When a REC is produced by a renewable generator it is sold and delivered to the buyer's account. Cash goes to the renewable generator and a REC, not cash, is physically delivered.

    Does the CFTC believe that REC's can be physically settled and qualify for the forward contract exemptions? Does the CFTC have the authority to regulate these state markets and RECs? Does the CFTC believe there is a need to regulate these markets and RECs?

Response: The proposed rulemaking issued jointly by the CFTC and the SEC to further define the term "swap" requested comment on whether the exclusion from the swap definition for forward contracts in nonfinancial commodities should apply to environmental commodities such as emissions allowances, carbon offsets/credits, or renewable energy certificates. The release specifically requested that commenters describe these commodities and explain how transactions can be physically settled where the commodity lacks a physical existence (other than on paper). The comment period for this proposed definitions rulemaking closed on July 22, 2011. The Commission will carefully consider the comments regarding these products in developing the final rule.

11. You had estimated in testimony in 2009 that there would be lower number of swap dealers than you and the rules currently estimate. How do you account for that disparity?

Response: The Dodd-Frank Act includes a definition of the term "swap dealer" and also requires the CFTC and SEC to jointly adopt rules further defining the term. The number of entities required to register is uncertain and will depend on the decisions of businesses involved. In an effort to estimate how many entities may register as swap dealers, CFTC staff analyzed the membership statements of relevant trade associations that list swap dealers as members. This was determined to be the best method to obtain a rough estimate at the time. Specific provisions of the Dodd-Frank Act definition likely will change the number of entities that register as swap dealers. The Commission is committed to implementing the statutory definition and closely following congressional intent. When I answered a question asked during a hearing of the Committee in February of 2009, I provided my best understanding at that time of the degree to which the swap dealing industry was concentrated in a few firms.

12. How did you decide on the specific factors for determining the de minimis exception? What data do you have suggesting that the thresholds set for these factors are appropriate in determining a de minimis amount of swap dealing?

<u>Response</u>: The proposed rulemaking issued jointly by the CFTC and the SEC to further define the term "swap dealer" included a description of the factors and thresholds proposed to be used for determining the statutory *de minimis* exemption to the swap dealer definition. The agencies proposed factors for the *de minimis* exemption based on the aggregate effective notional amount of an entity's trades, its level of trading activity with special entities, the number of counterparties it transacts with and the number of swaps it trades. The release specifically requested that the public provide comments regarding the proposed *de minimis* exemption, and many of the commenters that responded to the proposal addressed the factors and thresholds that should be applied. After comments are taken into account, the factors and thresholds for the *de minimis* exemption will be addressed in the final rule.

13. How many entities do you estimate will ultimately fall out of the swap dealer category under the regular business exception that would have otherwise been captured under the definition? What about under the de minimis exception?

<u>Response</u>: The proposed rulemaking issued jointly by the CFTC and the SEC to further define the term "swap dealer" discussed the statutory exclusion for "a person that enters into swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business," as well as the *de minimis* exemption. Many of the commenters that responded to the proposal addressed how the *de minimis* exemption and the "regular business exclusion" should be applied. The application of these provisions in the statutory swap dealer definition will be addressed in the final rule, after taking the comments into account. Their implications for the overall number of entities in the swap dealer category will depend on the nature and quantity of any particular entity's derivatives operation.

<u>Senator Pat Roberts</u>

Question 1:

During the hearing, I asked you a question concerning your proposed revisions to what constitutes a bona fide hedge. You stated that the situation in my example did sound as if it were hedging. Since the commodity industry -- from growers to buyers – is quite concerned about your interpretation of your proposed regulations, I would like to restate my question so that you have time to reflect upon your answer and so that you are able to give me a definitive "yes" or "no."

I gave you this very real example:

A Sumner County, Kansas, elevator expects in the near future to enter into forward contracts with area wheat farmers at a fixed price with delivery at a later date. To hedge this risk, the elevator "goes short" on wheat futures. Under the CFTC's proposed rule, this would seem to make the elevator's futures transaction a speculative one, and therefore not eligible for the commercial hedge exemption from any position limits, since at the time the elevator's futures

position was taken, there in fact was not an underlying physical contract. Is this a bona fide hedge?

