HEARING TO REVIEW IMPLEMENTATION OF TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

HEARINGS

BEFORE THE

COMMITTEE ON AGRICULTURE

AND THE

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

FEBRUARY 10, 15, 2011

Serial No. 112–1

Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

64–659 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON AGRICULTURE

FRANK D. LUCAS, Oklahoma, *Chairman*

BOB GOODLATTE, Virginia, *Vice Chairman*
TIMOTHY V. JOHNSON, Illinois
STEVE KING, Iowa
RANDY NEUGEBAUER, Texas
K. MICHAEL CONAWAY, Texas
JEFF FORTENBERRY, Nebraska
JEAN SCHMIDT, Ohio
GLENN THOMPSON, Pennsylvania
THOMAS J. ROONEY, Florida
MARLIN A. STUTZMAN, Indiana
BOB GIBBS, Ohio
AUSTIN SCOTT, Georgia
STEPHEN LEE FINCHER, Tennessee
SCOTT R. TIPTON, Colorado
STEVE SOUTHERLAND II, Florida
ERIC A. "RICK" CRAWFORD, Arkansas
MARTHA ROBY, Alabama
TIM HUELSKAMP, Kansas
SCOTT DESJARLAIS, Tennessee
RENEE L. ELLMERS, North Carolina
CHRISTOPHER P. GIBSON, New York
RANDY HULTGREN, Illinois
VICKY HARTZLER, Missouri
ROBERT T. SCHILLING, Illinois
REID J. RIBBLE, Wisconsin

COLLIN C. PETERSON, Minnesota, *Ranking Minority Member*
TIM HOLDEN, Pennsylvania
MIKE MCINTYRE, North Carolina
LEONARD L. BOSWELL, Iowa
JOE BACA, California
DENNIS A. CARDOZA, California
DAVID SCOTT, Georgia
HENRY CUELLAR, Texas
JIM COSTA, California
TIMOTHY J. WALZ, Minnesota
KURT SCHRADER, Oregon
LARRY KISSELL, North Carolina
WILLIAM L. OWENS, New York
CHELLIE PINGREE, Maine
JOE COURTNEY, Connecticut
PETER WELCH, Vermont
MARCIA L. FUDGE, Ohio
GREGORIO KILILI CAMACHO SABLAN, Northern Mariana Islands
TERRI A. SEWELL, Alabama
JAMES P. MCGOVERN, Massachusetts

PROFESSIONAL STAFF

NICOLE SCOTT, *Staff Director*
KEVIN J. KRAMP, *Chief Counsel*
TAMARA HINTON, *Communications Director*
ROBERT L. LAREW, *Minority Staff Director*

SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

K. MICHAEL CONAWAY, Texas, *Chairman*

STEVE KING, Iowa
RANDY NEUGEBAUER, Texas
JEAN SCHMIDT, Ohio
BOB GIBBS, Ohio
AUSTIN SCOTT, Georgia
ERIC A. "RICK" CRAWFORD, Arkansas
MARTHA ROBY, Alabama
TIM HUELSKAMP, Kansas
RENEE L. ELLMERS, North Carolina
CHRISTOPHER P. GIBSON, New York
RANDY HULTGREN, Illinois
VICKY HARTZLER, Missouri
ROBERT T. SCHILLING, Illinois

LEONARD L. BOSWELL, Iowa, *Ranking Minority Member*
MIKE MCINTYRE, North Carolina
TIMOTHY J. WALZ, Minnesota
LARRY KISSELL, North Carolina
JAMES P. MCGOVERN, Massachusetts
DENNIS A. CARDOZA, California
DAVID SCOTT, Georgia
JOE COURTNEY, Connecticut
PETER WELCH, Vermont
TERRI A. SEWELL, Alabama

MATT SCHERTZ, *Subcommittee Staff Director*

CONTENTS

Page

WITNESSES

HEARING TO REVIEW IMPLEMENTATION OF TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

THURSDAY, FEBRUARY 10, 2011

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

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

Members present: Representatives Lucas, Johnson, Conaway, Fortenberry, Stutzman, Austin Scott of Georgia, Fincher, Crawford, Huelskamp, Gibson, Hultgren, Hartzler, Schilling, Peterson, Holden, Boswell, David Scott of Georgia, Costa, Kissell, Welch, and McGovern.

Staff present: John Goldberg, John Konya, Kevin J. Kramp, Joshua Mathis, Ryan McKee, Debbie Smith, Pelham Straughn, Liz Friedlander, Clark Ogilvie, and Jamie W. Mitchell.

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

The CHAIRMAN. This hearing of the Committee on Agriculture to review the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act will come to order. With that, today this Committee begins what will be a long series of hearings to review the implementation of the derivatives provisions included in the Dodd-Frank Wall Street Reform Act.

This Committee first considered legislation to reform the derivatives legislation. The Ranking Member and I worked hard to reach bipartisan consensus around the legislation we believed would bring needed reforms to the derivatives markets, also maintaining robust and liquid markets to allow farmers, ranchers, and commercial end-users to manage risk and discover market-driven prices. While it was not ultimately the legislation that became law, I believe the same principles should be applied as we exercise our oversight responsibilities on implementation of Dodd-Frank.

The complexity of Title VII shouldn't be underestimated, but neither should the far-reaching impact it will have on our economy. Title VII isn't just about financial firms; it has the potential to impact every segment of our economy, from farmers and ranchers to manufacturers, energy companies, to healthcare and technology. That is why we must ensure that we get it right. As we work to

revive the economy and create new jobs, we simply cannot afford sweeping new regulations that are poorly vetted that impose substantial costs that outweigh the benefits for our financial system and our economy, or that are crafted in the interest of speed rather than sound policy.

In addition, I am concerned that the regulators may be considering rules at odds with the statute, or with Congressional intent. Although it may not have been perfect, Congress included an exemption in Dodd-Frank for end-users from the margin, clearing and exchange trading requirements. Yet, there are growing concerns among end-users that they may be subject to margin requirements for their over-the-counter trades, an outcome that is clearly inconsistent with Congressional intent. A margin requirement imposed upon end-users would subject them to significant cash burdens, cash that might otherwise be used to put to work in the economy. And at the same time, such a requirement would create a significant disincentive to responsible risk-managing practices that provide price stability and certainty, and allow companies to remain focused on their core businesses.

Today and through the coming months, we will focus our oversight on the following important areas: to ensure that in meeting regulatory objectives, there are not undue or misguided regulations that will impede well-functioning markets, economic growth and the global competitiveness of U.S. firms; to ensure the process by which the CFTC and other Federal financial regulators implement the rules is fair, transparent, rationally sequenced to support public comment, and in line with meaningful and deliberate cost-benefit analysis; to ensure new rules are consistent with the statutory language and Congressional intent of Dodd-Frank, particularly with regard to the end-users exemptions; and as a part of this review, we will examine the feasibility of the statutory time tables and any other provisions of Dodd-Frank that may be impediments to meeting these objectives.

[The prepared statement of Mr. Lucas follows:]

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

Today, this Committee begins what will be a long series of hearings to review the implementation of the derivatives provisions included in the Dodd-Frank Wall Street Reform Act.

When this Committee first considered legislation to reform derivatives regulation, the Ranking Member and I worked hard to reach bipartisan consensus around legislation we believed would bring needed reforms to the derivatives markets, while also maintaining robust and liquid markets to allow farmers, ranchers and commercial end-users to manage risk and discover market driven prices. While it was not ultimately the legislation that became law, I believe the same principles should be applied as we exercise our oversight responsibilities over implementation of Dodd-Frank.

The complexity of Title VII shouldn't be underestimated, but neither should the far-reaching impact it will have on our economy. Title VII isn't just about financial firms—it has the potential to impact every segment of our economy, from farmers and ranchers, to manufacturers and energy companies, to health care and technology.

And that is why we must ensure we get it right. As we work to revive the economy and create new jobs, we simply can't afford sweeping new regulations that are poorly vetted, that impose substantial costs that outweigh the benefits for our financial system and our economy, or that are crafted in the interest of speed—rather than in sound policy.

In addition, I am concerned that the regulators may be considering rules at odds with the statute or with Congressional intent. Although it may not have been perfect, Congress included an exemption in Dodd-Frank for end-users from the margin, clearing and exchange trading requirements. Yet, there are growing concerns among end-users that they may be subject to margin requirements for their over-the-counter trades—an outcome that is clearly inconsistent with Congressional intent. A margin requirement imposed upon end-users would subject them to significant cash burdens, cash that would otherwise be put to work in the economy. At the same time, such a requirement will create a significant disincentive to responsible risk management practices that provide price certainty and stability, and allow companies to remain focused on their core businesses.

Today, and through the coming months, we will focus our oversight in the following important areas:

- To ensure that in meeting regulatory objectives, there are not undue or misguided regulations that will impede well-functioning markets, economic growth and the global competitiveness of U.S. firms;
- To ensure the process by which the CFTC and other Federal financial regulators implement the rules is fair, transparent, rationally sequenced to support public comment, and in line with meaningful and deliberate cost-benefit analysis; and
- To ensure new rules are consistent with the statutory language and Congressional intent of Dodd-Frank, particularly with regard to the end-user exemption.

And, as part of this review, we will examine the feasibility of the statutory timetables, and any other provisions of Dodd-Frank, that may be impediments to meeting these objectives.

I look forward to hearing from our witnesses today.

The CHAIRMAN. I very much look forward to our witness's testimony today, and with that, I turn to the Ranking Member for his opening statement.

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

Mr. PETERSON. Good morning, and thank you, Mr. Chairman, for holding today's hearing. I welcome Chairman Gensler back to the Committee, we appreciate you being with us.

Today we are discussing the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. It is important that Dodd-Frank is the topic of the Committee's first oversight hearing of the new Congress, and I anticipate that there will be several more. It is also important that we get this right, and that the CFTC remain on track to implement the law in a responsible manner and as Congress intended.

Derivatives played a key role in the collapse of our financial markets. We had over $600 trillion over-the-counter derivatives market with no oversight, no transparency, no regulation. As a consequence of this and many other factors, the American taxpayer ended up having to bail out large financial institutions, like AIG, when the financial system fell apart.

Even before the financial crisis, nearly 3 years ago this Committee was looking into these markets, and we tried to address some of these issues in early 2009. Many of the provisions this Committee adopted with bipartisan support were ultimately included in the Dodd-Frank Act. Mandatory clearing of the over-the-counter swaps and requiring major swap participants and swap dealers to back up their deals with additional capital should help ensure that taxpayer dollars will not be needed to rescue these

large financial firms again, and hopefully bring greater stability to the swaps marketplace.

The Committee focused closely on ensuring that under these new rules, end-users could continue using derivatives to hedge risks associated with their underlying business, whether it is energy exploration, manufacturing, commercial activities, agriculture. End-users did not cause this financial crisis, and frankly, they were the victim of it.

We worked to see that mandatory clearing, mandatory training, new capital margin requirements, and other obligations fell upon the financial players responsible for this crisis, and not upon the commercial end-users. Proper oversight by this Committee will ensure that our efforts are implemented by the regulators.

The provisions of Dodd-Frank will also increase transparency to better arm end-users with negotiating with the big banks. Commercial end-users generally get the worst end of any swap deal because they simply do not have the same level of information on swap prices and terms as do their dealer counterparties. By requiring the big dealers to report and clear more of their swaps and move into more transparent marketplaces, commercial end-users will be able to get a better picture of the swaps market and be better armed in the negotiations with these dealers.

Unfortunately, there is still a lot of confusion and misinformation out there with regard to commercial end-users. I don't know exactly who is ginning this all up, but you know, at the end of the day, my opinion is if we bring transparency to this market, these end-users are going to get a better deal than they are getting now. This is actually going to cost them less money in the long run than they are paying now.

So we are looking forward to working with you, Mr. Chairman, and being involved in this process and working with the CFTC and Chairman Gensler to make sure that we get this right and we don't have another financial boondoggle like we had here a couple years ago.

Thank you.

[The prepared statement of Mr. Peterson follows:]

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

Good morning. Thank you Chairman Lucas for holding today's hearing and welcome, Chairman Gensler, to the Committee. Today we are discussing the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

It is appropriate that Dodd-Frank is the topic of the Committee's first oversight hearing of the new Congress, and I would anticipate there will be several more. It is important that we get this right and that the CFTC remain on track to implement the law in a responsible manner and as Congress intended.

Derivatives played a key role in the collapse of our financial markets. We had an over $600 trillion OTC derivatives market with no oversight, no transparency, and with no regulation. As a consequence of this and many other factors, the American taxpayer ended up having to bail out large financial institutions like AIG when the financial system fell apart.

Even before the financial crisis, nearly 3 years ago, this Committee was looking into these markets and we tried to address some of these issues in early 2009. Many of the provisions this Committee adopted with bipartisan support were ultimately included in the Dodd-Frank Act.

Mandatory clearing of over-the-counter swaps and requiring major swap participants and swap dealers to back up their swap deals with additional capital should

help ensure that taxpayer dollars will not be needed to rescue these large financial firms again and bring greater stability to the swaps marketplace.

The Committee focused closely on ensuring that under these new rules end-users could continue using derivatives to hedge the risks associated with their underlying business, whether it is energy exploration, manufacturing or other commercial activities. End-users did not cause the financial crisis; they were the victims of it.

We worked to see that mandatory clearing, mandatory trading, new capital and margin requirements, and other obligations fell upon the financial players responsible for the crisis and not upon commercial end-users. Proper oversight by this Committee will ensure that our efforts are implemented by the regulators.

The provisions of Dodd-Frank will also increase transparency to better arm end-users when negotiating with the big banks. Commercial end-users generally get the worse end of any swap deal because they simply do not have the same level of information on swap prices and terms as do their dealer counterparties. By requiring the big dealers to report and clear more of their swaps and move into more transparent marketplaces, commercial end-users will be able to get a better picture of the swaps market and be better armed in their negotiations with these dealers.

Unfortunately, there is still a lot of confusion and misinformation out there with regard to commercial end-users. I hope this hearing gives us an opportunity to clear some of that up. Because if implemented properly, the derivative title of Dodd-Frank could prove to be a major benefit to commercial end-users.

Again, I thank the Chairman for holding today's hearing and look forward to hearing from our witnesses.

The CHAIRMAN. That is absolutely correct, Ranking Member, and as our witness is preparing to offer his opening comments, do you have any inquiries you would like to make of the under classmen?

Mr. PETERSON. No, I will——

The CHAIRMAN. Save that for later? Fair enough.

The chair would request that other Members submit their opening statements for the record so the witnesses might begin their testimony to ensure there is ample time.

[The prepared statement of Mr. Tipton follows:]

PREPARED STATEMENT OF HON. SCOTT R. TIPTON, A REPRESENTATIVE IN CONGRESS FROM COLORADO

Thank you, Chairman Lucas, for convening today's hearing, and thank you to all of you here today. It is an honor to serve on this committee, and I welcome today's discussion of derivatives. I also want to give a special welcome to Mr. Scott Morrison, Senior Vice President and Chief Financial Officer of Ball Corporation, which is headquartered in Broomfield, Colorado. Mr. Morrison is on our panel today to share his concerns about the rulemaking.

As a small business owner, I understand the risks inherent in doing business, and I recognize the role derivatives play in helping farmers, manufacturers and other end-users manage risks. Agriculture is an important part of Colorado's economy, and we have many farmers who use derivatives to hedge against price swings in the crops they produce and in the fertilizer, fuel, and other supplies they rely on. We also have manufacturing companies like Ball Corporation who use derivatives as a prudent risk-management tool.

It is important to reduce systemic risk and improve market transparency. There are important provisions within Dodd-Frank for which the CFTC is currently drafting rules. As the rulemaking process progresses however, we must be watchful that the regulations being implemented do not unduly hamper private investment. End users like farmers and manufacturers did not cause the financial crisis, and that is why they were given an exemption within Title VII. Forcing them to comply with onerous rules will not help us achieve market transparency and risk reduction.

I have particular concerns about the margin requirement, and how this one regulation, if applied to end users, could tie up capital, hinder job creation, and further stall economic recovery while not doing anything to prevent another financial crisis. As a Member of the Small Business Committee, one of my priorities is regulatory reform; I oppose excessive government regulation that unduly impedes private sector job creation.

We have not yet seen rules from the CFTC concerning this capital and margin issue, but we must be watchful that the CFTC promulgates rules in line with the intent of the Dodd-Frank legislation. I have here a letter from Chairman Dodd and

Chairman Lincoln and a colloquy from Chairman Frank and Chairman Peterson, and they could not have been clearer in expressing their intent that capital and margin requirements should not apply to end users of derivatives. I hope that CFTC regulators are mindful of this, and they do not attempt to go beyond the scope of their authority and place capital requirements on end users that force them out of the derivatives market.

Thank you again, Mr. Chairman, for holding today's hearing. Today's discussion is important, and it is something we must continue as the rulemaking process moves forward. We will likely request further information from Mr. Gensler and the CFTC, and we will continue to exercise oversight over the rulemaking.

We would like to welcome our first panel to the table, the Honorable Gary Gensler, Chairman of the Commodity Futures Trading Commission, Washington, D.C. Mr. Gensler, Chairman, please begin when you are ready.

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

Mr. GENSLER. Chairman Lucas, Ranking Member Peterson, Members of this Committee, I thank you for inviting me here today to this hearing, as I understand it, your first oversight hearing, so it is quite an honor to be here in front of this new chair and this new Congress.

I am pleased to testify on behalf of the Commodity Futures Trading Commission. I also want to thank each of my fellow Commissioners for their hard work, their thoroughness, and commitment on implementing the legislation that was passed last year.

Markets work best when they are transparent, open, and competitive. The American public has benefited from these attributes in the futures market that you help oversee through overseeing us, and the securities markets, those markets that were regulated after the great regulatory reforms after an earlier crisis in the 1930s. Congress directed the CFTC and the SEC after this generation's crisis to try to bring similar features to what is called the swaps market, or over-the-counter derivatives market. The reforms that Congress enacted last summer will bring transparency and better pricing for corporations throughout America that use derivatives to hedge their risk. This is a significant change in the marketplace. Currently when a corporation or other end-users want to hedge a risk through the use of a swap, they don't benefit from a centralized marketplace as they might in a futures marketplace, and have that pricing in a transparent exchange or trading platform. So bringing transparency to these markets will improve information for end-users and other entities, provide greater competition in the marketplace, and yes, greater liquidity. Such transparency is also critical to lowering risk for the clearinghouses and risk in the large financial institutions that unfortunately 2 years ago the taxpayers stood behind.