If this is or is not a bona fide hedge would you explain the reasoning behind your answer.

I am also interested in your opinions on other common types of hedging transactions.

- For example, if one used a cash-settled swap in one location and a physical delivery futures contract at another location, such as a natural gas wholesaler buying gas at one point and delivering it to another, and if the purchase and sale occurred in the same month, would that be a bona fide hedge?

- How about a power plant owner entering into a swap on the power price and a Henry Hub futures contract in natural gas; in other words, it hedges the risk that the price of power will decline relative to the cost of natural gas. Since the two prices reference different commodities, would this constitute a bona fide hedge?

- The hedging of the value of "services that a person provides or purchases, or anticipates providing or purchasing" is a bona fide hedge under that quoted language from the Dodd-Frank Act. For example the hedging the "service" of transporting natural gas from one point to another can be measured as the difference between the price for which one can sell gas at the delivery point minus the price one can sell gas at the receipt point. Under the proposed regulations there is seemingly no provision for this hedging transaction as an "enumerated hedge" without the transporter having actually purchased or sold the natural gas.

- In order to hedge the risk of expected, but not executed, buy/sell transactions, a grain merchandiser may seek to lock in the price differential between a grain exchange reference price and, say, a Euronext France (MATIF) price -- prices which are readily available more than a year in advance. This does not appear to be an "enumerated hedge" under your regulations.

- Hedges on assets, such as hedging the anticipated value of the future revenue stream, to provide certainty to lenders in the purchase of a crude oil tanker or LNG vessel, would not appear to be bona fide hedges because the would-be ship owner does not own, or anticipates owning, the underlying commodities the price for which is hedged.

- Hedging in the last five days of an expiring futures contract appear not to qualify as a bona fide hedge. What is the Commissions reason for prohibiting all bona fide hedge positions in the last five days of trading?

I would appreciate your discussing these scenarios and the reasoning behind your answers. If in any of these examples, a transaction that is now commonly conducted would be prohibited under the new regulations once they go into effect, please explain your reasoning for this change.

<u>Response</u>: **The Commission published its proposed rule on position limits on January 26, 2011. The comment period closed on March 28, 2011, and the Commission is closely examining comments, including those comments requesting clarity on whether specific transactions would qualify for the bona fide hedging exemption and those requesting an expansion of the proposed definition.**

The proposal generally follows the existing definition under Commission regulations with exceptions related to positions that represent a substitute for a physical market transaction and related to swap positions. Generally, modifications to the existing regulations in the proposed rule are designed to ensure compliance with specific provisions in the Dodd-Frank Act.

The Commission's proposed rule incorporates the current requirements of Commission regulations for enumerated hedging transactions. It also provides an exemption for agents contractually responsible for the merchandising of cash positions with a person who owns the commodity or holds the cash market commitment being offset. This agent provision is consistent with the Commission's existing regulations.

The Commission has received comments regarding the proposal and will respond to them in development of the final rule.

Question 2:

In an April 15, 2011 report, the CFTC Inspector General indicated that the agency had relied mainly on its lawyers instead of its economists to produce "one-size-fits-all" cost estimates of CFTC proposed regulations. In fact, OIG said that for three of the four rules proposals it reviewed, the cost-benefit analyses were drafted by commission staff in divisions other than the CFTC's Office of Chief Economist. The OIG's report stated, "staff from the Office of Chief Economist reviewed the drafts, but their edits were not always accepted." In one instance the OIG stated the Office of Chief Economist did not participate at all. OIG said that "to a greater or lesser extent," for the three rules in question, the Office of General Counsel "appeared to have the greater 'say' in the proposed cost-benefit analyses." The OIG report also concluded that "similar approaches to economic analysis in the context of federal rulemaking have proved perilous for financial market regulators."