The CFTC is engaged in an open consultative process to complete implementation of Dodd-Frank. We are grateful for the public's input on the CFTC's rulemakings. In the summer, we identified 30 topic areas from the bill itself where rulemaking would be necessary. So far, we have proposed rules in 26 of those 30 areas. We have done so using significant input from the public prior to our proposing of rules, and during the official public comment periods. Importantly, commenters inform the Commission's consideration of

costs and benefits associated with the rules. We also have coordinated closely with other domestic regulators and international counterparts. As part of seeking public comment on each of these individual rules, we have asked a question related to the timing of implementation, and we do have latitude, and I thank you for the latitude about implementation dates. We have asked the public, looking at the entire set of rules, the entire mosaic of rules, to please inform the Commission as to what requirements can be met sooner and which ones will take a bit more time, given the cumulative effect of the rules and the potential costs of those rules.

One of the areas where we have yet to propose rules is in capital and margin, where we are working very closely in coordination with the banking regulators and the SEC. As it relates to margin, Congress recognized the different levels of risk posed by transactions between financial entities, a bank and an insurance company or hedge fund, and those involving non-financial end-users. This is reflected in the non-financial end-user exception to clearing. Transactions involving non-financial entities do not present the same risk to the financial system as those between two financial entities.

Why is this? In our opinion, and I think what is probably behind what Congress did, the risk of crisis spreading through the financial system is far greater the more interconnected financial companies are with other financial companies. This interconnectedness among financial entities can spread during a crisis—and then create economic harm to the public.

So consistent with what the Congress did with regard to clearing, the proposed rules, as we move forward at the CFTC, I believe margin requirements should only focus on transactions between the financial entities. Thus, we would not have or involve the non-financial end-users, consistent with what this Congress did.

Before I close, I will just briefly address one thing on resources. The futures marketplace that we oversee right now is $40 trillion in size. The swaps marketplace here in the U.S. that we are asked to oversee is about $300 trillion, half of what Chairman Lucas talked about. So thus, about seven times the size of the futures marketplace that we oversee, and it is far more complex. The CFTC's current funding is far less than what we would require to fulfill the mandate to oversee the swaps market that is seven times the size.

We look forward to working with this Congress on securing the adequate resources. I thank you and I look forward to questions.

[The prepared statement of Mr. Gensler follows:]

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

Good morning, Chairman Lucas, Ranking Member Peterson and Members of the Committee. I thank you for inviting me to today's hearing on implementing the 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 for their hard work and commitment on implementing the legislation.

Before I move into the testimony, I want to congratulate Chairman Lucas on becoming Chairman of this Committee that is so critical to both the economy and American agriculture. I also want to thank Chairman Lucas, Ranking Member Peterson and this Committee for leading the effort to bring regulatory reform to the over-the-counter derivatives—or "swaps"—markets. This Committee passed the first

bill during the last Congress—the bipartisan H.R. 977—that included comprehensive reform of derivatives. The joint framework for derivatives legislation that was released later by this Committee's leadership also helped frame the debate on how to best protect the American public through regulatory reform of swaps. H.R. 977 and the joint framework formed the basis of the derivatives title of the Wall Street Reform and Consumer Protection Act.

The Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed the Wall Street Reform and Consumer Protection Act (the Act). Title VII of the Act, entitled "The Wall Street Transparency and Accountability Act," amended the Commodity Exchange Act (CEA) to establish a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted to reduce risk, increase transparency and promote market integrity within the financial system by, among other things:

1. Providing for the registration and comprehensive regulation of swap dealers and major swap participants;
2. Imposing clearing and trade execution requirements on standardized derivatives products;
3. Creating robust record-keeping and real-time reporting regimes; and
4. Enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

The reforms mandated by Congress will reduce systemic risk to our financial system and bring sunshine and competition to the swaps markets. Markets work best when they are transparent, open and competitive. The American public has benefited from these attributes in the futures and securities markets since the great regulatory reforms of the 1930s. The reforms of Title VII will bring similar features to the swaps markets. Lowering risk and improving transparency will make the swaps markets safer and improve pricing for end-users.

Implementing the Wall Street Reform and Consumer Protection Act

The Wall Street Reform and Consumer Protection Act is very detailed, addressing all of the key policy issues regarding regulation of the swaps marketplace. To implement these regulations, the Act requires the CFTC and Securities and Exchange Commission (SEC), working with our fellow regulators, to write rules generally within 360 days. At the CFTC, we initially organized our effort around 30 teams who have been actively at work. We have recently added another team. We had our first meeting with the 30 team leads the day before the President signed the law.

The CFTC is working deliberatively and efficiently to promulgate rules required by Congress. The talented and dedicated staff of the CFTC has stepped up to the challenge and has recommended thoughtful rules—with a great deal of input from each of the five Commissioners—that would implement the Act. Thus far, the CFTC has approved 39 notices of proposed rulemaking, two interim final rules, four advanced notices of proposed rulemaking and one final rule.

The CFTC's process to implement the rulemakings required by the Act includes enhancements over the agency's prior practices in five important areas. Our goal was to provide the public with additional opportunities to inform the Commission on rulemakings, even before official public comment periods. I will expand on each of these five points in my testimony.

1. We began soliciting views from the public immediately after the Act was signed and prior to approving proposed rulemakings. This allowed the agency to receive input before the pens hit the paper.
2. We hosted a series of public, staff-led roundtables to hear ideas from the public prior to considering proposed rulemakings.
3. We engaged in significant outreach with other regulators—both foreign and domestic—to seek input on each rulemaking.
4. Information on both staff's and Commissioners' meetings with members of the public to hear their views on rulemakings has been made publicly available at *cftc.gov*.
5. The Commission held public meetings to consider proposed rulemakings. The meetings were webcast so that the Commission's deliberations were available to the public. Archive webcasts are available on our website as well.

Two principles are guiding us throughout the rule-writing process. First is the statute itself. We intend to comply fully with the statute's provisions and Congressional intent to lower risk and bring transparency to these markets.

Second, we are consulting heavily with both other regulators and the broader public. We are working very closely with the SEC, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and other prudential regulators, which includes sharing many of our memos, term sheets and draft work product. CFTC staff has had 376 meetings with other regulators on implementation of the Act.

Specifically, our rule-writing teams are working with the Federal Reserve in several critical areas: swap dealer regulation, clearinghouse regulation and swap data repositories, though we are consulting with them on a number of other areas as well. With the SEC, we are working on the entire range of rule-writing, including those previously mentioned as well as trading requirements, real time reporting and key definitions. So far, we have proposed two joint rules with the SEC as required by Congress.

In addition to working with our American counterparts, we have reached out to and are actively consulting with international regulators to harmonize our approach to swaps oversight. As we are with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators as well. Our discussions have focused on clearing and trading requirements, clearinghouses more generally and swaps data reporting issues, among many other topics.

We also are soliciting broad public input into the rules. On July 21st, we listed the 30 rule-writing teams and set up mailboxes for the public to comment directly. We determined it would be best to engage the public as broadly as possible even before publishing proposed rules. We have received 2,851 submissions from the public through the e-mail in-boxes as well as 1,111 official comments in response to notices of proposed rulemaking.

We also have organized nine roundtables to hear specifically on particular subjects. We have coordinated the majority of our roundtables with the SEC. These meetings have allowed us to hear directly from investors, market participants, end-users, academics, exchanges and clearinghouses on key topics including governance and conflicts of interest, real time reporting, swap data record-keeping and swap execution facilities, among others. The roundtables have been open to the public, and we have established call-in numbers for each of them so that anyone can listen in.

Additionally, many individuals have asked for meetings with either our staff or Commissioners to discuss swaps regulation. To date, we have had more than 500 such meetings. We are now posting on our website a list of all of the meetings CFTC staff, my fellow Commissioners and I have with outside organizations, as well as the participants, issues discussed and all materials given to us.

We began publishing proposed rulemakings at our first public meeting to implement the Act on October 1, 2010. We have sequenced our proposed rulemakings over 11 public meetings thus far. Our next meeting is scheduled for February 24.

Public meetings have allowed us to discuss proposed rules in the open. For the vast majority of proposed rulemakings, we have solicited public comments for a period of 60 days. On a few occasions, the public comment period lasted 30 days. As part of seeking public comment on each of the individual rules, we also have asked a question within many of the proposed rulemakings relating to the timing for the implementation of various requirements under these rules. In looking across the entire set of rules and taking into consideration the costs of cumulative regulations, public comments will help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time.

We have thus far proposed rulemakings in 26 of the 30 areas established last July. We still must propose rules on capital and margin requirements, product definitions (jointly with the SEC) and the Volcker Rule. We also are considering comments received in response to advanced notices of proposed rulemaking with regard to disruptive trading practices and segregation of funds for cleared swaps.

A number of months ago we also set up a 31st rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act. This is consistent with one of the requirements included in the recent Executive Order issued by the President, entitled "Improving Regulation and Regulatory Review."

In reviewing the Executive Order more broadly, the CFTC's practices are consistent with the Executive Order's principles. The CFTC has a robust process to involve and ensure public participation in the rulemaking process. The CFTC also consults broadly with other regulators to coordinate, harmonize and simplify regulations. We work to identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public. Further, the CFTC routinely seeks public comment on technical information and data considered during the regulatory process. Last, the CFTC conducts cost-benefit analyses in its

rulemakings as prescribed by Congress in Sec. 15(a) of the CEA rather than as prescribed in Section 1 of the Executive Order. The statute includes particularized factors to inform cost-benefit analyses that are specific to the markets regulated by the CFTC. Thus, we will continue to fulfill the CEA's statutory requirements. Even though the statute dictates different cost-benefit analysis methodology, the CFTC's practices are consistent with the executive order's principles.

In addition to considering conforming amendments to update the CFTC's existing regulations, we also will examine the remainder of our rule book consistent with the executive order's principles to review existing significant regulations. We intend to develop and make public a preliminary plan for the periodic review of significant regulations within the 120 day timeframe outlined in the Executive Order.

End-User Margin

One of the rules that the CFTC will consider pertains to capital and margin requirements. As it relates to margin, the Act states that, "to offset the greater risk to the swap dealer . . . and the financial system from the use of swaps that are not cleared," regulators shall "help ensure the safety and soundness of the swap dealer" and set margin requirements that are "appropriate for the risk associated with the non-cleared swaps."

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. Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities. The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Interconnectedness among financial entities allows one entity's failure to cause uncertainty and possible runs on the funding of other financial entities, which can spread risk and economic harm throughout the economy. Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.

Conclusion

Before I close, I will briefly address the resource needs of the CFTC. The futures marketplace that the CFTC currently oversees is approximately $40 trillion in notional amount. The swaps market that the Act tasks the CFTC with regulating has a notional amount roughly seven times the size of that of the futures market and is significantly more complex. Based upon figures compiled by the Office of the Comptroller of the Currency, the largest 25 bank holding companies currently have $277 trillion notional amount of swaps.

The CFTC's current funding is far less than what is required to properly fulfill our significantly expanded mission. Though we have an excellent, hardworking and talented staff, we just this past year got back to the staff levels that we had in the 1990s. To take on the challenges of our expanded mission, we will need significantly more staff resources and—very importantly—significantly more resources for technology. Technology is critical so that we can be as efficient as an agency as possible in overseeing these vast markets.

The CFTC currently is operating under a continuing resolution that provides funding at an annualized level of $169 million. The President requested $261 million for the CFTC in his proposed Fiscal Year (FY) 2011 budget. This included $216 million and 745 full-time employees for pre-reform authorities and $45 million to provide half of the staff estimated at that time needed to implement the Act. The President is scheduled to release his FY 2012 budget request soon.

Given the resource needs of the CFTC, we are working very closely with self regulatory organizations, including the National Futures Association, to determine what duties and roles they can take on in the swaps markets. Nevertheless, the CFTC has the ultimate statutory authority and responsibility for overseeing these markets. Therefore, it is essential that the CFTC have additional resources to reduce risk and promote transparency in the swaps markets.

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

The CHAIRMAN. Thank you, Chairman. I will begin the questioning.

We are hearing from companies across the country that the rulemaking process that CFTC may very well just simply be moving too quickly, and that the sequence of the rules is precluding them from commenting in a meaningful way. You have to figure out the chain of flow before you can offer comments. The proposed rules re-

flect what some are concerned might be rushed policies that potentially jeopardize the viability of the derivatives market, which ultimately would be to the impediment of the economy.

You have acknowledged, Chairman, that it may be necessary to phase in compliance with the new rules, and we certainly commend you for those efforts and comments. But Chairman, the concerns about the rulemaking process are shared by market participants, not in any one particular part of the economy, but in a broad cross section. Despite statutory directives, CFTC and the SEC are not only moving in different directions, but the rules you are proposing on critical issues are inconsistent, including real-time reporting, the swap execution facility rules, the ownership and governance rules. In addition, you will need to build consensus, I would think, among your Commissioners, in line with the bipartisan tradition of this Committee, I strongly urge you to work to minimize those divided votes among your Commissioners and build consensus.

So I guess that said, Mr. Gensler, does the Commission need more time to vet the rules, to collect the data, to build a consensus, to do all the things that are important so that we can minimize the adversarial consequences to the—adverse consequences to the market and our economy? Do you need more time, Chairman?

Mr. GENSLER. I think that the Congress laid out this 1 year timeframe, and that the Commission—I commend all of my fellow Commissioners and the excellent staff at the CFTC has reached out to the public. I commend the public. There has been enormous input. We have had well over 500 meetings with the public. I think we have had thousands of comments.

We do, right now, have a natural pause. Though we have a couple of rules still—important rules to propose, we are where the public can now start to see the entire rule set, and in fact, one of the rules that has been raised is the entity definition rule whose closing period is in a couple of weeks, February 22. I would certainly encourage everybody in the public, if you have a comment on any of the rules that are out there, because there is this interplay that the Chairman talks about between the rules. Please submit it. Let us know in this period of time, and we will make sure that our Commissioners and the staff know all the comments and all the rules, even if a comment period is closed. We do have the discretion to continue to consider that, look at the whole mosaic.

I don't envision us taking up final rules, really, until this spring, so there is a natural pause right now where we can hear from the public, hear from Congress, and consider this in the whole mosaic as we move forward. We are human. Some of these rules will be put in place after July. There is no doubt that some will be after July, but I think that we did have a significant crisis 2 years ago, and we are trying to address that crisis, and also lower regulatory uncertainty by finishing these rules.

The CHAIRMAN. Chairman, we are very sensitive to the effects on the economy of these decisions. Can you assert that under the current statutory timeframes that the cost-benefit analysis that the CFTC has performed are related to each rule, and the rules imposed in a comprehensive fashion? Can you assert to me that they would stand up to an independent evaluation?

Mr. GENSLER. Well, we have actually direction from Congress in statute on how to comply with cost-benefit analyses. This agency, with this Committee's direction 11 years ago, has something called Section 15(a) of our statute that says how to do it, and to take into consideration many of the factors you talked about.

So yes, Mr. Chairman, we—and all of our rules comply with the very directed, specific, cost-benefit analysis that Congress has laid out for us to consider factors like lowering risk, promoting price discovery, and the integrity of markets. By their nature, they are very important factors for this market.

The CHAIRMAN. Can you commit to this Committee, Chairman, that without an extension of the statutory deadline, these rules will not impose undue costs on end-users or cause the distortion to the market by adversely impacting liquidity?

Mr. GENSLER. We are very sensitive to end-users. End-users—the corporations, tens of thousands of them, municipalities, hospitals, small real estate developers, need these products to hedge their risk, and that is absolutely critical. That is why Congress left that—you can do customized bilateral swaps that are not going to be in the clearinghouses. I believe we are going to address the margin issue forthwith in March, very directly.

So yes, sir, I believe that end-users will benefit, actually, from greater liquidity because there will be greater transparency in the marketplaces, but at the same time, not be brought into clearing or margining.

The CHAIRMAN. Thank you, Mr. Chairman. My time has expired and I turn to the Ranking Member for his questions.

Mr. PETERSON. Thank you, Mr. Chairman.

You know, one of the reasons we gave the CFTC the latitude here, we were looking at doing this ourselves. The more I dug into it, the more I realized it was pretty complicated stuff and we were probably going to screw it up. I think they are working through this and I believe that they are sensitive to this.

I guess the question I have, it seems to me that these end-users are actually going to have—lower their costs. If you get this information available, they are going to be able to go to more than one swap dealer and basically play them off against each other and get a better deal, right?

Mr. GENSLER. I think that they will have greater transparency, even if they don't have to come into the clearing or trading. In essence, they get the benefit because all their financial firms' transactions have to be in the clearing, so they get to see that pricing.

Mr. PETERSON. Do these end—have you looked into this? Do these end-users now do business with more than one entity, or are they basically always doing their swaps with one bank? You know, is there a way for them to actually go out to five banks and get the best deal? I mean, how does that work?

Mr. GENSLER. Congressman, they can——

Mr. PETERSON. I mean, there is no information——

Mr. GENSLER. Many end-users spend a significant amount of time in their treasury function, working with multiple banks, three to five, six. Sometimes they do put them in competition. But what a central exchange does is put them more naturally in competition, and they get the benefit of seeing that price.

Mr. PETERSON. I understand that, but I guess the stuff that can't be cleared or that is not enough for a clearinghouse. So we are going to make that information available and you are going to try to get that more out there in real time.

So these customized trades, right now there is no information, nobody knows what is going on. So it almost seems like, with those kinds of things they are probably just dealing with, it is one bank in the dark in terms of what the pricing is.

Mr. GENSLER. You are absolutely right. The more customized, the more particular usually it is one bank. That still would be allowed, but you could also have the benefit of seeing where the standard transactions were priced, and you would say, "Ah-ha, it is over here, it is priced this way, I can get a better-informed negotiation."

Mr. PETERSON. Well, I personally think that what this fight is about is that this is actually going to reduce the spreads and reduce the profits of these Wall Street guys, and that is what is stirring all this up. That is what I think, but what do I know? I am just a dirt farmer from Minnesota.

One of the other issues, there is this story about these banking elite getting together and trying to corner this market and keep this under control. We gave you guys some authority to try and go in there and try to put some rules on in terms of—so that can't happen, so that we have—so we don't have the big Wall Street guys controlling these clearinghouses, which I think they have been trying to do. So where is that all in the process?

Mr. GENSLER. I think Congress recognized markets work best when not only are they transparent, but open and competitive, and you included that the clearinghouses have to have what is called open access, and the trading platforms have to have something called impartial access. So our proposed rules—and we look forward to the public comment on it—say on both of those that they really do have to be open. The clearinghouse's membership have to be far more open than currently exists. The clearinghouses have to manage their risk, but they can scale that risk. A smaller member would only have smaller participation, and then a bigger member, bigger participation.

Mr. PETERSON. Well, I heard some discussion that apparently some of the big financials have been resisting getting involved in some of these clearing entities because they—apparently because they can't control it or something. Is that—have you looked into that, or—I mean, has there been a reluctance to join some of the clearing folks that have been—that clearly know what they are doing and they have been operating and it is working, but because they can't—apparently because they can't control it, I guess.

Mr. GENSLER. Historically I think there is some truth to that. Clearinghouses, though, under the new Dodd-Frank would be far more open, because that is what Congress directed. There would be more competition amongst the dealers, and the public would benefit, I think from that competition, while we still will have the risk reduction of clearinghouses.