The report goes on to say that staff in the Office of General Counsel strongly encouraged the staff from the Office of Chief Economist not to deviate from accepted methodologies for cost-benefit analyses employed by the Commission for 10 years, which apparently limited the scope of the cost-benefit analysis under section 15(a) to an analysis of the rule as a whole. Staff from the Office of General Counsel opined that deviating from this long-standing standard could result in litigation risk, and that the adoption of a new methodology could require the Commission to engage in the same methodology for future rules (or a litigation risk could result).

- Please explain the fear regarding litigation risk if more quantitative economic analyses were adopted by CFTC?

Response: The CFTC strives to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but also are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual and policy bases for its rulemakings.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns in each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices and address compliance costs consistent with the obligations of the CFTC to promote market integrity, reduce risk and increase transparency, as directed in Title VII of the Dodd-Frank Act. Information from each of these meetings – including a full transcript -- is available on the CFTC's website and has been factored into each applicable rulemaking.

In carrying out each of its rulemakings under the Dodd-Frank Act, the Commission seeks to avoid litigation risk by adhering closely to the statute and to congressional intent. In its procedures, the Commission strives to apply consistent standards with necessary modifications when in the public's interest.

With each proposed rule, the Commission has sought public comment regarding costs and benefits and is taking these comments into account.

- Do you concur that "similar approaches to economic analysis in the context of federal rulemaking have proved perilous for financial market regulators"?

Response: By closely adhering to statutory requirements and to Congressional intent, the Commission hopes to ensure that the final rules it adopts are defensible.

- Has CFTC changed its practices to include greater input into the economic analyses by the Office of the Chief Economist?

Response: On May 13, 2011, the Commission's Chief Economist and General Counsel jointly issued guidance to CFTC rulemaking teams. Under that guidance, the Office of the Chief Economist (OCE) assigns a staff person for each rulemaking team to provide quantitative and qualitative input on costs and benefits of the final rulemaking. Under the

guidance, the OCE representative is to employ price theory economics or a similar methodology to assess associated costs and benefits.

CFTC economists have been playing an integral role in the formation and analysis of cost-benefit considerations. The Commission is dedicated to maintaining the integrity and functioning of derivatives markets without imposing undue burdens on market participants or the broader economy.

Question 3:

There is concern about the feasibility of the proposed indemnity subsection "work-around" solution and the number of caveats associated with it set out in your letter to Commissioner Barnier. Some are worried that this will lead to the fragmenting of global market data sets, making it difficult for regulators to have a complete picture of the market and diminishing transparency. Assuming the language of the Dodd-Frank Act limits your options, would you support a legislative solution which gives the Commission the authority to waive the indemnity requirement where there is an acceptable data protection standard in place? (e.g. government-to-government Memoranda of Understanding, or adherence to an international regulatory standard, such as the OTC Derivatives Regulators Forum)?

Response: The CFTC is working to provide sufficient access to information maintained by registered swap data repositories (SDRs) to appropriate domestic and foreign regulatory authorities. On August 4, 2011, the CFTC adopted final rules relating to the registration, regulation and oversight of SDRs. Recognizing that a "confidentiality and indemnification agreement" may be difficult for other regulators to execute, the CFTC's rules identify circumstances where appropriate domestic and foreign regulators may be provided access to swap information maintained by SDRs without being subject to the notice and indemnification requirement. An appropriate foreign regulator may be provided access to the SDR without a confidentiality and indemnification agreement if the foreign regulator is acting in a regulatory capacity with respect to the SDR and the SDR also is registered with the foreign regulator.

Question 4:

Regulators around the globe have incorporated model-based capital requirements into their regulations and the Dodd Frank Act requires the financial and banking regulators to write capital requirements for swap dealers and security-based swap dealers. While testifying before the committee, you stated that the Dodd-Frank Act gives the CFTC authority to recognize a foreign regulator's capital rules if they are comparable, or nearly comparable, to those of U.S. regulators. Will the CFTC, in its rulemaking on capital requirements for swap dealers, recognize a foreign financial institution's risk based capital models that have been approved by their home country regulator? Has the CFTC determined the criteria it will consider when evaluating a model approved by a foreign regulator?