Mr. PETERSON. That is probably not going to happen until you actually get these rules in place that force this to happen, right?

Mr. GENSLER. I think that some of it will happen beforehand because they will see what is coming, and we will get very good com-

ments and we will change some of the rules based on those comments, but openness and competitiveness was at the core of what Congress asked us to do in these rules.

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

The CHAIRMAN. The gentleman's time has expired. We turn to the gentleman from Illinois, Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

Let me address my comments or I guess my questions, Mr. Gensler, specifically to your—to the definition of a *swap dealer* under the Act.

According to the rules that you promulgated in December, and be as specific as you can with this, how many entities do you think will be required to register as swap dealers under those rules, specifically? I know you can't tell me or I assume you can't tell me exactly, but as best you can.

Mr. GENSLER. That is an excellent question. We have estimated about 200. We looked at the ISDA website. They have over 800 members, and approximately—well, there are some that are called primary members——

Mr. JOHNSON. So you are saying about 200?

Mr. GENSLER. About 200.

Mr. JOHNSON. Okay.

Mr. GENSLER. Some of those I would say would be multiple dealers. Some of the big dealers have said they were going to register four or five or six legal entities, so that 200 actually is fewer companies.

Mr. JOHNSON. Do you recall—I am assuming you recall in February of 2009 at your confirmation hearing where you addressed that issue?

Mr. GENSLER. You could help remind me.

Mr. JOHNSON. Yes, let me help remind you. Do you recall at your testimony before the Senate Banking Committee that you estimated between 15 and 20 entities would qualify for virtually the entire regulatory scheme? Do you recall that comment and that answer?

Mr. GENSLER. And that——

Mr. JOHNSON. I am just asking you if you recall that. You do? You recall having given that response?

Mr. GENSLER. You have helped me recall that.

Mr. JOHNSON. Okay. I guess what I am asking you is there is a pretty significant difference between 15 and 20 and 200. I am just wondering whether your viewpoint has changed in the last several years, or whether that is an evolutionary process as well.

Mr. GENSLER. Most of those 15 have told us they will register multiple legal entities. Some have said they were going to register six or seven, some have said four or five. So without naming the largest banks, but most of the largest banks have said they have several legal entities. So that——

Mr. JOHNSON. Okay. I am assuming the answer is your viewpoint has changed.

In terms of the *de minimis* exception, the definition under the Act, can you tell this Committee now specifically companies that would qualify for that exemption?

Mr. GENSLER. I don't——

Mr. JOHNSON. I assume you are aware specifically explicitly included a *de minimis* exception under the definition of swap dealers. My question is, what entities exist now that you believe qualify for that exception?

Mr. GENSLER. Well, I think that many companies will not be swap dealers. Tens of thousands of companies will not be swap dealers because they are end-users. The *de minimis* exemption is also likely to include certain small banks, certain companies that from time-to-time might offer risk management services to others, but as a small number——

Mr. JOHNSON. Can you give the Committee the names—specifically the names of companies who qualify for that exemption?

Mr. GENSLER. I do not have names. They would come in and talk to us, and we are looking forward to the public comment to see whether we need to adjust that *de minimis* number, as well.

Mr. JOHNSON. In terms of cooperatives, and I guess I am addressing my comments not only to the dairy co-ops that will have the opportunity to testify here—or at least on their behalf later, but also rural electric co-ops which play a huge role in many of our districts.

What do you think—what is your viewpoint about the impact—let me rephrase that. Do you believe that those cooperatives, the dairy co-ops, let us even take the rural electric co-ops, will have to register as swap dealers, or do you think they will be exempt?

Mr. GENSLER. Let me take them one at a time. I am not familiar with any rural electric cooperative that has—and we have talked to them, has raised this issue, but we are looking forward to their public comment. I don't want to preclude—they might somehow raise a comment. On the dairy cooperatives, we have had a lot of very good dialogue, and I think it is wrapped into something, if I might say, related to how they do their business. Most of what they do, as I understand it, actually are not swaps, they are forwards. If there is an intent to deliver dairy product or cattle product or grain wheats, it is actually exempted. We are going to take—and I know that Congressman Peterson had a colloquy——

Mr. JOHNSON. My time is coming to a close. I am not trying to cut you off, but I would like to get a specific answer, as best you can, as to whether you believe those cooperatives are going to be——

Mr. GENSLER. As best I can, I think most of what they do aren't even swaps, that they are forwards or forwards with embedded options. But again, we look forward to their comments. We are working very closely with the dairy cooperatives.

Mr. JOHNSON. And I guess my concluding question in those cooperatives—because my time is coming to a close—what do you believe—I do—whether you believe that there will be a specific impact on the members of those cooperatives who are also obviously the farmers and otherwise, if they are subjected to regulation of this Act. I am assuming you think there will be an impact?

Mr. GENSLER. I think that they will benefit from the transparency from the marketplace, and we have put out a proposed rule that ag swaps should be treated similarly and they get the benefit of that, of other swaps.

Mr. JOHNSON. Thank you for your comments.

The CHAIRMAN. The gentleman's time has expired. We now turn to the gentleman from Pennsylvania for his 5 minutes.

Mr. HOLDEN. Thank you, Mr. Chairman.

Chairman Gensler, I believe you tried to reference a colloquy that I think then-Chairman Peterson and I had on the floor during a debate where we talked about Farm Credit institutions and credit unions and small banks and thrifts being exempt because they did not cause the problem and they should not be subject to regulations. Is that what you were just attempting to say to Mr. Johnson?

Mr. GENSLER. It may have been part of that colloquy. I was referencing a forwards exemption colloquy, so it may have been part of that colloquy.

Mr. HOLDEN. Yes, because that was the intention of the legislation, that these institutions that did not cause the problem not be subject to it. And some of these institutions do have assets greater than $10 billion, particularly the big Farm Credit System. Are you considering exemptions there?

Mr. GENSLER. We have asked the public for comment in—I think it was in December—if I recall, to help us with regard to this. Congress gave us the authority under the clearing exemption to extend that to certain—I think the words in the statute was small banks, farm credit, and—I'm sorry, there was a third category—credit unions.

Mr. HOLDEN. Right, thank you.

The Commission's proposed rule requires such reporting as soon as technologically possible and for lock trades a reporting delay of 15 minutes is permitted. From your discussions within the industry, what is technologically possible with regard to real-time reporting?

Mr. GENSLER. If it is traded on a platform, if it is traded on an exchange, as soon as technologically practical is within seconds. If it is bilateral, we recognize that in some circumstances that might take some time. But these are for the smaller transactions. The bigger trades, what are called blocks, there would be a delay and that is what Congress has asked us to do, and we have asked a lot of questions of the public about that delay.

Mr. HOLDEN. I had a public utility in to see me yesterday about this issue, and they thought 15 minutes was not reasonable. We had a meeting yesterday with Ranking Member Peterson and we seem to think—what is your opinion on what—if you had up to 24 hours as opposed to 15 minutes? What is the difference?

Mr. GENSLER. Well, I think then the market loses transparency. The market greatly benefits from real-time reporting. Now, in terms of that utility, that utility would not have to do a transaction on an exchange because they have an exemption from Congress to be out of it. So on the bilateral transactions, we have not suggested the 15 minutes. We have actually asked a whole series of questions as to what would be appropriate, and we put it in three categories. On an exchange, it is as soon as technologically practical, if it is small. If it is a block and it is on an exchange, it is a 15 minute delay, and the third category are these bilaterals where we just ask, frankly, a lot of questions.

Mr. HOLDEN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back his time. The chair now recognizes the gentleman from Texas, Mr. Conaway, for 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman. Mr. Chairman, thank you, very good to be here.

I am going to play off the Chairman's question in reference to cost-benefit analysis. The President sent out a letter a couple of weeks ago that directed Executive Branch agencies, which you didn't necessarily come under, that had a sentence in it that required cost-benefit analysis in the quantitative and qualitative natures must be considered. But in your testimony, you said that you are in principle going to put your agency under his letter, but then page seven and eight you say specifically that you are not going to use the definition in his paragraph, but instead, are going to fall back under 15(a).

Reading both of those, some of the same words are used. Some would say there is really no distinction between the two. You apparently have made a distinction between the requirement under the President's letter to consider the qualitative and quantitative amounts for the cost-benefits. Why the distinction with pulling yourself out of that one sentence?

Mr. GENSLER. An excellent question, because Congress actually has prescribed a very detailed way that we do this under what is called 15(a), and it includes considering the price discovery market, lowering risk, the integrity of markets, and so we feel that we have a prescribed way and that we have to follow Congress. I think it is consistent. We have also asked the public in each of our rules, please comment on the cost-benefit analysis, share anything quantitative with us so we can be better informed as we move to final rule.

So we do want to hear from the public on any quantitative means, but we need to follow Congress——

Mr. CONAWAY. So you are thinking 15(a) is a stricter or more informative way to look at the cost-benefit analysis than what the President used in his letter?

Mr. GENSLER. Well, I don't want to comment on the President, but it is more informed because Congress tells us what we have to do, so we do feel we have to follow Congress, with all respect to his Executive Order.

Mr. CONAWAY. Yes, it looked like his Order was better.

Playing off of Mr. Johnson's question, if you do pick up commercial firms, energy companies and others in your definition of *swap dealers,* will you regulate their entire business? How will you distinguish—will they have to set up separate subsidiaries to run this through so that you don't reach into their non-swap dealer positions that——

Mr. GENSLER. It would only be on the legal entity. Some of the largest integrated oil companies also have a risk management business and it is in a separate legal entity, and we are working with them very closely. We are being informed by them even before we write the capital rules as to how they should apply, for instance, capital rules, but it would only be to the legal entity, or Congress gave us some authority to do it on the activities. So we can——

Mr. CONAWAY. But your testimony to us is you have no intention of going after ExxonMobil's non——

Mr. GENSLER. No, no, no.

Mr. CONAWAY. Whether they set up a separate entity and/or they just conducted it under the mother ship.

Mr. GENSLER. No, it would just be the legal entity that registered.

Mr. CONAWAY. Pushing the OTC markets into an exchange-like environment where we have problems with the exchange-like environment, a phrase that is new to me, but maybe you guys are all—high frequency algorhythmic trading, which may have caused a flash crash, a new phrase. How is—how will you protect these new entities or this new exchange-like environment from, as we said earlier, new products and/or these existing kinds of massive consumer-driven trades that with your transparency and instant reporting allow folks to get ahead, whatever, take advantage of positions as these folks have?

Mr. GENSLER. At the risk of giving a shout-out to the CME over here, I know Terry is here, but the futures exchanges have very solid risk management practices—they are called safeguards—before you can enter a trade. So what we did in our execution platform, the SEF proposal, is we said to the public, please tell us which risk safeguard should be as a minimum involved here.

What at a minimum should be there for this very reason? Also, Scott O'Malia, who heads our technology advisory committee, has asked that committee for a full report on what we can do in this way as well.

Mr. CONAWAY. Thank you. One final comment. I am hopeful that, given the extensive input you are getting from users and everybody involved in your testimony and what you are actually doing, that there will be, between the proposed rules and the final rules, clear evidence that you did listen and that you did consider what folks had to say to you as opposed to just, here are the proposed rules. We received this massive information that is just too much to deal with. Here is the final rule.

Mr. GENSLER. We are absolutely listening and the five Commissioners—the back and forth is working. Not every comment will we agree with, but many of them are really helpful. They are all helpful, many of them we agree with.

Mr. CONAWAY. Very politic of you.

The CHAIRMAN. The gentleman's time has expired. I now recognize the gentleman from Iowa, Mr. Boswell, for 5 minutes.

Mr. BOSWELL. Thank you, Mr. Chairman, and thank you, Mr. Gensler, for your good work. I have been pretty impressed over the last couple years, and I think you have a good crew and you are working very hard and very diligently. I appreciate it.

I would associate myself with Mr. Conaway and, in fact, everyone who has spoken. I think we sincerely—and what they have said and what you said, we want transparency. Transparency kind of reveals all, and I would be interested what comment you might make—further comment. What is the resistance to transparency? I think I kind of know what it is, but I would like to hear what your thoughts are on it. What is the resistance, you know? Out in the

rest of the world we would probably say they must have something to hide.

Mr. GENSLER. Well, information does sometimes lead to profits. If one has a profit motive—and absolutely, I honor this. I was on Wall Street for 18 years. Information is part of fulfilling your role to customers, but it is also a way to make profit.

So I think Congress adjusted the information advantage a little bit more towards the end-user and the public, and a little bit away from the financial community. Not dramatically, but that little change has some resistance. Some also say it lowers liquidity. I don't necessarily concur with that. I think the transparency increases liquidity, as long as you have an appropriate exception for the large block trades. I think Congress asked us to do that, and we are looking forward to the public comment on whether or not we got the block trading exception correct.

Mr. BOSWELL. Well, I think you are right on and I appreciate that, so I compliment your work. Keep it up.

With that, since I am agreeing with what you said, Mr. Chairman and Ranking Member, I am going to yield back.

The CHAIRMAN. The gentleman yields back his time. I now recognize the gentleman from Georgia, Mr. Scott, for 5 minutes.

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

Chairman Gensler, did I understand your correctly to say that you don't have the budget currently to implement the rules and regulations that you are mandated to implement under Dodd-Frank?

Mr. GENSLER. You heard me correct. We don't have the budget or resources to oversee. We can complete the rule-writing through this summer and early fall. We are human. Some of these will slip, but we only have about 680 people. We estimate that we probably need upwards to 400 more people. The markets are seven times larger and far more complex than the markets we currently oversee, and we think we need also to probably double our technology budget over some time.

This is a challenge because our great nation has too much debt, and I appreciate this is not an easy ask that we might be asking this Congress to think about.

Mr. AUSTIN SCOTT of Georgia. Yes, sir, and it is one that might not happen. I would appreciate it if you would submit to the Committee an analysis of your anticipated budget and what positions those people would be hired into and what their roles would be.

Mr. GENSLER. We look forward to doing that, actually, I think next Monday or Tuesday. When the President reveals his overall budget, we also will send to this Committee, as we do annually, a full detail of that.

Mr. AUSTIN SCOTT of Georgia. Okay. Did I understand when you talked about the number of entities that when you were confirmed, you said it would be 15 to 20, now you are saying—I heard as many as 200 and then I heard well, some of the entities would do—so maybe seven times 20 is 140, but are we 150, are we 200? I mean, how many different entities are we going to be——

Mr. GENSLER. We made an estimate for budgeting purposes, and we have looked closely at the International Swap and Derivative Association membership list. We have also looked at who has come

in and knocked on our door, but you are absolutely right. Those 15 or 20 many have anywhere from four to seven each. Then we looked at the smaller entities that might only have one or two.

Part of what happened is Congress included a provision that was associated with Chairman Lincoln at the time that said that some of the things had to be moved out of the bank into an affiliate, so that push-out provision sort of multiplied the number of potential dealers.

Mr. AUSTIN SCOTT of Georgia. If I may, Mr. Chairman?

I guess, Chairman Gensler, one of the things I am having a difficult time with in the math there is how many employees you expect to have per entity that you are going to be regulating? I mean, if you do that math, in simple terms, what are you talking, six, eight, ten employees per entity that you are going to regulate?

Mr. GENSLER. Well actually, I wish it were that simple, but we currently only have the staff that we roughly had in the 1990s to oversee the futures marketplace, so we oversee many other entities that are not swap dealers. They are called futures commission merchants and clearinghouses and the like. We were 620 people in 1992, we are 680 people now. With Congress's help we sort of got back to where we were to cover the futures market, but not for the swaps marketplace, these upward of 400 people would be to oversee potentially 300 to 400 entities. We are going to work very closely with something called the National Futures Association and see how much we can delegate to them. The National Futures Association and Dan Roth, they are ready and willing to help out and take on many of these things, but we probably can't and shouldn't move everything to them.

Mr. AUSTIN SCOTT of Georgia. But again, you acknowledge that you don't have the budget necessary to handle the implementation of the rules?

Mr. GENSLER. That is a yes.

Mr. AUSTIN SCOTT of Georgia. And how does a bill get passed without—that mandates an increase in spending that doesn't have the spending tied to it?

Mr. GENSLER. Well, partly because there are different committees of authorization and appropriation—and we are on an annual budget cycle. Also, we are one of the few financial regulators that is not self-funded. I am not asking for that. I am just noting it. So many of the other financial entities are—have self-funding. The SEC and CFTC work with Congress and I look forward to this continuing dialogue on this.

Mr. AUSTIN SCOTT of Georgia. Thank you, Mr. Chairman. I yield the remainder of my time.

The CHAIRMAN. The gentleman's time has expired, and it is a good thing the Chairman is not asking, because he is not getting that.

I now recognize the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman.

First of all, Mr. Gensler, let me ask you. I have heard from a few of our market participants that the CFTC's proposed rule on margin segregation is highly problematic, and perhaps unnecessary. According to them, the proposal could potentially raise the cost of

clearing with only small risk management benefits, and since we are not requiring the same customer protection in future clearinghouses which have never failed, I question the need for the change, given the fact that swaps and futures should be regulated in an equivalent manner.

So my question to you is this. If what these folks are saying is true, then can you explain why CFTC is exploring this issue when, number one, it is not required to do so by the Dodd-Frank legislation, and number two, it could be very expensive for market participants, and number three, it is directed towards a problem that does not even seem to exist.

Mr. GENSLER. The question that Congressman Scott asks relates to what we put out, an advance notice of proposed rulemaking, not a proposal, but it is a way to gather input on the question of segregating customer funds at the clearinghouses. Congress says that funds should not be commingled, except for convenience. That is roughly how it is worded. In the futures industry, customer funds have been commingled for convenience.

Many of the buy-side, meaning big pension funds and asset managers, asked us to explore segregated accounts. So rather than making a proposal, we actually just ask a series of questions. That comment period recently closed. We are reviewing—and you are right, Congressman, many people said to go to full segregation might raise costs, and so the Commissioners and the staff are reviewing those comments even before we make the proposal. It has been very beneficial.

There are some differing views. Some, I will say, on the pension side and asset management side would like to continue to have segregated accounts. Many in the clearing community and others raised the cost factors, and we are going to sort this through even before we make a proposal.

Mr. DAVID SCOTT of Georgia. Well, that is very good because I think that you should, and especially since it is not required by the Dodd-Frank legislation. If some of these folks are saying that it is very, very expensive, I think—and my suggestion is you really look at it with a very jaundiced eye here. I appreciate that.

Let me ask you another question. I want to go back to something Mr. Johnson had brought up into this whole issue of the carve-out, the *de minimis* carve-out. Can you tell me specifically how the CFTC came up with the proposed notional value dollar amount, one, and the yearly swap limit?