Response: Pursuant to Section 731 of the Dodd-Frank Act, the CFTC has proposed capital requirements for swap dealers (SDs) and major swap participants (MSPs) that are

not subject to prudential regulation by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration or the Federal Housing Finance Agency (collectively the prudential regulators). The CFTC has consulted with the prudential regulators as well as with the Securities and Exchange Commission in developing the proposed capital rules.

Under the proposed rules, an SD or MSP may apply for Commission approval to use internal models for purposes of its capital calculations. Initially, only SDs and MSPs whose internal models are approved and subject to ongoing review by the Federal Reserve Board or, as applicable, the SEC, would be permitted to apply for such Commission approval. The proposed rules also provide that the Commission may at any time determine by written order to accept applications requesting approval of internal models used by other SDs and MSPs that are not subject to review by the Federal Reserve Board or the SEC.

If an SD or MSP is subject to the tangible net equity requirement and has not received approval to use internal models, it would be required to calculate its market risk and over-the-counter credit risk exposures based upon certain internationally recognized standardized methodologies under the Basel Accord. The comment period on this proposal closed on July 11, 2011, and the Commission will consider the public's comments in developing final rules.

Senator Saxby Chambliss

1. Mr. Gensler, have you made any final decisions on how you plan to sequence the adoption and implementation of Dodd-Frank rulemakings? Is that document something you plan to share with the Committee? With the public?

Response: **A list of rules and the timeframe in which they may be considered was recently posted on the Commission's website. The Commission is focused on considering these rules thoughtfully – not against a clock. There will likely be changes to that outline down the road.**

In the last quarter of 2011, the CFTC is expected to consider rules related to clearinghouse core principles and position limits. I hope that the agency will also consider final rules on entity and product definitions, both of which are joint rules with the SEC. In addition, I hope we'll consider final rules on swap data recordkeeping and reporting; real-time reporting; and regulations for trading platforms, such as Designated Contract Markets and Foreign Boards of Trade – all of which will help make the swaps market more open and transparent. We are looking to consider external business conduct rules and internal business conduct rules related to risk management, supervision, conflicts of interest, recordkeeping, and chief compliance officers. I also anticipate seeking public input on the application of Dodd-Frank's Section 722(d).

This fall we also will consider further exemptive relief from the application of Dodd-Frank's Title VII requirements. I've already directed staff to draft recommendations, with

the relief appropriately tailored -- for instance, taking into account the possible completion of entity and product definition rules.

After the first of the year, I expect we will take up final rules related to swap execution facilities. The agency has been working closely with other regulators, both domestic and international, on capital and margin, but I expect we will take up these final rules next year as well. We also are looking to finalize rules on documentation, straight-through trade processing, client clearing, and segregation for uncleared swaps in 2012.

2. Mr. Gensler, there have been many comments, voiced to my office, to yours, and in the press as well, about the differences between how the SEC and CFTC should carry out their respective regulation of swaps under Dodd-Frank. While you have been able to reach consensus on many areas of joint rulemakings that you are tasked with, some notable differences have emerged in your proposals . Concerning Swap Execution Facilities for instance, I understand the CFTC has proposed that these request for quotes (RFQs) to be sent out to a minimum of five market participants while the SEC allows RFQs to be sent to just one participant. Can you update the committee on how the CFTC and SEC plan to resolve this difference, or is this a distinction we should expect to see in a final rule as well? What is the justification of the difference given the statutory language for these entities is nearly identical?

Response: The CFTC's proposed SEF rule will provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other market participants. It also will allow them to make indications of interest – or what is often referred to as "indicative quotes" – to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors and Main Street businesses both the flexibility to execute and trade by a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandates for transparency and competition where multiple market participants can communicate with one another and gain the benefit of a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, whereby they would reach out to a minimum number of other market participants for quotes. For block transactions, swap transactions involving non-financial end-users, swaps that are not "made available for trading" and bilateral transactions, it allows market participants to get the benefits of the swap execution facilities' greater transparency, or they would still be allowed to execute by voice or other means of trading.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the SEC to harmonize approaches, the CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and will move forward to

consider a final rule only after staff has had the opportunity to analyze them and after Commissioners are able to discuss them and provide feedback to staff.

3. In his comments last week in Singapore, Secretary Geithner, has suggested that other countries should begin to adopt an approach of derivatives regulation that looks more like the approach taken with the Dodd-Frank legislation, though the reactions from those countries suggest they do not agree. Traditionally, Memoranda of Understanding between the CFTC and foreign regulators have been used to address the differences between our regulations and those of your counterparts. Do you believe that we will find ourselves at an impasse with foreign regulators and if not, when do you expect to enter into memoranda of understandings to address scenarios concerning swap entities that are subject to conflicting and dueling regulatory requirements?

Response: **The Commission is actively consulting and coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs. Our discussions have focused on clearing and trading requirements, clearinghouses more generally and swaps data reporting issues, among other topics.**

As we do with domestic regulators, the CFTC shares many of our memos, term sheets and draft work product with international regulators. We have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority, the new European Securities and Markets Authority, the Japanese Financial Services Authority, and regulators in Canada, France, Germany and Switzerland. I have met with European Commission officials for Internal Market and Services, to discuss ensuring consistency in swaps market regulation.

Both the CFTC and European Union are moving forward to address the four key objectives set forth by the G20 in September 2009, namely clearing through central counterparties, trading on exchanges or electronic trading platforms, recordkeeping, reporting and higher capital requirements for non-cleared swaps.

Through consultation, regulators are working to bring consistency to oversight of the swaps markets. In September of last year, the European Commission released its swaps proposal.

These efforts to promote international consistency will continue, including the development of appropriate agreements as necessary.

4. Dodd-Frank directs the CFTC to adopt position limits "as appropriate." Given that the CFTC does not currently have comprehensive data for the swap markets, how does it intend to ensure that the formulas it uses to set limits will be appropriate - particularly for non-spot months for which there is less trading data currently available? Isn't there a real danger that the CFTC will set position limits prematurely, impeding the liquidity of the U.S. futures markets and perhaps driving business out of the U.S. onto foreign boards of trade? CFTC Commissioner Sommers and O'Malia have noted that imposing position limits without a thorough understanding of these markets is a flawed approach. Given this lack of data and the fact that the CFTC does not currently even know the size of the commodity swap market, shouldn't the CFTC wait to implement Phase Two of the position limit proposal until it has more information?

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

Position limits have served since the Commodity Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce. When the CFTC set position limits in the past, the agency sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. Integrity is enhanced when participation is broad and the market is not overly concentrated.

The CFTC considers all of the comments it receives to inform its final rulemakings. The CFTC and its staff will review all estimates of costs and benefits that are received from commenters and any data or studies supporting them.

The CFTC's proposed rule includes one position limits regime for the spot month and another regime for single-month and all-months combined limits. It would implement spot-month limits, which are currently set in agriculture, energy and metals markets, sooner than the single-month or all-months-combined limits. Single-month and all-months-combined limits, which currently are only set for certain agricultural contracts, would be re-established in the energy and metals markets and extended to certain swaps. Under the formula proposed in January, the limits would be set using data on the swaps and futures markets collected through the position reporting rule.

Senator John Thune

1. Agriculture is South Dakota's No. 1 industry, and livestock and grain are the largest contributors to that activity. I'm concerned about the ability of those industries having access to important risk management tools to affordably hedge their production, processing, and marketing risks. Specifically, I am concerned about the potential unintended consequence of many agricultural entities being regulated under the Dodd-Frank Wall Street Reform and Consumer Protection Act as if they were large, systemically important institutions.

Response: Derivatives market reforms will benefit the economy and American businesses by making the swaps marketplace more transparent, open and competitive.

Each part of our nation's economy relies on a well-functioning derivatives marketplace. The derivatives markets are used to hedge risk and discover prices.

The derivatives markets have grown from those agricultural futures through the 20th and 21st centuries to include swaps. The swaps markets provide businesses with a means of locking in rates or prices in one part of their business so that they can focus on what they are best at – whether it be producing goods or providing services.