Mr. GENSLER. In working with the Securities and Exchange Commission—this was a joint role—we had to start somewhere. What is the meaning of the word *de minimis,* and to remember, all end-users are out. It is just if you do some risk management services, if you offer yourself as a dealer, when is it *de minimis?* So I think we proposed a $100 million notional amount. I apologize; I can't remember the exact statistics on the number of counterparties. We are looking forward to public comment on that, but we are trying to follow Congressional intent. End-users are out, but what does this word *de minimis* mean and working with the SEC and hearing in many of these pre-meetings what some people do, we have made a proposal.

Mr. DAVID SCOTT of Georgia. Yes. Can you tell me what kind of firm that the CFTC had in mind when crafting this carve-out, and does such a firm even exist?

Mr. GENSLER. It was a firm that, in essence, did not have end-users behind them of any magnitude. So if you are holding yourself out to end-users and making markets, then it is possible that you are actually a swap dealer. If, in fact, you just have five or ten counterparties, it is far more likely you are an end-user.

So it was trying to relate that somebody that just has five or ten counterparties, that is not a swap dealer. That doesn't have——

Mr. DAVID SCOTT of Georgia. And are you willing to revise this carve-out to make it meaningful to non-systematically risky commercial companies that offer swaps, so that they can conduct their business without being caught up in the same net as the large banks?

Mr. GENSLER. Well, we look forward to the public comment on all of these, so revisions, as I said to Congressman Conaway, there are going to be numerous revisions. I just don't know in this *de minimis* area how it will be revised. There are some non-bank swap dealers, a few of the very largest integrated oil companies have come in and we are talking to them and working with them, who actually provide risk management services downstream to hundreds of end-users. I think it was Congress's intent that there will be some non-banks. In essence, AIG was a non-bank swap dealer. But we take very serious that there is a *de minimis* exemption, and we look forward to the public's comment on it.

Mr. DAVID SCOTT of Georgia. Thank you very much, and thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. I now recognize the gentleman from Tennessee, Mr. Fincher, for 5 minutes.

Mr. FINCHER. Thank you, Mr. Chairman. Thank you for your time today.

A couple of questions, just quick. Have you assessed the impact of derivatives business moving to the foreign markets?

Mr. GENSLER. We are working very closely with the foreign regulators to ensure, as best we can, with different cultures and different political systems that we have consistent regulatory treatment. I am optimistic. Certainly in the clearing world, the end-user exemption, the data repositories, the dealer world, Europeans and we are quite aligned. They are still probably time-wise behind us. They are not moving as quickly, but I think this spring and summer they will probably take it up in their European Parliament, so we are working very closely to ensure, as best we can, consistency.

We have done one other thing, if I might say. We actually have shared a lot of our internal work paper, our memos and everything in the fall with the Europeans and in some instances in Japan and Asia, the actual documents to get their feedback so we could be as aligned as possible, again, given they haven't passed their law yet.

Mr. FINCHER. The second question—and I will echo what Mr. Boswell said a few minutes ago about transparency being the key here. We can see what is happening. Which regions of the country may be affected the most?

Mr. GENSLER. Well unfortunately, every region of the country had to put up $180 billion into AIG, so I think transparency lowers

the risk of these toxic assets for every region of the country. And I think every region of the country uses these derivatives. There are $300 trillion, which if you—just the arithmetic is $20 of swaps for every dollar in the economy. It could be when somebody drives up to a gas station in Wichita or Frederick, Maryland, or anywhere that that gas tank somewhere somebody has hedged behind it. So greater transparency and lower risk will benefit the economy at large.

Mr. FINCHER. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. I now recognize the gentlelady from Ohio, Ms. Fudge, for 5 minutes. Okay. I now recognize the gentlelady from Alabama, Ms. Sewell. I now recognize Mr. McGovern for 5 minutes.

Mr. MCGOVERN. All the questions I was going to ask have already been asked, but I appreciate very much your being here, your testimony, and look forward to working with you. I am particularly concerned about the issue of making sure you have adequate funding to be able to carry out your enormous task here. I just want to say thank you for your great work.

Mr. GENSLER. I thank you. It is good to see you again.

Mr. MCGOVERN. Nice to see you again.

The CHAIRMAN. The chair now recognizes the gentlelady from Missouri, Mrs. Hartzler.

Ms. HARTZLER. Thank you, Mr. Chairman.

I have had a lot of interesting discussions over the last few weeks with people in my district, people in my area, and I represent a large agriculture area. I have visited with people from the Kansas City Board of Trade last weekend. I visited with the utilities in my district, and I can tell you the common thread among all of them is that your staff is going far beyond the—what the bill's original intent is. It is a huge amount of regulations. It is going to be very onerous on businesses and on the way things are supposed to be conducted. I understand you have over 31 teams of people writing these rules, and yet the people that are going to be impacted by them don't have teams, and they have one, two, three individuals that are trying to wade through. The proposals that you have put forth for these rules are 45 pages long, 26 pages long, 60 pages long. Here is a specific comment that was made by the President of the Kansas City Board of Trade in a letter, and I would like for you to, just in general, respond to it. It says "As you might suspect, we have been suffering through the myriad of regulations pouring out of the CFTC's result of the financial regulatory reform legislation. We are concerned and disappointed that the CFTC is using the Dodd-Frank legislation to not only implement a regulatory regime for previously unregulated OTC trading, but as an opportunity to propose unnecessary and extremely prescriptive regulations on already regulated derivative markets. The regulated markets were not the cause of the 2008 financial crisis. In fact, these regulated markets operated exemplary under regulatory initiatives required to implement under extreme market volatility and pressures. We are left wondering why, with all the regulatory initiatives required to implement the provisions of Dodd-Frank, does the CFTC find it necessary to impose prescriptive regulations on an

already well-functioning regulated marketplace?" That is just one of the comments that I have heard. I would like for you to respond.

Mr. GENSLER. I thank you. Two thoughts. One is really, we encourage the public, if you have a comment on any of the rules, even if a comment period has closed, we have discretion, the staff and the Commissioners, to still consider that. I note that one of the rules that people most focus on is this definition of *swap dealer*. That comment period closes in a couple weeks, February 22, to be more precise. I would hope that the public, if you have, looking at the whole mosaic, want to comment, comment. We will get it to the right staff, we will get it to all the Commissioners. We have that discretion.

The second thought I just wanted to share with you because it comes from the really fine people at the Kansas City Board of Trade. One of the reasons we have taken up rules with regard to clearinghouses and what is called designated contract markets of futures exchange as the Kansas City Board is, is because now they can also offer swaps. Congress said that a clearinghouse, if they wanted to at the Kansas City Board or their exchange, could offer swaps.

So the product can also be there. I haven't personally read his letter. Now I will make sure to read it closely. The futures marketplace has been a strong, vibrant, transparent marketplace, and largely we want to make sure the swaps marketplace learns from that and is similar to the futures marketplace.

Ms. HARTZLER. Yes. I would just hope that the CFTC doesn't use—only abides by the parameters in the legislation, and we can discuss what has been passed. I would like to repeal a lot of it, but that is currently on the books and don't overstep what is there to try to reach out further. We need less regulations overall, I believe.

Mr. GENSLER. Let me assure you, I share your view. July 20, the day before the President signed a bill, we got the 30 team leads together and I said we shouldn't over-read this statute nor under-read this statute. We should just do what the statute tells us to do. It is a very historic piece of legislation. That is what we are doing and hopefully with public comment, we will keep being reminded of that.

Ms. HARTZLER. Thank you. Transparency, yes, is important, but it is more important or just as important that in our economy, we don't hurt businesses that are currently working for jobs and for our overall country. Thank you.

Mr. GENSLER. Thank you.

The CHAIRMAN. The gentlelady's time has expired. We now turn to the gentlelady from Maine. We now turn to the gentleman from North Carolina for his 5 minutes.

Mr. KISSELL. Thank you, Mr. Chairman. Mr. Gensler, thank you for being here today.

We have heard a lot of comments about public comments, and not trying to speculate or to foresee where the comments might be going, but just curious, what do you feel is the area the public is most concerned about, has commented about, maybe misunderstands, maybe just—you know, what is the feel for what the public is saying so far?

Mr. GENSLER. That is an excellent question. We have had about 2,800 comments before we made the proposals, 500 meetings, and 1,100 comments after the proposal so far. It is a little hard to bring it all together. Usually comments are about something that affects them. That is a natural thing. End-users, which we have had a lot of debate and discussion about, want to ensure that the margining doesn't cover them. I think hopefully we have addressed that in these prepared remarks that we don't see extending margin to these non-financial end-users, at least at the CFTC.

There have been a lot of end-users that wanted to make sure they weren't caught up in the major swap participant definition. That seems to have calmed down greatly once we put the proposal out, because we really made those numbers very large and systemic. There are still, as people have talked back and forth, end-users who don't want to be caught up in this swap dealer definition.

So I am giving you some sense of it. If you move over into the Wall Street community, the Wall Street community is largely about timing of implementation, that they need to get the resources to do it, and so forth. There is a back and forth about transparency. Transparency tends to help the end-users. It probably shifts some of the advantages away from the financial community, modestly.

So there is a lot of back and forth about transparency with the financial community.

But I am trying to summarize. I guess that would be about 4,000 comments and 500 meetings. It is not fair to any one commenter to try to summarize all of that.

Mr. KISSELL. Thank you, sir, and I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. The gentleman from Kansas is now recognized for 5 minutes.

Mr. HUELSKAMP. Thank you, Mr. Chairman. I appreciate the opportunity to ask a couple questions here. I just want to follow up on a few of the earlier questions, if I may.

Mr. Chairman, you did note—made some comment, I guess, if one does have a profit motive—I think it was a reference to those that would qualify. Are there folks in this marketplace that do not have a profit motive?

Mr. GENSLER. There are many nonprofit entities that use derivatives and should be allowed to use derivatives, hospitals, municipalities and so forth.

Mr. HUELSKAMP. I was presuming when you said they didn't have a profit motive that somehow they weren't trying to protect a risk or had a financial interest, but they certainly all have a financial interest, correct?

Mr. GENSLER. Oh, I think that is correct. I think it is hedging a financial interest, hedging a commodity, wheat or corn. There can be speculators, who are certainly a very important part of the markets as well.

Mr. HUELSKAMP. And which portions of the markets would the speculators *versus* the end-users that are hedgers?

Mr. GENSLER. Well, the way that Congress laid out the end-user provision, if it is not a financial company, so not a bank or insurance company, and it was hedging a commercial risk, it is out of clearing and we believe out of margin. We put a proposal out that

said you could be hedging any input, any service, you could be hedging a factory, a loan, any commodity. We look forward to the public comment, but we tried to be very expansive and exhaustive in terms of defining that hedging out widely. Again, we will get the public comment to see if we missed something, but we tried to be pretty expansive on that.

Mr. HUELSKAMP. Thank you, and I appreciate that.

It is my understanding as well that you do have the authority to exempt small banks and small Farm Credit System institutions and credit unions from the clearing requirement. I just want to know for certain, do you intend to exempt these entities?

Mr. GENSLER. We look forward to hearing from the public. We have not as a Commission made any determination, other than Congress gave us the authority to exempt and we have asked questions from the public as to how we should address that authority.

Mr. HUELSKAMP. Any information or any discussions internally? I mean, do you—can you give a sense whether you plan on using that authority, or you are just going to wait until July and let us all know then?

Mr. GENSLER. No, I think our comment period will close earlier, and if we were to use it, we would have to propose an exemption, but I don't want to get ahead of the staff and my fellow Commissioners. I think we need to really take in what people have said. This is with regard to the clearing exception.

Mr. HUELSKAMP. Do you—so you believe you could wait until July 1 to let folks know whether they are exempted or not, or will you let them know before that time period? Any thoughts on that?

Mr. GENSLER. Well, again, we have an active schedule to review the comments, to take those up. If we were to exempt, we would be making a proposal well in advance. I mean, that is part of our spring agenda is to take up the clearing requirements.

Mr. HUELSKAMP. So do you expect these small entities to comment on all the proposed rules and tell if and when they find out they are exempt?

Mr. GENSLER. Well, the small entities to which you are referring by and large are not swap dealers. There may be one or two exceptions that—I can't speak for thousands. There are 7,000 or 8,000 small banks in this country. I doubt many of them are swap dealers.

So this is just about the clearing requirement, and we are getting comments in about this authority to possibly exempt, whether it be the Farm Credit, the credit unions, or the banks.

We are also working with the regulators. We worked very closely with Debbie Mantz and her people, and of course, the folks at the Farm Credit Administration and the banking regulators.

Mr. HUELSKAMP. Do you believe these small financial institutions pose a threat to the stability of your system?

Mr. GENSLER. I think the threat is the other way. Clearing lowers risk to the whole economy, and I would hate to come to the day when a Secretary of the Treasury says I can't let a big bank fail because they are so interconnected to the Farm Credit System. The risk is the other way in that some 10, 20 years from now a Secretary of the Treasury says I can't let them fail because they will bring down the Farm Credit System. That is the problem.

Mr. HUELSKAMP. So in your opinion, they do not pose a risk? It is the risk the other way?

Mr. GENSLER. Yes, but then it is this interconnectedness that is the risk.

Mr. HUELSKAMP. Thank you, Mr. Chairman.

The CHAIRMAN. The chair now turns to the gentleman from Vermont for 5 minutes.

Mr. WELCH. Thank you very much, Mr. Chairman.

Mr. Gensler, as I understand it, there are two goals here. One is to make certain that the hedging a benefit is absolutely available at the least possible costs and the least possible threat to the overall financial condition of the economy to end-users. Is that correct?

Mr. GENSLER. I believe that is a key goal in transparency and competition helps avail to that goal.

Mr. WELCH. Right, and those are—transparency and competition are seen as tools to help provide benefit—economic benefit to the end-user, correct?

Mr. GENSLER. Correct.

Mr. WELCH. Then ultimately the American public.

Mr. GENSLER. Right.

Mr. WELCH. And there is—if you have end-users, they also rely on some financial institutions in order to carry out the trades that provide them with the hedging protection. Is that more or less what the relationship is?

Mr. GENSLER. That has been historically correct, but there are also on-exchange transactions. Even in the futures market it is relying on the marketplace. It could be a speculator on the other side or another hedger on the other side anonymously on the other side through centralized markets, which work very well, and in fact, often have more transparency.

Mr. WELCH. All right. So if you are an end-user, an airline or a farm operation, your interest, presumably, is in getting the best price for the product you are buying to hedge, correct?

Mr. GENSLER. And also to get something that fits your hedging needs is very important.

Mr. WELCH. Is there any reason why transparency in immediate or reporting that is as soon as technologically possible as to the transaction would be an impediment to a hedger from getting what they need?

Mr. GENSLER. I believe as long as we follow Congress's mandate that the blocks are delayed and second, that we protect that the confidentiality of the parties, that it is not an impediment, but we still need to make sure that we protect the confidentiality of the parties, of course.

Mr. WELCH. All right. So some of the financial institutions, I understand, have raised questions about this, and I am wondering if you could just state what you understand to be their arguments?

Mr. GENSLER. Their argument is that it could take time to hedge their product. If it is a block trade they would have a time to hedge their product. Certainly if it is on an exchange, one would hope that they have enough liquidity.

The second argument they would say is that somehow we are diminishing liquidity. I don't actually think the economic study shows that. I think transparency enhances liquidity, not diminishes

liquidity, but they would take the other side of that, and I respect that we might have a difference on that.

Mr. WELCH. And just, if you could, try to explain to us what they claim is the rationale for that argument.

Mr. GENSLER. They might say that they themselves would take on less risk. This is a marketplace that is very large, $300 trillion. If I could just do a little arithmetic, one percent of one percent is $30 billion, so if transparency brings just a little better pricing, one percent of one percent, which is called a basis point on Wall Street, is $30 billion. So you could see what is—there is a lot at stake here, and end-users can't always see these little basis points, but they add up like the grains of sand in the financial sector.

Mr. WELCH. When the NASDAQ market went to a more transparent system and there was more transparency in immediate reporting between the bid and the ask price, were some of the arguments that were made in opposition to making that change similar to what you are hearing now?

Mr. GENSLER. I don't want to say they are identical, but they are often similar.

Mr. WELCH. And has it played out with the changes that were made in NASDAQ that did increase transparency and timeliness of reporting, has that proven to be an impediment to the financial firms?

Mr. GENSLER. As I understand it, it has increased competition and increased liquidity in the marketplace. It also narrowed what is called the spreads or bid offer spreads in the marketplace.

Mr. WELCH. Okay, thank you. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back his time. I now turn to the gentleman from Illinois, Mr. Hultgren, for his 5 minutes.

Mr. HULTGREN. Thank you, Chairman Lucas. Thank you, Chairman Gensler.

Under Title VII, Congress took an appropriate step and provided an exemption from the major swap participant definition for pension funds. While the protected pension—this protected them from inappropriate regulations as MSPs, pension funds are included under the definition of *financial entities.* I am concerned about the substantial cost this will impose on pension funds, especially from Illinois and see the significant strain that our state and other states are feeling, and I am very concerned about the unfunded obligation that we are facing there.

Chairman Gensler, my question is can you commit to this Committee that in the rules that will impact pension funds and their trading relationships, the CFTC will take every precaution not to impose significant and additional new costs on pension funds?

Mr. GENSLER. Well, I think that we are—when we look at all the rules, if I can expand a bit, past pension funds, we take seriously the guidance from this Congress about cost-benefit analysis. Pension funds, I don't believe that there is a pension fund that has come in after we proposed the rules that say that they are going to be a major swap participant, so I am not aware there are any. But please, I look forward to continuing a dialogue if you know of some. We want to know what we need to do there in the major swap participant area, but more broadly, I think your question is to ensure that pension funds get the benefit of the transparency in

these markets. Pension funds, some of them were the ones that asked us to look at that earlier issue that Congressman Scott asked about. So, we are working and listening to a lot of pension funds who want transparency and issues resolved for their benefit in this marketplace.

Mr. HULTGREN. So pretty much to answer the question, you don't see any additional cost that you would expect from the rule-making—from the decisions that you will be making that will impact pension funds?

Mr. GENSLER. Well, I think that pension funds are going to benefit from the additional transparency, the safeguards in clearing, the safeguards in segregation of their funds. I don't know if we will come out with individual or commingled or funds some other issue.

I don't know of any pension fund that will be a dealer or a major swap participant. Again, if there is one, I am sure my saying this they will find us. They all seem to find us.

Mr. HULTGREN. One quick question here as my time is winding down.

Competitiveness is very important for us, especially in the world stage here. How does the CFTC ascertain whether its rules will cause U.S. firms or swap transactions to move overseas, and if you have made any determination there, what are you doing to make sure that we keep firms here?

Mr. GENSLER. Congress included in statute a provision to cover transactions that have a direct and substantial effect in the U.S., 722(d). I know it well because I have read it so many times. Most of the international banks have been in and say they will register swap dealers because they are doing business with U.S. end-users. So, all these major banks say they will register. We still have a lot to sort through on this, and it is going to be very helpful to hear from the financial community that we are covering the trades that have that 722(d) effect. It affects the U.S. markets and the U.S. end-users and so forth.