While the derivatives market has changed significantly since swaps were first transacted in the 1980s, the constant is that the financial community maintains information advantages over their nonfinancial counterparties.

The Dodd-Frank Act includes essential reforms to bring sunshine to the opaque swaps markets. Economists and policymakers for decades have recognized that market transparency benefits the public.

In the Dodd-Frank Act, Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Consistent with this, the CFTC's proposed rules on margin requirements focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.

2. What approach is the Commission taking to ensure that the rules do not negatively affect the ability of South Dakota farmers and ranchers to have access to customized hedging instruments? How does the Commission intend to provide for a commercially meaningful "de minimis exception" that would allow entities who were not intended by Congress to be regulated as swap dealers to continue to provide important risk management services to the agriculture sector?

<u>Response</u>: The proposed rulemaking issued jointly by the CFTC and the SEC to further define the term "swap dealer" included a description of the factors and thresholds proposed to be used for determining the *de minimis* exemption to the swap dealer definition, and a discussion of the application of the definition to the agriculture sector. The release specifically requested that the public provide comments regarding the proposed *de minimis* exemption. Many of the commenters that responded to the proposal addressed the factors and thresholds that should be applied, as well as the application of the swap dealer definition to the agriculture sector, including cooperatives that enter into swaps with their members. After taking the public's comments into account, the final rule will address the factors and thresholds for the *de minimis* exemption and the application of the swap dealer definition to different types of entities, such as those in the agriculture sector.

Questions for Dr. Michael S. Gibson, Senior Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, from Senator Chambliss:

1. Mr. Gibson, with respect to the CFTC's proposal regarding capital requirements for nonbank swap dealers, the CFTC states that they are prepared to recognize risk based Basel-consistent capital models currently recognized by the SEC and the Federal Reserve. What advice have you given to the CFTC regarding applying a capital regime resigned for banks to a commercial or other non-bank swap dealer?

Federal Reserve Board staff believe that Basel III capital rules generally would be appropriate to set a non-bank swap dealer's minimum capital requirement, and we have informally shared this view with CFTC staff.

Questions for Dr. Michael S. Gibson, Senior Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, from Chairwoman Stabenow:

1. The prudential regulators' margin rule would classify financial end users into high and low risk categories. Do prudential regulators have any reliable estimates of the number of "high-risk" financial end users identified by the proposed rule?

As noted in the notice of proposed rulemaking, the number of counterparties and the extent to which certain types of firms are likely to be counterparties are unknown. For this and other reasons, the Agencies have requested comment in the proposal regarding the quantitative impact of the proposed margin requirements, including with respect to the number and types of counterparties affected. With respect to persons likely to be classified as high-risk financial end users under the proposed rule, the Agencies expect that a large number of such persons will be hedge funds.

2. Is it your intent to apply margin to non-financial end users and their captive finance affiliates?

For swaps with a nonfinancial end user counterparty, the proposed rule would not specify a minimum margin requirement. Rather, it would allow a banking organization that is a dealer or major participant to establish a threshold, based on a credit exposure limit that is approved and monitored as part of the credit approval process, below which the end user would not have to post margin. The proposed rule would not impose any caps on the credit exposure limits for nonfinancial end user counterparties. In effect, the proposed rule would maintain the status quo for a bank swap dealer, where the dealer conducts due diligence on its counterparty, determines a credit exposure limit with respect to the counterparty that is consistent with the dealer's risk appetite and is documented in a credit support agreement, and does not require margin payments from the nonfinancial end user as long as the exposure remains below the limit.

Captive finance companies would be classified as nonfinancial end users under the proposed rule if they did not meet the proposed rule's definition of "financial end user" (e.g., by being predominantly engaged in financial activities).

3. Will the prudential regulators allow the flexible use of noncash collateral for purposes of margin as directed in the statute?

The proposed rule identifies a limited set of securities as eligible non-cash collateral for the initial and variation margin requirements, consistent with the statutory requirement that the rule permit non-cash collateral while preserving the "financial integrity of markets trading swaps" and the "stability of the United States financial system."