We are also working with the international regulators to ensure the best they can that they adopt similar rules. We have a very close partnership with the European community, and with the folks in London. Japan moved ahead of us. They adopted their rules last year. But we are working together very closely. I think I am going to be back in Europe again in March, and the European Parliament is taking up their legislation.

Mr. HULTGREN. So you do recognize that the rules that you make could affect whether firms decide to remain here in America or move overseas, and that will be part of your calculation or part of your planning? Is that right?

Mr. GENSLER. It is absolutely part, but we are, as mandated by Congress to ensure that we cover those transactions that are happening with U.S. entities or other direct and substantial affect here. So regardless, even if it is an overseas entity dealing with a U.S. counterparty, that overseas swap dealer is likely covered under the Act and will be registering. Most of them have come in and say they anticipate registering to deal with U.S. counterparties.

Mr. HULTGREN. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time is now expired. We turn to the gentleman from California to be recognized for 5 minutes.

Mr. COSTA. Thank you very much, Mr. Chairman.

Just to kind of continue to pursue that line of questioning. You said the Japanese in the process of implementing their regulations and the Europeans—I do some work with the European Parliament, I know, are under their deliberation. There has been a lot of speculation, I know, 2 years ago when we talked about the whole notion of clearinghouses and whether or not there would be a competitive advantage or disadvantage on either continent, based upon the new set of rules we were establishing. The question is speculative, but could one not determine or think that based upon what is going in Japan, and now what is going on in Europe, that there is not going to be some sort of a sense in which there is a similarity in terms of the way ultimately this gets worked out so that—I mean, or do you think that when you meet and confer with your counterparts in Europe, that they are trying to seek a competitive advantage or disadvantage that would allow those to register in one continent *versus* the other?

Mr. GENSLER. Excellent question. As it relates to clearing, I think we are very much in line. There is an international forum called IOSCA that works on these international standards for clearing and elsewhere. We currently have registered 15 clearinghouses. We think that will grow to 20 or 21, maybe there will be some others. Some of those are overseas. For instance, the largest interest rate swap clearinghouse we have today is in London. It has been registered with us since 2001. It has $240 trillion of interest rate swaps.

Mr. COSTA. I think we met with them.

Mr. GENSLER. So we already have that, and so even if it is over in Europe or in Japan and wants to do business here in the U.S., we will register it. We will then work on a Memorandum of Understanding with that foreign regulator so we can leverage off their expertise. We are resource constrained anyway, but we work and we have these Memoranda of Understanding with the Europeans, with Canada, and a number of other places.

Mr. COSTA. As this process continues, I think we will want to revisit that. It should be very interesting to see how it settles.

Mr. GENSLER. I think you are absolutely right, and I think that there will be some attempts for regulatory arbitrage. I don't think it will be in the clearing space, but I am not naïve. It could be.

Mr. COSTA. Getting back to the—and I believe the Chairman touched on it in his opening comments, obviously this is a complex law that you are in the process of doing your rulemaking and your implementation. We talked about the timeline for public input, and then following there your process. Are you going to come out with some actual timelines for us in the near future that you can present to the Committee as to how this will roll out over the course of this year and when the rules will actually be published in the *Federal Register,* and where will you go from there?

Mr. GENSLER. We are going to take this pause period, February and March as I call it a pause to look at the whole mosaic. We probably—I hope that we will have some further roundtables to hear from the public about the implementation phase and what can

be done early, what can be done later in terms of implementation. And as we firm that up, I think we would be sharing it.

The other piece——

Mr. COSTA. But I mean after the public input is complete, then, I mean, you are going to need time to them formulate——

Mr. GENSLER. That is right.

Mr. COSTA.—the rules and—I mean, do you see this all being concluded by the end of this year?

Mr. GENSLER. I think so. Congress has actually asked us to do it by July, and we are human, so some of it will certainly be after July. But I would envision it starting this spring and summer we will be taking up the final rules. We will be publishing. Some of them will be the easier, maybe less controversial ones early.

Mr. COSTA. Two quick questions here before my time is expired. What percent of the swap markets do you believe are between the non-financial end-users and financial entities, and does the size of the swap markets allow exemption to safely exist?

Mr. GENSLER. Based on Bank for International Settlements data, it is somewhere in the order of nine or ten percent of notional amount is between non-financial entities or the end-user exception. I believe Congress addresses——

Mr. COSTA. Quickly, before my last question. Foreign currency swaps, will they be regulated under the swaps under the law by the Secretary of the Treasury? Have you spoken with the Secretary of the Treasury?

Mr. GENSLER. I think you would have to ask the Secretary of the Treasury what he is going to do on that, with all respect. Congress gave him the authority and he and I have spoken about it, but it is certainly the Secretary of the Treasury's determination to make and to share with Congress.

Mr. COSTA. Do you expect a decision for him to make—when do you expect a decision for him to make? Do you——

Mr. GENSLER. I don't know. Certainly I would be glad to direct your question to the Treasury and ask them to comment to you. I don't know if they have made that public.

Mr. COSTA. Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. The gentleman's time has expired. The chair now turns to the gentleman from New York, Mr. Gibson, for 5 minutes.

Mr. GIBSON. Thanks very much, Mr. Chairman, and I want to apologize to our witness. I have multiple hearings that I am taking care of today. I did confer with my aide before I got back in, and it has been a very comprehensive hearing, and you have answered nearly all of the questions that I had.

Really, just a simple one remains. How big do you assess the over-the-counter market is, in terms of dollars and participants?

Mr. GENSLER. The market worldwide is about $600 trillion notional, about a little less than half of that is here, but let us call it $300 trillion. The 25 largest bank holding companies have about $277 trillion, as of the most recent data from the Comptroller of the Currency. Participants, thousands of participants are in it because they use it as a hedging, all these we have been calling end-users use it to hedge, but I can't tell you how many. It is probably over 10,000 that actually use it.

Mr. GIBSON. And so given that, it is certainly a daunting challenge. Do you feel that the pace of which you are going to unfold these regulations can be absorbed by this market?

Mr. GENSLER. I think that through the extensive work that Congress did in its oversight and putting together the Act and the extensive work the Securities and Exchange Commission and CFTC are doing, the major market participants who will be either swap dealers or clearinghouses and so forth have been very seriously engaged. The end-users, by and large, are exempted from clearing, trading, and I believe should be from the margining.

So I would say yes, in terms of these large clearinghouses and financial entities. They are very engaged. I think as it relates to the CFTC, I think this schedule that Congress has laid out is doable. We are human. Some of it will slip, and I believe we are committed to looking at our whole rule book as the President put in the Executive Order. We are going to look at the rest of our rule book and see if that needs to be updated as well. We are going to publish some plan to do that in the next 120 days or 120 days from when he made his Executive Order.

Mr. GIBSON. Okay, I appreciate the responses. I am somewhat concerned, but I have noted what you said and I look forward to working with you as we go forward.

Mr. GENSLER. I look forward to working with you directly as well.

Mr. GIBSON. I yield back.

The CHAIRMAN. The gentleman yields back the balance of his time. The chair recognizes the gentleman from Illinois, Mr. Schilling, for 5 minutes.

Mr. SCHILLING. Thank you, Mr. Chairman. Thank you, Mr. Gensler.

A lot of my questions have already been answered. I am just a small business owner from Illinois and you know, one of the things that I have noticed that really kind of got me to run for an office for the first time in my entire life is that a lot of times our government tends to see something and then overreact to it, and move too rapidly. You know, growing up as a kid and through most of my adult life, we didn't—businesses could be over-taxed, over-regulated, and there wasn't really much they could do. I guess one of my big concerns is that what is going to happen is we are going to rush this through. We have talked several times about how important this is, and I think we are moving very fast with it. I know you are under time constraints, but you know, my concern is we are going to have companies like CME and others that are going to say, "Hey, you know what, we are going to move out of the country," and we are going lose more jobs here in the United States, which is one of the reasons why I showed up here.

You know, that is thing. I am just hoping that when we move along—you know, as a business owner, I look at the long-term effects of every decision that I make because it makes me successful or not. I think that is the—what has been—the burden that has been laid upon your shoulders. I know that is a big burden, but you know, American families, the people that are raising their kids and buying houses and things like that, that when we do make decisions that we make sure we give a thorough thought.

But I mean, all of my questions have been answered. That was just kind of my comment to you, sir.

Mr. GENSLER. I thank you. Since we just met, what is the business that you are in?

Mr. SCHILLING. St. Giuseppe's Pizza. It is an Italian restaurant.

Mr. GENSLER. Terrific. We take this very seriously. The American public doesn't connect necessarily day-to-day with derivatives, but they stand behind even that pizza that you sold. Somewhere in that supply chain, someone was using derivatives to hedge a product along the way. It may have been the wheat that went, ultimately, into that pizza. But also, the crisis was very real in 2008, and that $180 billion went into AIG, which was an ineffectively regulated non-bank in the derivatives marketplace, which you know, is $600 for every one of your constituents, if you just do the arithmetic.

So I think that is what we are trying to do and what Congress really did, and we have to comply with that statute to lower the risk, make sure that end-users aren't caught up into it inadvertently, but that the dealer community is regulated, the clearinghouses lower risk, and then all the end-users get the benefit of the transparency.

Mr. SCHILLING. All right, very good. I thank you for your time. I yield back.

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

Mr. FORTENBERRY. Thank you, Mr. Chairman. I appreciate the time.

I would like to step away from the immediate discussion and talk about some broader perspectives. If we understand the very fundamental purpose of these markets to be to mitigate risk and to inform price discovery, we traditionally had—and perhaps you can answer this if I am not correct—80 percent of the market traditional hedgers *versus* 20 percent speculators, or maybe 70/30. It is my understanding that some of those proportions are now inverted. If you look at where we are today in terms of our own economic situation, you can trace the beginnings of this back to the run-up in commodity speculation in oil prices, which then began to create some problems in the economy, create layoffs, which then exposed the housing bubble due to liberalized credit, which had all the various manifestations after that of problematic, bizarre, and financial instruments on Wall Street, and here we sit after a couple years of the Treasury Secretary coming to us and saying you must do this and bail out all these firms in order to prevent economic Armageddon.

The point being is the very markets designed to mitigate risk, had they created risk?

Mr. GENSLER. I think in the case of this swaps market or what is called over-the-counter derivatives, you are correct, that they did help many entities mitigate risk, but they also concentrated risk. That the crisis was for many reasons, the housing bubble as you talked about and other reasons, but part of it was the derivatives marketplace, particularly this product called credit default swaps. I think it also helped concentrate risks. Rather than mitigating and spreading risk, it concentrated risk so that in the height of the cri-

sis the Administration at that time felt it needed to come to Congress, and as you know, extend bailouts to these large financial entities, AIG and others. We shouldn't put the American public at that risk. There should be a freedom to fail, that these firms can fail and not be so interconnected through their derivatives contracts with the rest of the financial entities.

Mr. FORTENBERRY. I had a local Chamber of Commerce group come to see me a year or so back, including a number of small bankers, and I asked any of them if they had ever used or heard of a synthetic collateralized debt obligation, and they just stared at me with blank stares.

Mr. GENSLER. I am guessing——

Mr. FORTENBERRY. Thank you for not knowing exactly what that means. Again, when you have institutions that are disconnected from an understanding of the underlying asset value and a machine out there that pops up the bad information in terms of ratings and insurers that are, again, not understanding that underlying asset value in those portfolios and raking in commissions, and no check mechanisms on that.

That was the manifestation of the full extent of the problem due to liberalized credit that was out there, but also a lack of mechanisms that prevented, as you say, the concentration of risk and oversight mechanisms that would have stopped this type of development.

But let us go back to that earlier point. Do we have now a disproportionate number of hedgers *versus* speculators, and is that a related problem to these markets becoming investment markets *versus* markets designed to mitigate risk?

Mr. GENSLER. This is an age old debate, the role of speculators and hedgers in markets. Our markets——

Mr. FORTENBERRY. But it is traditionally—we are in a different period now where the proportion of speculators is much, much higher, if my understanding is correct, than traditional hedgers.

Mr. GENSLER. In some markets that is certainly the case. Speculators and hedgers both have a role in markets. Agencies such as ours and SEC work hard to protect against fraud and manipulation. Congress has also asked our agency to use something called position limits to protect against the burdens of what is called excessive speculation, and we have done that over the decades in certain physical commodity markets.

Mr. FORTENBERRY. Do you see any parallel between the run up and commodity speculation at the moment and what happened in 2008?

Mr. GENSLER. Well, I think that the American public, which you are correct, is observing this run up and the costs they see in the gas tank and so forth are very real. We put out proposals on position limits to use the authority that this body—and in fact, this Committee was probably the first Committee that asked us to do that back in 2008 if I remember. Congressman Peterson will probably remind me, and Chairman Lucas.

So we are looking forward to the public comment on that related to the energy market. It will get a lot of comment. We got 8,200 comments on the proposal we put out a year ago.

Mr. FORTENBERRY. Well, I look forward to hearing the results of that.

Mr. GENSLER. Thank you.

Mr. FORTENBERRY. Thank you.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Arkansas is recognized for 5 minutes.

Mr. CRAWFORD. Thank you, Mr. Chairman, and thank you, Mr. Gensler, for being here. I apologize for my tardiness. I also had another hearing to attend.

You just alluded to one of the questions I was going to ask, and that was the empirical data. In your opinion, the diverse fluctuation in the commodity prices, is that due to spec trading or is that due to fundamental market activity? And based on—is your opinion going to be based on some empirical data you can cite?

Mr. GENSLER. Speculators and hedgers each meet in a marketplace and both have roles in the marketplaces. We as an agency have been asked by Congress to ensure that the markets have integrity, free of fraud, manipulation. We do not regulate prices or the level of prices, or volatility itself, but we have to ensure that the markets have integrity. Part of that is this position limit regime to ensure that—and over the decades we have used it in the agricultural commodities, and at times with the exchanges worked together to do it in the energy markets to ensure that they are not so concentrated, that there are only a handful of actors, rather than a diversity of actors within a marketplace so that price function, that price discovery function has a diversity of folks in there. That is what is underlying our approach with regard to this marketplace.

I know it didn't directly answer your question, but it gave you sort of a concept as to how we have done it.

Mr. CRAWFORD. It did. It kind of leads me to my next question.

Over the last several years, the open outcry price discovery mechanism has been, particularly for agricultural end-users, farmers that were hedging, that has been pretty critical to real price discovery in the marketplace for them. As you said, hedgers and spec traders meet. What role do you think e-trading has played in a broad sense to possibly exacerbate the problem?

Mr. GENSLER. Well, it has been a very significant change over the last 10 years. Nearly 90 percent of the futures market—again, Terry could tell you a better number. I think it is 88 percent maybe of the markets now are electronic. That doesn't mean high frequency, just electronic. I think that technology will continue in that direction, and so we have to have the tools and the exchanges have to have the tools to be able to monitor that electronic trading, that there are appropriate safeguards before somebody enters a trade, and appropriate pauses if the markets get so unbalanced. Like on May 6, there was actually a pause in the trading that I think was at a critical time. We have asked the public a lot of questions to make sure that that reality—and it is a reality that we are in electronic markets now—still works for the benefit of the investing and hedging public.

Mr. CRAWFORD. Does the 24/7 model global marketplace, does that play into this volatility? Does it increase volatility because we are used to seeing the pit close, and that was your closing price?

Now with e-trading and 24/7, has that sort of created more of a volatility issue?

Mr. GENSLER. Well, I think it has extended it across a 24 hour timeframe, and that there are more news events that can move a market overnight, certainly in the currency and financial markets, and in the oil markets, which is very global—energy markets are very global. For some of the agricultural markets, their real liquidity is during the period of time that it is open in the futures market.

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

The CHAIRMAN. The gentleman's time has expired. The time the Member has is expired.

With the Ranking Member's indulgence, I would like to ask the Chairman of the Commission a couple more questions before we release him.

You know, Mr. Chairman, I have been very sensitive, as a number of my colleagues have, as we discuss the margin questions and potential impact for end-users. Do you believe that you have the authority to impose a margin requirement on both parties in transactions involving end-users? Do you believe you have the authority?

Mr. GENSLER. I believe we have the authority not to, and that is what we plan to do if I move forward. Only we ever see the nonbanks, so we need to address that. I think that is consistent with what Congress did in the clearing area.

The CHAIRMAN. So if you believe—and I am not putting words in your mouth—that you don't have the authority? Is that the way I should interpret that?

Mr. GENSLER. No, I said I believe we have the authority not to impose it, and that is what certainly my recommendation to the staff is and the Commission, moving forward.

The CHAIRMAN. That is an interesting answer. Well, in the rule it will finally come together, will it leave open the possibility for dealers to require end-users to post margin?

Mr. GENSLER. We haven't written it, but I believe the dealers today have that. It is a matter of individual negotiation, and many dealers extend credit, because that is really what it means when you don't post margin is extending credit. Many dealers extend credit to end-users, but often—dealers often require margin to be posted after you hit a certain trigger. And that would still be allowed. Dealers would have the same authorities they would have today to do that by individual negotiation, depending upon end-user's balance sheet, if an end-user might have assets that are good enough, then the dealer can make that determination.

The CHAIRMAN. Let me think this through one more time.

So you believe you have the authority not to impose. I guess that means you have the authority to make a decision, so you could, but the rule would indeed leave the possibility in certain circumstances for dealers to require—so is the outcome—would it still be that end-users, in order—potentially the outcome would be for end-users, in order to engage in these transactions, would either face a margin requirement from the dealer or increased costs associated with the margin requirement imposed by their dealer?

Mr. GENSLER. No, I don't think so. I think it would be exactly where it is right now. Dealers today entering into transactions with

non-financial entities and individually negotiate those arrangements, as they might negotiate a line of credit or negotiate any arrangement. It would have to be documented. We are proposing that they have documentation. That helps lower risk. But it would be up to the—at least where I am. I can't speak for all the other fellow regulators. That would still be up to that individually negotiated arrangement between the dealer and the end-user, as it is today.

The CHAIRMAN. Thinking back, Chairman, to a letter at some point in the process from Senator Dodd and Senator Lincoln to myself and the Ranking Member, which tried to clarify legislative intent, I believe the letter explicitly said the legislation does not authorize regulators to impose on the marginal end-users. I guess I just simply note, sir, that it sounds like as your friends on the authorizing committee, we are going to be watching and working very closely with you in the coming days.

Mr. GENSLER. I look forward to that. I think that that would help us.

The CHAIRMAN. We will have a lot of fun, Mr. Chairman.

With that, thank you for your time. You are excused.

Mr. GENSLER. Thank you, and for all the very excellent questions.

The CHAIRMAN. And while the Chairman is stepping away from the table, we will prepare for our next panel.

As our second panel is coming to the table and preparing for the testimony, I would like to welcome them and introduce them.

First is Edward Gallagher, President, Dairy Risk Management Services, Dairy Farmers of America, and Vice President, Risk Management, the Dairylea Cooperative, on behalf of the National Council of Farmer Cooperatives in Syracuse, New York. Also joining him at the table will be Mr. Terrence Duffy, Executive Chairman, CME Group Incorporated, Chicago, Illinois. Mr. Robert Pickel, Executive Vice Chairman at the International Swaps and Derivatives Association, Incorporated, New York City. Mr. Scott Morrison, Senior Vice President and CFO, Ball Corporation, on behalf of the Coalition for Derivatives End-Users from Bloomfield, Colorado, and Lee Olesky, Chief Executive Officer of Tradeweb, New York, New York.

And with that, Mr. Gallagher, whenever you are prepared, you may begin.

STATEMENT OF EDWARD W. GALLAGHER, PRESIDENT, DAIRY RISK MANAGEMENT SERVICES, DAIRY FARMERS OF AMERICA; VICE PRESIDENT, RISK MANAGEMENT, DAIRYLEA COOPERATIVE, WASHINGTON, D.C.; ON BEHALF OF NATIONAL COUNCIL OF FARMER COOPERATIVES

Mr. GALLAGHER. I am sorry. Implementation of the Dodd-Frank Act—I appreciate the opportunity to discuss the role of the over-the-counter derivatives market and helping farmers and farmer-owned cooperatives manage commodity price risks.

As I was introduced, I am Edward Gallagher. I am the President of Dairy Risk Management Services at DFA, and Vice President, Dairylea. I am here representing both DFA, Dairylea, and the National Council of Farmer Cooperatives.

Farmer cooperatives, businesses owned, governed, and controlled by farmers, ranchers, and growers are an important part of the

success of American agriculture, and provide a comprehensive array of services for their members. Providing risk management tools is among those services. These tools help to mitigate commercial risk in the production, processing, and selling of a large portion of this country's food supply.

We ask that the implementation of the Dodd-Frank law enhance opportunities for farmers and their cooperatives. It is imperative that we continue to mitigate these market risks, and it is imperative that we forebear regulatory changes that reduce program offerings and increase the very risks that the law was intended to address.

A cooperative can aggregate its own members' small volume hedges or forward contracts, and offset that risk with a futures contract or by entering into a customized hedge via the swap market. More and more producers are depending on their cooperatives to provide them with these tools to manage this risk, and assist them in locking in margins or creating insurance-like margin safety nets. Please refer to my written statement for some examples of these.

Dairylea, DFA, and the National Council support elements of the Dodd-Frank Act bringing more transparency and oversight to the OTC derivatives markets. Our overall objective in the implementation of the Act is to preserve the ability of cooperatives to manage commercial risk and support the growing demand from our member-owners for products to help them mitigate the growing volatility in commodity markets.

We have had a number of opportunities to express our concerns to the CFTC, and they have been accessible and engaged and open in our issues, and I appreciate the comment that I heard from Chairman Gensler this morning.

At this juncture, our largest concerns are in the uncertainty around the definitions in capital margin rules. While the CFTC continues to propose regulations for swaps and swap dealers, it is, although perhaps made a little bit more clear today what transactions and who will be subject to those additional regulations.

Further, some activities of cooperatives would appear to be captured under the swap dealer definition contained in CFTC's initial draft regulations. We believe that by applying the interpretive approach for identifying whether a person is a swap dealer as outlined in the proposed rules, CFTC would likely capture a number of entities that were never intended to be regulated as swap dealers, including farmer-owned cooperatives.

If farmer cooperatives were to be regulated as dealers, increased requirements for posting capital and margin and perhaps complying with reporting, record-keeping, and other regulatory requirements, could make providing those services uneconomical to our members. Such action would result in the unintended consequence of increasing the very risk that the law intends to mitigate. We do not believe that this was Congress's intention, and would urge the Committee, as you have today, to reiterate that with the CFTC. Thank you for doing that.

It is also our understanding that there will be no requirements for imposing margins on end-users who are hedging or mitigating commercial risk. We trust that will be the case when the regula-

tions are put in place. However, we would be concerned over excessive margin requirements on dealers and major swap participants on transactions entered into with end-users who are hedging. We fear an increased cost structure associated with our hedging operations due to higher transaction costs would ultimately discourage prudent hedging practices all the way back to the farm.

Last, it is vitally important to the economic viability of producers to continue to utilize forward contracting transactions with their cooperatives as a means of mitigating their commercial business risk. These forward contracts create cash price delivery contracts, allowing producers to mitigate risk and have more certainty over future price input, costs, and margins. We ask that the definitions acknowledge that forward contracts, including those using imbedded price options, continue to be excluded from CFTC swap regulations.

Thank you again for the opportunity to testify today before the Committee, and thank you for your leadership and interest in the implementation of the Dodd-Frank Act. We look forward to working with you and the CFTC on this endeavor, and others that may arise that impact the well-being of America's farmers and the agricultural cooperatives they own and govern.

Thank you.

[The prepared statement of Mr. Gallagher follows:]

PREPARED STATEMENT OF EDWARD W. GALLAGHER, PRESIDENT, DAIRY RISK MANAGEMENT SERVICES, DAIRY FARMERS OF AMERICA; VICE PRESIDENT, RISK MANAGEMENT, DAIRYLEA COOPERATIVE, WASHINGTON, D.C.; ON BEHALF OF NATIONAL COUNCIL OF FARMER COOPERATIVES

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, thank you for the opportunity today to discuss the role of the over-the-counter (OTC) derivatives' market in helping farmers and farmer-owned cooperatives manage commodity price risks, and some of the key issues we see in implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

I am Edward Gallagher, President of Dairy Risk Management Services, a division of Dairy Farmers of America (DFA), and Vice President of Economics and Risk Management at Dairylea Cooperative. Together, those two cooperatives represent more than 17,000 dairy farmer members in 48 states.

I also serve on the National Council of Farmer Cooperatives' (NCFC) Commodity Futures Trading Commission (CFTC) working group, which was formed to provide technical assistance to NCFC on commodity markets, including implementation of Title VII of the Dodd-Frank Act. On behalf of the DFA-Dairylea dairy farmer-owners, and more broadly the more than two million farmers and ranchers who belong to farmer cooperatives, I appreciate the Committee for holding this hearing on the key issues of implementing the Dodd-Frank Act.

Farmer cooperatives—businesses owned and controlled by farmers, ranchers, and growers—are an important part of the success of American agriculture, and provide a comprehensive array of services for their members. These diverse organizations handle, process and market virtually every type of agricultural commodity produced. They also provide farmers with access to infrastructure necessary to manufacture, distribute and sell a variety of farm inputs.

In all cases farmers are empowered, as elected board members, to make decisions affecting the current and future activities of their cooperative. Earnings derived from these activities are returned by cooperatives to their farmer-members on a patronage basis thereby enhancing their overall farm income.

America's farmer cooperatives also generate benefits that strengthen our national economy. They provide jobs to nearly 250,000 Americans with a combined payroll over $8 billion. Many of these jobs are in rural areas where employment opportunities are often limited.

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. We are considered end-users because we own, produce, manufacture, process and/or merchandise agricultural commodities. Often times, the end-user status is based on our operations being the aggregators of our individual farmer-owners risks—either the risks directly associated with operating their individual farm business or the risks associated with operating the multi-farm aggregated risk of manufacturing or processing plant operations.

Due to market volatility in recent years, cooperatives are increasingly using OTC products to better manage exposure by customizing their hedges. This practice increases the effectiveness of risk mitigation and reduces costs to the cooperatives and their farmer members.

In addition, OTC derivatives offer cooperatives the ability to provide customized products to producers to help them better manage their risk and returns. A cooperative can aggregate its owner-members' small volume hedges or forward contracts and offset that risk with a futures contract or by entering into another customized hedge via the swap markets. More and more producers are depending on their cooperatives to provide them with these tools to manage price risk and to assist them in locking in margins or creating insurance-like margin safety nets.

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 hedge with a cooperative in a regional or federated system.
- Cooperatives offer livestock producers customized contracts at non-exchange traded weights to better match the corresponding number of head they have, while also reducing producers' financial exposure to daily margin calls. The cooperative offsets its risk of those contracts by entering into a corresponding hedge with another counterparty.
- Customized solutions are developed by the cooperative to assist individual farmers with their fuel hedging needs as individual farmers do not have the fuel demands necessary to consume a standard 42,000 gallon monthly NYMEX contract.
- A cooperative aggregates its members' small volume hedges or forward contracts and transfers that risk to a swap partner. A swap dealer or other commercial counterparty would otherwise not have the interest in servicing such small entities.

While my colleagues at grain, farm supply, and livestock cooperatives could provide greater details on how the above programs work for those sectors, they are all similar in concept and purpose to the risk management programs we provide to our Dairylea-DFA producers. We enter into OTC derivatives to hedge the price risk of the commodities we supply, process or handle.

Our member-owners include small farms (such as a 50 cow member-owner in Pennsylvania), mid-size farms (such as a 350 cow member-owner in Wisconsin) and larger farms with 1,000 or more cows. This diversity in member-owners requires us to offer a broad range of tools to meet their risk management needs, including services to help members mitigate the commercial risk associated with the high volatility in milk and input prices.

We offer our members a forward contracting program as a primary means of mitigating commercial risk. As one alternative under the forward contracting program, we offer our member-owners a fixed price for their milk and a hedge on their feed purchases. These risk mitigation tools are critical for our farmers. Many producers are not able to use the futures markets to hedge input risk because of the larger volumes underlying the relevant futures contracts. Furthermore, corn and soybean contracts do not trade on a monthly basis—while most of our members purchase livestock feed on a monthly basis. However, through our forward contracting program, we can offer a more customized solution for our member-owners. Yet, we can only provide this service to our member-owners because of our ability to enter into swaps for customizable volumes and time periods different from the applicable futures contract.

Implementation of the Dodd-Frank Act

Dairylea-DFA and NCFC support 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. We have had a number of opportunities to express our concerns to the CFTC and they have been accessible

and engaged on our issues. We thank them for being open to NCFC members and staff in gaining a better understanding of how cooperatives are using the OTC market. In fact, several CFTC Commissioners recognized this at their public meeting on January 20th.

However, the current "definitions" proposed rule appears to be headed down a path that would sweep farmer cooperatives into regulations intended for swap dealers and would increase costs and inhibit our ability to provide risk management tools to producers.

We do not believe this was Congress's intention and would urge this Committee to reiterate that with the CFTC. Furthermore, we do not believe that any Member of this Committee would want any action taken that would reduce the price and risk management options available to our producer-members, especially during these highly volatile economic times. Yet on its current path, that may well be the consequence of the rulemaking process unless the Committee makes known its desires otherwise.

Our overall objective in the implementation of the Act is to preserve the ability of cooperatives to use the OTC market to manage commercial risks, and at the same time support the growing demand from our member-owners for hedging products to help them mitigate the growing volatility in commodity prices.

At this juncture, our largest concerns are in the uncertainty around the "definitions" and "capital and margin" rules. While the CFTC continues to propose regulations for swaps and swap dealers, it is unclear to us what transactions, and who, will be subjected to those additional regulations.

Further, the above examples are activities that would appear to be captured under the "swap dealer" definition contained in CFTC's initial draft regulations. We believe that by applying the "interpretive approach for identifying whether a person is a swap dealer" as outlined in the proposed rule, CFTC would likely capture a number of entities that were never intended to be regulated as swap dealers, including farmer cooperatives. This is because cooperatives engage in activities that look very similar to those of a dealer when they enter into swaps with farmers, local elevators, and customers as they provide risk mitigation services and products throughout the agriculture and energy sector.

If farmer cooperatives were to be regulated as dealers, increased requirements for posting capital and margin, complying with reporting, record keeping and other regulatory requirements intended for large systemically important institutions could make providing those services uneconomical to our members. Such action would result in the unintended consequence of increasing the very risk the law intends to mitigate.

It is also our understanding that there will be no requirements for imposing margin on end-users who are hedging or mitigating commercial risk—we trust that will be the case when the regulations are put in place. However, we would be concerned over excessive margin requirements on dealers and major swap participants on transactions entered into with end-users who are hedging. We fear an increased cost structure associated with our hedging operations due to higher transaction costs would ultimately be passed on in the form of higher prices for inputs to our farmer-owners while discouraging prudent hedging practices.

Last, it is vitally important to the economic viability of our members to continue to utilize forward contracting transactions with their cooperatives as a means of mitigating their commercial business risk. These forward contracts create cash-price delivery contracts allowing our members mitigate risk and have more certainty over future price, input costs and margins. We ask that the definitions acknowledge that forward contracts, including those using embedded price options—allowing for such forward contracts as a minimum milk price that gets adjusted upwards if feed prices rise, but the minimum milk price does not change if feed prices fall—continue to be excluded from CFTC swap regulation.

In closing, NCFC seeks the following:

- Treat agricultural cooperatives as end-users since they aggregate the commercial risk of individual farmer-members and are treated as such by the CFTC, currently;
- Exclude agricultural cooperatives from the definition of a swap dealer; and
- Exempt agricultural cooperatives from mandatory clearing or margining but allow them to perform either at their discretion.

Thank you again for the opportunity to testify today before the Committee. And thank you for your leadership and interest in the implementation of the Dodd-Frank Act. We 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.

Recently, the CFTC wrote: "Permitting agricultural swaps to trade under the same terms and conditions as other swaps should provide greater certainty and stability to existent and emerging markets so that financial innovation and market development can proceed in and effective and competitive manner."[1] We wholeheartedly agree with the CFTC. As it relates to agricultural cooperatives, who are the primary source of hedging innovation for farmers, we trust the rules permitting these actions will not stifle the very innovation it is trying to create—or worse yet reduce our ability to help producers manage their ever increasing commercial risks.

Thank you.

The CHAIRMAN. The gentleman's time has expired. The chair now recognizes Mr. Duffy for 5 minutes.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP, INC., CHICAGO, IL

Mr. DUFFY. Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to testify on the CFTC's rulemaking to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am Terry Duffy, Executive Chairman of CME Group, which includes our clearinghouse and our four exchanges, the CME, the CBOT, NYMEX, and COMEX.

In 2000, Congress leveled the playing field with our foreign competitors and permitted us to prosper as an engine of economic growth in Chicago, New York, and the nation as a whole. I have had the opportunity on numerous occasions to testify in front of this Committee. I am sorry to report today that however, the CFTC's Dodd-Frank rulemaking threatens that prosperity and the growth of our markets.

In 2008, the financial crisis focused well-warranted attention on the lack of regulation on OTC financial markets. The industry learned a number of important lessons, and Congress crafted legislation that we hope reduces the risk that there could be a repeat performance of that near disaster. It is important to note that regulated futures and markets and futures clearinghouses operated flawlessly during and after the crisis. Futures markets performed all of their essential functions without interruption, and despite failures of significant financial firms, our clearinghouse experienced no default. Significantly, no customer on the futures side lost their collateral or were unable to transfer positions immediately and continue to manage risk.

We support the goals of the Dodd-Frank Act, to reduce systemic risk to central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. However, with respect to futures exchanges and clearinghouses, the CFTC has devoted significant resources to regulations. They impose unwarranted costs and stifle innovation, and many are inconsistent or not required by Dodd-Frank. Several Commissioners have counseled caution on the rulemaking front in recognition of budgetary constraints. A less welcome response has been the suggestion that the CFTC's budget limitations will mean delayed approval for applications and findings necessary to operate in compliance with Dodd-Frank. Such delay would, among other things, stifle innovation, job creation,

[1] *Federal Register,* Vol. 76, No. 23, Thursday, February 3, 2011, page 6103.

and economic growth in our industry. We do not object to the CFTC receiving an appropriate budget; however, we do object to the CFTC wasting scarce resources to impose uncalled for regulations and duplicating the oversight of self-regulatory organizations subject to its jurisdiction.

Furthermore, they may impose burdens on the industry that require increased CFTC staff and expenditures that could never have been justified if an adequate cost-benefit analysis had been performed.

Some of the CFTC's objectionable rule proposals might be explained by the rush to push proposals out the door before they are ready in order to permit the CFTC to adopt final rules in time to meet statutory deadlines; however, the consistent theme of the CFTC's rulemaking has been to expand its authority by changing its role from an oversight agency whose purpose has been to assure compliance with sound principles, to a front-line decision maker that imposes its business judgments on every operational aspect of derivatives trading and clearing.

This role reversal would require doubling of the Commission's staff and budget. It will also impose astronomical costs on the industry and the end-users of derivatives. Sadly, there is no evidence that any of this is necessary or even likely to be useful.

Some Members of the Commission clearly recognize these issues. They have been forthright in suggesting that the CFTC deliberate further to ensure that the public interest, rather than haste in meeting deadlines, temperates an ambitious agenda. Others do not. Dodd-Frank was not an invitation to pile irrational regulatory burdens on exchanges, clearinghouses, and other participants. While the Commission was granted discretion, it was directed to make fact-based determinations, grounded in evidence and sound economic theory, that regulations are necessary, cost effective, and will accomplish the overall purpose. Unfortunately, the Commission's extensive obligations under Dodd-Frank are making it all but impossible for the Commission's staff to document the need for many of the agency's rulemaking. Instead, the Commission has either ignored its obligations to justify its proposed rules, or simply ignored clear direction that such justification is necessary.

For example, Congress preserved and expanded a scheme of principle-based regulation by expanding the list of core principles, and granting self-regulatory organizations reasonable discretion in establishing the manner in which the self-regulatory organization complies with the core principles. The Commission asked for, and Congress gave it power, to adopt rules respecting core principles, but Congress did not direct the agency to put an end to principals based regulation. Yet the Commission, immediately and for no apparent reason, proposed comprehensive regulations to convert all of the core principles into a prescriptive rules-based regulatory system. This is the ultimate solution in search of a problem. It adds unnecessary bureaucratic red tape to a well-functioning system, while at the same time the President and the Congress have called for an end to such overreaching.

My written testimony includes numerous additional examples of misdirected or improper rulemaking. This Congress can mitigate some of the problems that have plagued the CFTC rulemaking

process. It can do this by extending the rulemaking schedule so that professionals, including exchanges, clearinghouses, dealers, market makers, and end-users can have their views heard. This would give the CFTC a realistic opportunity to assess those views and measure the real cost imposed by its new regulations. Otherwise, the unintended adverse consequences of these ambiguities and the rush to regulation will stifle effective exchange innovation. It will also block the most important growth pass in our industry, including clearing of the OTC transactions. This is inconsistent with the Dodd-Frank's goal of increasing transparency and limiting risks by moving more derivatives transactions onto clearinghouses.

I look forward to answering the questions of the Committee. Thank you.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP, INC., CHICAGO, IL

Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to testify respecting implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111–203, July 21, 2010) ("DFA"). I am Terry Duffy, Executive Chairman of CME Group, which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX") (together "CME Group Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME also includes CME Clearing, a derivatives clearing organization and one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter ("OTC") derivatives transactions through CME Clearing and CME ClearPort®.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions. In addition, CME Group distributes real-time pricing and volume data through a global distribution network of approximately 500 directly connected vendor firms serving approximately 400,000 price display subscribers and hundreds of thousands of additional order entry system users. CME's proven high reliability, high availability platform coupled with robust administrative systems represent vast expertise and performance in managing market center data offerings.