Non-cash collateral can be consistent with market integrity and financial stability when an appropriate haircut can be established. An appropriate haircut is one that is large enough so that if the counterparty defaults, the non-defaulting counterparty can sell the collateral at a price that offsets the cost of replacing the defaulted counterparty's swap positions. An appropriate haircut

also takes account of the likelihood that the value of many types of non-cash collateral will be under stress when a derivatives counterparty defaults.

The notice of proposed rulemaking asked public commenters to respond to several questions about possible expansions of the set of eligible collateral, including how to determine an appropriate haircut. We will carefully consider the comments received in response to these and other questions posed in the proposed rulemaking when moving forward with a final rule.

Finally, it should be noted that collateral posted by non-financial end users for exposures below the credit exposure limit (as discussed in the answer to the previous question) is not limited to the set of eligible collateral in the proposed rule, because the proposed rule only applies to exposures above the credit exposure limit. Bank swap dealers would be free to continue to accept whatever collateral they currently accept from non-financial end users as long as the exposure stays below the credit exposure limit.

4. The OCC's Inspector General recently released an estimate of the potential cost of imposing margin on swap transactions. Do prudential regulators have any reliable estimates of the impact of Dodd-Frank on economic growth and job creation due to increased margin requirements?

Before moving ahead with a final rule, the Federal Reserve expects to use any information submitted by public commenters on the proposed rule to more precisely assess the costs and benefits of the margin requirements that are required under Dodd-Frank. It was not possible to make a precise estimate of the quantitative costs of the proposed margin rule prior to issuing it for comment for several reasons. First, there are many changes that are occurring in the derivatives market as a result of regulatory reform that will affect the cost of the margin rule, including uncertainty with respect to (i) which entities will be classified as swap dealers or major swap participants; (ii) the extent to which existing derivatives would be rolled-over or renewed; and (iii) the extent to which derivatives currently traded on an over-the-counter basis will move to central clearing. Second, there are a number of specific and technical aspects of the proposed rule that are difficult to assess without a large amount of highly detailed data on the size of derivative positions as well as the underlying rationale of bank swap dealers for maintaining those positions.

5. As the prudential regulators have noted, the definition of a financial end user is "substantially similar to, the definition of a financial entity that is ineligible to use the end user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act". While the proposed margin rule borrows from the Dodd-Frank Act's definition of financial entities, the definitions are not identical. Could you explain what "substantially similar" means in this context?

The proposed rule's definition of "financial end user," located as § __.2(h) of the proposed rule, contains seven prongs that, if met, would cause a person to be considered a financial end user for purposes of the proposed rule. The first four of these prongs, covering commodity pools, private

funds, employee benefit plans, and persons predominantly engaged in financial activities, are identical to those used in the definition of "financial entity" for purposes of the mandatory clearing requirements added by sections 723 and 763 of the Dodd-Frank Act.

The latter three prongs of the proposed rule's definition are not included in the definition of "financial entity" for purposes of the mandatory clearing requirements. These prongs capture foreign commodity pools and private funds and foreign governments that the Agencies have proposed also to treat as financial end users, as well as any other entity that an Agency, in its discretion, designates as a financial end user for purposes of the proposed rule.

The definition of "financial entity" for purposes of the mandatory clearing requirements also contains two related provisions that are not included in the Agencies' proposed rule. First, the financial entity definition in sections 723 and 763 of the Dodd-Frank Act directs the CFTC and SEC to consider exempting small banks from the mandatory clearing requirement, savings associations, farm credit system institutions, and credit unions, which are otherwise covered by the definition because they are predominantly engaged in financial activities. Second, that financial entity definition includes a special "limitation" that excludes from the definition certain financing affiliates of commercial firms, if specified criteria are met.

6. The prudential regulators' margin rule would require all counterparties to document their "credit support arrangements." Would existing credit support arrangements meet the new requirements in the proposed rule and be deemed "appropriate"?

Whether an existing credit support arrangement would meet the requirements of the proposed rule will depend on the precise terms and conditions of that arrangement, in particular whether it specifies a covered swap entity's rights to collect initial and variation margin, the valuation methods for swaps, and dispute resolution procedures.