The financial crisis focused well-warranted attention on the lack of regulation of OTC financial markets. We learned a number of important lessons and Congress crafted legislation that, we hope, reduces the likelihood of a repetition of that near disaster. However, it is important to emphasize that regulated futures markets and futures clearing houses operated flawlessly. Futures markets performed all of their essential functions without interruption and, despite failures of significant financial firms, our clearing house experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk.

We support the overarching goals of DFA to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. Unfortunately, DFA left many important issues to be resolved by regulators with little or ambiguous direction and set unnecessarily tight deadlines on rulemakings by the agencies charged with implementation of the Act. In response to the urgent schedule imposed by DFA, the Commodity Futures Trading Commission ("CFTC" or "Commission") has proposed hundreds of pages of new or expanded regulations.

In our view, many of the proposals are inconsistent with DFA, not required by DFA, and/or impose burdens on the industry that require an increase in CFTC staff and expenditures that could never be justified if an adequate cost-benefit analysis

had been performed. In the view of many experienced derivative industry professionals, the CFTC has been selectively reading DFA to implement a policy that is likely to defeat the real goals of DFA.

We realize that the Commission is under immense pressure to complete many rulemakings within a very short time period. Put simply, DFA set forth an unrealistic rulemaking schedule. And even more problematically, many of the rulemakings required by DFA are interrelated. That is, DFA requires many intertwined rulemakings with varying deadlines. Entities such as CME often cannot fully anticipate the meaning of a proposed rule when that proposed rule is reliant on another rule that is not yet in its final form. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect of the proposed rules.

This Congress can mitigate some of the problems that have plagued the CFTC rulemaking process by extending the rulemaking schedule so that professionals, including exchanges, clearing houses, dealers, market makers, and end-users can have their views heard and so that the CFTC will have a realistic opportunity to assess those views and measure the real costs imposed by its new regulations. Otherwise, the unintended adverse consequences of those ambiguities and the rush to regulation will impair effective exchange innovation and stifle the most important growth paths in our industry, including the clearing of OTC transactions. Indeed, the threat of such policies has already driven major customers to move business off U.S. markets.

Several Commissioners clearly recognize this issue and have been forthright in suggesting that the CFTC temper its ambitions. For example, in her recent statement opposing proposed rules in the area of position limits, Commissioner Sommers expressed concern regarding the lack of analysis performed before proposal of the rules. She specifically noted that she was troubled by the lack of analysis of swap markets and of whether the proposal would "cause price discovery in the commodity to shift to trading on foreign boards of trade," and that "driving business overseas remains a long standing concern." Further, Commissioner Sommers noted that, in any case, the Commission did not have the capacity to enforce the proposed rule.[1] Commissioner Dunn has echoed our concerns regarding the lack of CFTC funding and the potential detrimental effects of a prescriptive, rather than principles-based, regime upon the markets. More specifically, he expressed concern that if the CFTC's "budget woes continue, [his] fear is that the CFTC may simply become a restrictive regulator. In essence, [it] will need to say 'No' a lot more . . . No to anything [it does] not believe in good faith that [it has] the resources to manage" and that "such a restrictive regime may be detrimental to innovation and competition."[2] Commis-

---

[1] In full, Commissioner Sommers stated: "I oppose the proposal before us today because I believe it is flawed in a number of respects. First, I believe we should conduct a complete analysis of the swap market data before we determine the appropriate formula to propose. We have not done that. Second, without data on swap market positions, the spot month limits we are proposing are not enforceable. I think it is bad policy to propose regulations that the agency does not have the capacity to enforce. Third, in Section 4a(a)(1) of the Commodity Exchange Act, Congress specifically authorized the Commission to consider different limits on different groups or classes of traders. This language was added in Section 737 of Dodd-Frank. The proposal before us today does not analyze, or in any way consider, whether different limits are appropriate for different groups or classes of traders. Finally, Section 737 of Dodd-Frank states that the Commission shall strive to ensure that position limits will not cause price discovery in the commodity to shift to trading on foreign boards of trade. This proposal does not contain any analysis of how the proposal attempts to accomplish this goal. In fact, the proposal does not even mention this goal. Driving business overseas is a long standing concern of mine, and that concern remains unaddressed."

Commissioner Jill E. Sommers, Opening Statement, Open Meeting on the Ninth Series of Proposed Rulemakings under the Dodd-Frank Act, (January 13, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement011311.html*.

[2] Commissioner Dunn stated: "Lastly, I would like to speak briefly about the budget crisis the CFTC is facing. The CFTC is currently operating on a continuing resolution with funds insufficient to implement and enforce the Dodd-Frank Act. My fear at the beginning of this process was that due to our lack of funds the CFTC would be forced to move from a principles based regulatory regime to a more prescriptive regime. If our budget woes continue, my fear is that the CFTC may simply become a restrictive regulator. In essence, we will need to say 'No' a lot more. No to new products. No to new applications. No to anything we do not believe in good faith that we have the resources to manage. Such a restrictive regime may be detrimental to innovation and competition, but it would allow us to fulfill our duties under the law, with the resources we have available."

Commissioner Michael V. Dunn, Opening Statement, Public Meeting on Proposed Rules Under Dodd-Frank Act (January 13, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/dunnstatement011311.html.*

sioner O'Malia has likewise expressed concern regarding the effect of proposed regulations on the markets. More specifically, the Commissioner has expressed concern that new regulation could make it "too costly to clear." He noted that there are several "changes to [the] existing rules that will contribute to increased costs." Such cost increases have the effect of "reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach."[3]

We are concerned that many of the Commission's rulemakings to date would unnecessarily convert the regulatory system for the futures markets from the highly successful principles-based regime that has permitted U.S. Futures markets to prosper as an engine of economic growth for this nation, to a restrictive, prescription-based regime that will stifle growth and innovation. We are also concerned that many of the Commission's proposed rulemakings go beyond the specific mandates of DFA, and do not comply with the Administrative Procedure Act's requirements that rulemakings be legitimately grounded in evidence and strong economic theory. I will now address, in turn, several proposed rules issued by the Commission that illustrate these problems.

1. Proposed Rulemaking on Position Limits[4]

One example of this is the Commission's proposal to impose broad, fixed position limits for all physically delivered commodities. The Commission's proposed position limit regulations ignore the clear Congressional directives, which DFA added to section 4a of the Commodity Exchange Act, to set position limits "as the Commission finds are necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of" a commodity.[5] Without any basis to make this finding, the Commission instead justified its position limit proposal as follows:

> The Commission is not required to find that an undue burden on interstate commerce resulting from excessive speculation exists or is likely to occur in the future in order to impose position limits. Nor is the Commission required to make an affirmative finding that position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices or otherwise necessary for market protection. Rather, the Commission may impose position limits prophylactically, based on its reasonable judgment that such limits are necessary for the purpose of "diminishing, eliminating, or preventing" such burdens on interstate commerce that the Congress has found result from excessive speculation. 76 *Federal Register* 4752 at 4754 (January 26, 2011), Position Limits for Derivatives.

---

[3] In *Facing the Consequences: "Too Costly to Clear,"* Commissioner O'Malia stated: "I have serious concerns about the cost of clearing. I believe everyone recognizes that the Dodd-Frank Act mandates the clearing of swaps, and that as a result, we are concentrating market risk in clearinghouses to mitigate risk in other parts of the financial system. I said this back in October, and unfortunately, I have not been proven wrong yet. Our challenge in implementing these new clearing rules is in not making it 'too costly to clear.' Regardless of what the new market structures ultimately look like, hedging commercial risk and operating in general will become more expensive as costs increase across the board, from trading and clearing, to compliance and reporting."

"In the short time I have been involved in this rulemaking process, I have seen a distinct but consistent pattern. There seems to be a strong correlation between risk reduction and cash. Any time the clearing rulemaking team discusses increasing risk reduction, it is followed by a conversation regarding the cost of compliance and how much more cash is required."

"For example, there are several changes to our existing rules that will contribute to increased costs, including more stringent standards for those clearinghouses deemed to be systemically significant. The Commission staff has also recommended establishing a new margining regime for the swaps market that is different from the futures market model because it requires individual segregation of customer collateral. I am told this will increase costs to the customer and create moral hazard by reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach."

Commissioner Scott D. O'Malia, *Derivatives Reform: Preparing for Change, Title VII of the Dodd-Frank Act: 732 Pages and Counting,* Keynote Address (January 25, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-3.html.*

[4] 76 *Fed. Reg.* 4752 (proposed Jan. 26, 2011) (to be codified at 17 CFR pts. 1, 150–51).

[5] My December 15, 2010, testimony before the Subcommittee on General Farm Commodities and Risk Management of the House Committee on Agriculture includes a more complete legal analysis of the DFA requirements.

At the December 15, 2010, hearing of the General Farm Commodities and Risk Management Subcommittee of the House Agriculture Committee on the subject of the implementation of DFA's provisions respecting position limits, there was strong bipartisan agreement among the Subcommittee Members with the sentiments expressed by Representative Moran:

> Despite what some believe is a mandate for the Commission to set position limits within a definite period of time, the Dodd-Frank legislation actually qualifies CFTC's position-limit authority. Section 737 of the Dodd-Frank Act amends the Commodity Exchange Act so that Section 4A–A2A states, "The Commission shall, by rule, establish limits on the amount of positions as appropriate." The Act then states, "In subparagraph B, for exempt commodities, the limit required under subparagraph A shall be established within 180 days after the date of enactment of this paragraph." When subparagraphs A and B are read in conjunction, the Act states that when position limits are required under subparagraph A, the Commission shall set the limits within 180 days under paragraph B. Subparagraph A says the position-limit rule should be only prescribed when appropriate.
>
> Therefore, the 180 day timetable is only triggered if position limits are appropriate. In regard to the word "appropriate," the Commission has three distinct problems. First, the Commission has never made an affirmative finding that position limits are appropriate to curtail excessive speculation. In fact, to date, the only reports issued by the commission or its staff failed to identify a connection between market trends and excessive speculation. This is not to say that there is no connection, but it does say the commission does not have enough information to draw an affirmative conclusion.

"The second and third issues relating to the appropriateness of position limits are regulated to adequacy of information about OTC markets. On December 8, 2010, the commission published a proposed rule on swap data record-keeping and reporting requirements. This proposed rule is open to comment until February 7, 2011, and the rule is not expected to be final and effective until summer at the earliest. Furthermore, the commission has yet to issue a proposed rulemaking about swap data repositories. Until a swap data repository is set up and running, it is difficult to see how it would be appropriate for the commission to set position limits." CME group is not opposed to position limits and other means to prevent market congestion; we employ limits in most of our physically delivered contracts.

However, we use limits and accountability levels, as contemplated by the Congressionally-approved Core Principles for Designated Contract Markets ("DCMs"), to mitigate potential congestion during delivery periods and to help us identify and respond in advance of any threat to manipulate our markets. CME Group believes that the core purpose that should govern Federal and exchange-set position limits, to the extent such limits are necessary and appropriate, should be to reduce the threat of price manipulation and other disruptions to the integrity of prices. We agree that such activity destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery and we have the greatest incentive and best information to prevent such misconduct.

We don't want to lose sight of the real economic cost of imposing position limits that are unwarranted. For the last 150 years, modern day futures markets have served as the most efficient and transparent means to discover prices and manage exposure to price fluctuations. Regulated futures exchanges operate centralized, transparent markets to facilitate price discovery by permitting the best informed and most interested parties to express their opinions by buying and selling for future delivery. Such markets are a vital part of a smooth functioning economy. Futures exchanges allow producers, processors and agribusiness to transfer and reduce risks through *bona fide* hedging and risk management strategies. This risk transfer means producers can plant more crops. Commercial participants can ship more goods. Risk transfer only works because speculators are prepared to provide liquidity and to accept the price risk that others do not. Futures exchanges and speculators have been a force to reduce price volatility and mitigate risk. Overly inclusive position limits adversely impact legitimate trading and impair the ability of producers to hedge. Worse, the drive certain classes of speculators into physical markets and distort the physical supply chain and prices.

2. Proposed Rulemaking on Mandatory Swaps Clearing Review Process [6]

Another example of a rule proposal that raises concerns and could produce consequences counter to the fundamental purposes of DFA is the Commission's proposed rule relating to the process for review of swaps for mandatory clearing. The proposed regulation treats an application by a derivatives clearing organization ("DCO") to list a particular swap for clearing as obliging that DCO to perform due diligence and analysis for the Commission respecting a broad swath of swaps, as to which the DCO has no information and no interest in clearing. In effect, a DCO that wishes to list a new swap would be saddled with the obligation to collect and analyze massive amounts of information to enable the Commission to determine whether the swap that is the subject of the application and any other swap that is within the same "group, category, type, or class" should be subject to the mandatory clearing requirement.

This proposed regulation is one among several proposals that impose costs and obligations whose effect and impact are contrary to the purposes of Title VII of DFA. The costs in terms of time and effort to secure and present the information required by the proposed regulation would be a massive disincentive to DCOs to voluntarily undertake to clear a "new" swap. The Commission lacks authority to transfer the obligations that the statute imposes on it to a DCO. The proposed regulation eliminates the possibility of a simple, speedy decision on whether a particular swap transaction can be cleared—a decision that the DFA surely intended should be made quickly in the interests of customers who seek the benefits of clearing—and forces a DCO to participate in an unwieldy, unstructured and endless process to determine whether mandatory clearing is required. Regulation section 39.5(b)(5) starkly illustrates this outcome. Every simple request to clear a swap is converted into a marathon that is likely to kill the runner before Athens is in sight. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. The Commission is the sole judge of completion and the only test is its unfettered discretion. Only then does the 90 day period begin to run. This turns DFA on its head.

3. Conversion from Principles-Based to Rules-Based Regulation [7]

Some of the CFTC's rule proposals are explained by the ambiguities created during the rush to push DFA to a final vote. For example, Congress preserved and expanded the scheme of principles-based regulation by expanding the list of core principles and granting self regulatory organizations "reasonable discretion in establishing the manner in which the [self regulatory organization] complies with the core principles." Congress granted the Commission the authority to adopt rules respecting core principles, but did not direct it to eliminate principles-based regulation.

The agency's prescriptive regulatory approach would convert its role from an oversight agency, whose role is to assure compliance with sound principles, to a front line decision maker that imposes its business judgments on every operational aspect of derivatives trading and clearing. This role reversal will require doubling of the Commission's staff and budget and impose astronomical costs on the industry and the end-users of derivatives. Yet there is no evidence that this interpretation of Congressional intent behind DFA is necessary or will be beneficial to the public or to the functioning of the markets. This approach will also unnecessarily deplete the agency's limited resources. In keeping with the President's Executive Order to reduce unnecessary regulatory cost, the CFTC should be required to reconsider each of its proposals with an eye toward performing those functions that are clearly mandated by DFA.

Prior to DFA, the Commodity Exchange Act ("CEA"), as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), prohibited the CFTC from mandating exclusive means of compliance with the Core Principles applicable to regulated entities. *See* CEA 5c(a)(2). The CFTC set forth "[g]uidance on, and Acceptable Practices in, Compliance with Core Principles," but these statements operated only as guidance or as a safe harbor for compliance—not as requirements.

Changes to the CEA made by DFA gave the Commission discretion to, where necessary, step back from this principles-based regime. That is, they changed the language of the CEA to state that boards of trade "shall have reasonable discretion in establishing the manner in which they comply with the core principles, unless otherwise determined by the Commission by rule or regulation." *See, e.g.,* DFA § 735(b), amending Section 5(d)(1)(B) of the CEA. To begin, this language assumes that the principles-based regime will remain in effect and that, as such, regulated entities

[6] 75 *Fed. Reg.* 667277 (proposed Nov. 2, 2010) (to be codified at 17 CFR pts. 1, 150, 151).
[7] *See,* 75 *Fed. Reg.* 80747 (proposed Dec. 22, 2010) (to be codified at 17 CFR pts. 1, 16, 38).

will have reasonable discretion as to the manner with which they comply with the Core Principles except in limited circumstances in which more specific rules addressing compliance with a core principle are necessary. The Commission has used this change in language, however, to propose specific requirements for multiple Core Principles—almost all Core Principles in the case of DCMs—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

The principles-based regime of the CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearing houses permitted U.S. exchanges to regain their competitive position in the global market. U.S. futures exchanges are able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA and thereby avoiding stifling regulatory review. Indeed, U.S. futures exchanges have operated more efficiently, more economically and with fewer complaints under this system than at any time in their history.

(a) Proposed Rulemaking under Core Principle 9 for DCMs

One example of the Commission's unnecessary and problematic departure from the principles-based regime is its proposed rule under Core Principle 9 for DCMs—Execution of Transactions, which states that a DCM "shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market" but that "the rules of a board of trade may authorize . . . (i) transfer trades or office trades; (ii) an exchange of (I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps; or (iii) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]."

Proposed rule 38.502(a) would require that 85% or greater of the total volume of any contract listed on a DCM be traded on the DCM's centralized market, as calculated over a 12 month period. The Commission asserts that this is necessary because "the price discovery function of trading in the centralized market" must be protected. 75 *Fed. Reg.* at 80588. However, Congress gave no indication in DFA that it considered setting an arbitrary limit as an appropriate means to regulate under the Core Principles. Indeed, in other portions of DFA, where Congress thought that a numerical limit could be necessary, it stated so. For example, in Section 726 addressing rulemaking on Conflicts of Interest, Congress specifically stated that rules "may include numerical limits on the control of, or the voting rights" of certain specified entities in DCOs, DCMs or Swap Execution Facilities ("SEFs").

Congress did not sanction arbitrary proscriptions by the Commission, and the 85% exchange trading requirement is completely arbitrary. That is, the Commission justifies the requirement only with its observations as to percentages of various contracts traded on various exchanges—it provides no support for a position that the 85% requirement provides or is necessary to provide a "competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade," as is required under Core Principle 9. Further, Core Principle 9, as noted above, expressly permits DCMs to authorize off-exchange transactions including for exchanges to related positions pursuant to their rules.

The Commission does not assert in its proposal that the 85% exchange trading requirement has any regulatory benefit for either it or market participants. Indeed, there is no such benefit. The Commission does not receive any additional information regarding the market through the proposed 85% requirement. That is, if an instrument is not traded on an exchange, it will in many cases simply be traded on an SEF or in the OTC market as a swap. Following DFA, the swap and OTC markets, like the futures market, is regulated by the Commission. Thus, the Commission will receive the same information for use in regulation regardless of whether the instrument is traded in the centralized market or not.

Moreover, imposition of the proposed 85% exchange trading requirement will have extremely negative effects on the industry. The 85% requirement would significantly deter the development of new products by exchanges like CME. This is because new products generally initially gain trading momentum in off-exchange transactions. Indeed, it takes years for new products to reach the 85% exchange trading requirement proposed by the Commission. For example, one now popular and very liquid foreign exchange product developed and offered by CME would not have met the 85% requirement for 4 years after it was initially offered. The product's on-exchange

trading continued to increase over 10 years, and it now trades only 2% off-exchange. Under the proposed rule, CME would have had to delist this product.[8]

Imposition of an 85% exchange trading requirement would also have adverse effects on market participants. If instruments that are most often traded off-exchange are forced onto the centralized market, customers will lose cross-margin efficiencies that they currently enjoy and will be forced to post additional cash or assets as margin. For example, customers who currently hold open positions on CME Clearport® will be required to post a total of approximately $3.9 billion in margin (at the clearing firm level, across all clearing firms).

(b) Proposed Comparable Fee Structures Under Core Principle 2 for DCMs

In the case of certain proposed fee restrictions to be placed on DCMs, the Commission not only retreats needlessly from principles-based regulation but also greatly exceeds its authority under DFA. DCM Core Principle 2, which appears in DFA Section 735, states, in part, that a DCM "shall establish, monitor, and enforce compliance with rules of the contract market including . . . access requirements." Under this Core Principle, the Commission has proposed rule 38.151, which states that a DCM "must provide its members, market participants and independent software vendors with impartial access to its market and services including . . . comparable fee structures for members, market participants and independent software vendors receiving equal access to, or services from, the [DCM]."

The CFTC's attempt to regulate DCM member, market participant and independent software vendor fees is unsupportable. The CFTC is expressly authorized by statute to charge reasonable fees to recoup the costs of services it provides. 7 U.S.C. 16a(c). The Commission may not bootstrap that authority to set or limit the fees charged by DCMs or to impose an industry-wide fee cap that has the effect of a tax. *See Federal Power Commission* v. *New England Power Co.,* 415 U.S. 345, 349 (1974) ("[W]hole industries are not in the category of those who may be assessed [regulatory service fees], the thrust of the Act reaching only specific charges for specific services to specific individuals or companies."). In any event, the CFTC's overreaching is not supported by DFA. Nowhere in the CEA is the CFTC authorized to set or limit fees a DCM may charge. To the extent the CFTC believes its authority to oversee impartial access to trading platforms may provide a basis for its assertion of authority, that attempt to read new and significant powers into the CEA should be rejected.

3. Provisions Common to Registered Entities[9]

The CFMA streamlined the procedures for listing new products and amending rules that did not impact the economic interests of persons holding open contracts. These changes recognized that the previous system required massive, worthless paper pushing efforts by exchanges and by the CFTC's staff. It slowed innovation and offered no demonstrable public benefit. Our ability to compete on a global scale, which had been progressively eroded by the disparity between the U.S. process and the rules under which foreign competitors operated, was restored.

Under current rules, before a product is self-certified or a new rule or rule amendment is proposed, DCMs and DCOs conduct a due diligence review to support their conclusion that the product or rule complies with the Act and Core Principles. The point of the self-certification process that Congress retained in DFA is that registered entities that list new products have a self-interest in making sure that the new products meet applicable legal standards. Breach of this certification requirement potentially subjects the DCM or DCO to regulatory liability. In addition, in some circumstances, a DCM or DCO may be subject to litigation or other commercial remedies for listing a new product, and the avoidance of these costs and burdens is sufficient incentive for DCMs and DCOs to remain compliant with the Act.

Nothing in the last decade of self-certification suggests that this concept is flawed or that registered entities have employed this power recklessly or abusively. During 2010, CME launched 438 new products and submitted 342 rules or rule amendments to the Commission. There was no legitimate complaint respecting the self-certification process during this time. Put simply, the existing process has worked, and there is no reason for the Commission to impose additional burdens, which are not required by DFA, to impair that process.

---

[8] More specifically, the product traded 32% off-exchange when it was first offered in 2000, 31% off-exchange in 2001, 25% in 2002, 20% in 2003, finally within the 85% requirement at 13% off-exchange in 2004, 10% in 2005, 7% in 2006, 5% in 2007, 3% in 2008, and 2% in 2009 and 2010.

[9] 75 *Fed. Reg.* 67282 (proposed Nov. 2, 2010) (to be codified at 17 CFR pt. 40).

Section 745 of DFA merely states, in relevant part, that "a registered entity may elect to list for trading or accept for clearing any new contract, or other instrument, or may elect to approve or implement any new rule or rule amendment, by providing to the Commission a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act)." To be sure, DFA in no way directs the Commission to require the submission of all documents supporting such a certification nor to require a review of the legal implications of the product or rule with regard to laws other than DFA. Essentially, it requires exactly what was required prior to the passage of DFA—a certification that the product, rule or rule amendment complies with the CEA. Nonetheless, the Commission has taken it upon itself to impose these additional and burdensome submission requirements upon registered entities.

The new requirements are likely to significantly impair the speed and value of innovation by U.S. exchanges and clearing houses, which will be required to watch their innovations brought to market by foreign competitors while the U.S. agency checks boxes to insure that filings are complete. Moreover, given the volume of filings required by the notice of proposed rulemaking, the Commission will require significant increases in staffing and other resources. The Commission's resources should be better aligned with the implementation of the goals of DFA rather than "correcting" a well-functioning and efficient process.

The proposed rules greatly and unnecessarily increase the documentation burden associated with this submission process, and it seems inevitable that they will greatly slow the process of new rule and product introduction. First, a registered entity must submit "all documentation" relied upon to determine whether a new product, rule or rule amendment complies with applicable Core Principles. This requirement is, to begin with, vague, and thus is likely to result in the submission of unnecessary and non-useful information. More importantly, this requirement imposes an additional burden on both registered entities, which must compile and produce all such documentation, and the Commission, which must review it. The benefits, if any, to be gathered by this requirement are significantly outweighed by the costs imposed both on the marketplace and the Commission.

Second, the proposed rules require registered entities to examine potential legal issues associated with the listing of products and include representations related to these issues in their submissions. Specifically, a registered entity must provide a certification that it has undertaken a due diligence review of the legal conditions, including conditions that relate to contractual and intellectual property rights. The imposition of such a legal due diligence standard is clearly outside the scope of DFA and is unnecessarily vague and impractical, if not impossible, to comply with in any meaningful manner. An entity, such as CME, involved in product creation and design is always cognizant of material intellectual property issues that might arise. This amorphous and potentially vast legal diligence requirement could require that registered entities expand what could reasonably be considered to be a material or colorable intellectual property analysis and undertake extensive intellectual property analysis, including patent, copyright and trademark searches in order to satisfy the regulatory mandates. This would greatly increase the cost and timing of listing products without providing any true corresponding benefit to the marketplace. Indeed, the Commission itself admits in its NOPR that these proposed rules will increase the overall information collection burden on registered entities *by approximately 8,300 hours per year.* 75 *Fed. Reg.* at 67290.

Further, these rules steer the Commission closer to the product and rule approval process currently employed by the SEC, about which those regulated by the SEC complained at the CFTC–SEC harmonization hearings. Indeed, William J. Brodsky of the Chicago Board of Options Exchange testified that the SEC's approval process "inhibits innovation in the securities markets" and urged the adoption of the CFTC's certification process.

4. Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest [10]

The Commission's proposed rules regarding the mitigation of conflicts of interest in DCOs, DCMs and SEFs ("Regulated Entities") also exceed its rulemaking authority under DFA and impose constraints on governance that are unrelated to the purposes of DFA or the CEA. The Commission purports to act pursuant to Section 726 of DFA but ignores the clear boundaries of its authority under that section, which

[10] 75 *Fed. Reg.* 63732 (proposed October 18, 2010) (to be codified at 17 CFR pts. 1, 37, 38, 39, 40).

it cites to justify taking control of every aspect of the governance of those Regulated Entities. Section 726 conditions the Commission's right to adopt rules mitigating conflicts of interest to circumstances where the Commission has made a finding that the rule is "necessary and appropriate" to "improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest *in connection with a swap dealer or major swap participant's conduct of business with,* a [Regulated Entity] that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment." (emphasis added) The "necessary and appropriate" requirement constrains the Commission to enact rules that are no more intrusive than necessary to fulfill the stated Congressional intent—in other words, the regulations must be narrowly-tailored to minimize their burden on the industry. The Commission failed to make the required determination that the proposed regulations were "necessary and proper" and, unsurprisingly, the proposed rules are not narrowly-tailored but rather overbroad, outside of the authority granted to it by DFA and extraordinarily burdensome.

The Commission proposed governance rules and ownership limitations that affect all Regulated Entities, including those in which no swap dealer has a material debt or equity investment and those that do not even trade or clear swaps. Moreover, the governance rules proposed have nothing to do with conflicts of interest, as that term is understood in the context of corporate governance. Instead, the Commission has created a concept of "structural conflicts," which has no recognized meaning outside of the Commission's own declarations and is unrelated to "conflict of interest" as used in the CEA. The Commission proposed rules to regulate the ownership of voting interests in Regulated Entities by any member of those Regulated Entities, including members whose interests are unrelated or even contrary to the interests of the defined "enumerated entities." In addition, the Commission is attempting to impose membership condition requirements for a broad range of committees that are unrelated to the decision making to which Section 726 was directed.

The Commission's proposed rules are most notably overbroad and burdensome in that they address not only ownership issues but the internal structure of public corporations governed by state law and listing requirements of SEC regulated national securities exchanges. More specifically, the proposed regulations set requirements for the composition of corporate boards, require Regulated Entities to have certain internal committees of specified compositions and even propose a new definition for a "public director." Such rules in no way relate to the conflict of interest Congress sought to address through Section 726. Moreover, these proposed rules improperly intrude into an area of traditional state sovereignty. It is well-established that matters of internal corporate governance are regulated by the states, specifically the state of incorporation. Regulators may not enact rules that intrude into traditional areas of state sovereignty unless Federal law compels such an intrusion. Here, Section 726 provides no such authorization.

Perhaps most importantly, the proposed structural governance requirements cannot be "necessary and appropriate," as required by DFA, because applicable state law renders them completely unnecessary. State law imposes fiduciary duties on directors of corporations that mandate that they act in the best interests of the corporation and its shareholders—not in their own best interests or the best interests of other entities with whom they may have a relationship. As such, regardless of how a board or committee is composed, the members must act in the best interest of the exchange or clearinghouse. The Commission's concerns—that members, enumerated entities, or other individuals not meeting its definition of "public director" will act in their own interests—and its proposed structural requirements are wholly unnecessary and impose additional costs on the industry—not to mention additional enforcement costs—completely needlessly.

5. Prohibition on Market Manipulation [11]

The Commission's proposed rules on Market Manipulation, although not representing as clear an overstepping of its boundaries under DFA, are also problematic because they are extremely vague. The Commission has proposed two rules related to market manipulation: Rule 180.1, modeled after SEC Rule 10b–5 and intended as a broad, catch-all provision for fraudulent conduct; and Rule 180.2, which mirrors new CEA Section 6(c)(3) and is aimed at prohibiting price manipulation. *See* 75 *Fed. Reg.* at 67658. Clearly, there is a shared interest among market participants, exchanges and regulators in having market and regulatory infrastructures that promote fair, transparent and efficient markets and that mitigate exposure to risks that threaten the integrity and stability of the market. In that context, how-

[11] 75 *Fed. Reg.* 67657–62 (proposed Nov. 3, 2010) (to be codified at 17 CFR pt. 180).

ever, market participants also desire clarity with respect to the rules and fairness and consistency with regard to their enforcement.

As to its proposed rule 180.1, the Commission relies on SEC precedent to provide further clarity with respect to its interpretation and notes that it intends to implement the rule to reflect its "distinct regulatory mission." However, the Commission fails to explain how the rule and precedent will be adapted to reflect the differences between futures and securities markets. *See* 75 *Fed. Reg.* at 67658–60. For example, the Commission does not provide clarity as to if and to what extent it intends to apply insider trading precedent to futures markets. Making this concept applicable to futures markets would fundamentally change the nature of the market, not to mention all but halting participation by hedgers, yet the Commission does not even address this issue. Rule 180.1 is further unclear as to what standard of *scienter* the Commission intends to adopt for liability under the rule. Rule 180.2 is comparably vague, providing, for example, no guidance as to what sort of behavior is "intended to interfere with the legitimate forces of supply and demand" and how the Commission intends to determine whether a price has been affected by illegitimate factors.

These proposed rules, like many others, have clearly been proposed in haste and fail to provide market participants with sufficient notice of whether contemplated trading practices run afoul of them. Indeed, the proposed rules are so unclear as to be subject to constitutional challenge. That is, due process precludes the government from penalizing a private party for violating a rule without first providing adequate notice that conduct is forbidden by the rule. In the area of market manipulation especially, impermissible conduct must be clearly defined lest the rules chill legitimate market participation and undermine the hedging and price discovery functions of the market by threatening sanctions for what otherwise would be considered completely legal activity. That is, if market participants do not know the rules of the road in advance and lack confidence that the disciplinary regime will operate fairly and rationally, market participation will be chilled because there is a significant risk that legitimate trading practices will be arbitrarily construed, *post hoc*, as unlawful.

6. Anti-disruptive Practices Authority Contained in DFA[12]

Rules regarding Disruptive Trade Practices (DFA Section 747) run the risk of being similarly vague and resulting in chilling of market participation. At this juncture, the Commission has issued only an Advance notice of proposed rulemaking ("ANPR") on this issue, and the ANPR demonstrates the Commission's understanding that it must provide clarity beyond that provided by DFA. Still, it is worthy of note that Section 747 of DFA, which authorizes the Commission to promulgate additional rules if they are reasonably necessary to prohibit trading practices that are "disruptive of fair and equitable trading," is exceedingly vague as written and does not provide market participants with adequate notice as to whether contemplated conduct is forbidden. Hasty rulemaking resulting in vague rules in the area of disruptive trade practices will have the same effect as such rulemaking in the area of market manipulation—participation in the market and the hedging and price discovery functions of the market will be chilled due to uncertainty among participants as to whether their contemplated conduct is acceptable.

The above are merely a few examples of instances in which CME believes the Commission has proposed rules inconsistent with DFA or that impose unjustified costs and burdens on both the industry and the Commission. We ask this Congress to extend the rulemaking schedule under DFA to allow time for industry professionals of various viewpoints to fully express their views and concerns to the Commission and for the Commission to have a realistic opportunity to assess and respond to those views and to realistically assess the costs and burdens imposed by the new regulations. We urge the Congress to ensure that implementation of DFA is consistent with the Congressional directives in the Act and does not unnecessarily harm hedging and risk transfer markets that U.S. companies depend upon to reduce business risks and increase economic growth.

The CHAIRMAN. Mr. Pickel, 5 minutes.

[12] 75 *Fed. Reg.* 67301 (proposed November 2, 2010) (to be codified at 17 CFR pt. 1).

STATEMENT OF ROBERT G. PICKEL, EXECUTIVE VICE CHAIRMAN, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Mr. PICKEL. Mr. Chairman, Ranking Member Peterson, and Members of the Committee, thank you for the opportunity to testify once again today before this Committee, this time regarding implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Like all of you here today, ISDA is very supportive of efforts to build a more robust and effective financial regulatory framework. We fully share the goal of U.S. policymakers and policymakers around the world to enhance the safety and soundness of our financial markets. ISDA has taken numerous steps over the years to make OTC markets safe and efficient, and has a strong incentive to see the Dodd-Frank Act implemented effectively. We are actively at work in key areas, such as reducing counterparty risk and increasing transparency, that support these goals.

We are, however, concerned at the volume of, and the compressed timeframe for, finalizing the rules required under the Act that may work against the law's essential purpose, impede the availability of hedging tools that U.S. companies need to manage their risks, and adversely impact the competitiveness of U.S.-based derivatives markets.

The timelines contained in the Dodd-Frank Act require the CFTC and the SEC to move at a speed that we believe will make it difficult to establish a sound regulatory environment. Thus, we strongly support a phased in implementation of any new regulatory requirements to protect against unintended consequences.

In light of the already difficult timelines, we are also concerned that some of the proposed regulations go beyond the statutory requirements of the Dodd-Frank Act, pulling resources away from implementation of regulations focused on safety and soundness and creating new rules that will adversely affect the existing swaps market with little apparent benefit.

We also urge the agencies and this Committee as the rulemaking process moves forward, to take the time to consider the aggregate effect of the totality of the regulations.

As I listened to the first—Chairman Gensler on the first panel, there were several questions about the size of this market, the size of this business. We often use this notion of notional amount, which is $600 trillion globally, roughly $300 trillion here in the United States. What I think is also important to focus on is despite that size, trading in the OTC markets is relatively limited in terms of number of contracts. Roughly 5,500 interest rate swaps contracts are executed each day in over 20 currencies around the globe. This compares to the approximately 300,000 tickets per day that are executed in the U.S. Government and Euro dollar futures contracts on the CME. Daily OTC interest rate swap volume is two percent of the corresponding CME Group futures contracts. The daily volume of trades executed in U.S. dollars is less than one percent of the corresponding futures contracts. If we look at the more standardized trades, those trades that will likely go into a clearing environment and perhaps traded on a swap execution facility, there are approximately 2,000 standardized interest rate swaps executed on

an average day. The largest maturity for 10 year U.S. dollar swaps trade about 200 times a day, or once every 4 minutes, quite different from the frequency of trading of a contract that you would see on the CME. I think it is important, as we look at issues of implementation, as we look at issues of block trading and transparency, that we keep in mind the number of contracts that are traded each day in the OTC markets around the world.

As the Committee moves forward, I urge you to consider three important factors as it considers the rules that are being implemented at the CFTC. ISDA strongly believes that preserving market liquidity is a critical consideration in the promulgation of new regulatory requirements. Liquidity is the lifeblood of the financial system. It is universally recognized as a key element of an efficient marketplace, and necessary for financial markets to remain viable. We would recommend, then, that when considering aspects of the Dodd-Frank Act that could impact liquidity, such as appropriate exceptions to real-time reporting for block trades, that the Commission engage in robust market and impact analyses of these proposals prior to finalizing their rules.

Although adverse effects on liquidity can be avoided or mitigated in the implementation process, increased costs related to new regulations are often unavoidable. It is imperative that the Commission recognize the need to accurately assess all costs, both explicit and implicit, and mitigate these costs to the maximum extent possible. These costs can be alleviated by leveraging existing industry processes and practices, and by ensuring that new regulations do not go beyond the mandates set by the Dodd-Frank Act.

Last, I would urge the Committee to consider—and as certainly indicated in numerous remarks today—that as the Commissions proceed, they should consider the competitiveness of the U.S. financial markets and U.S. financial firms when setting these new requirements. Over 90 percent of the largest U.S. companies use OTC derivatives to manage their business and financial risks. We are concerned that overly restrictive requirements, coupled with increased and unnecessary costs, may result in transfers of business and eventually jobs overseas.

In conclusion, we appreciate the enormous task that has been set out for the CFTC and the SEC in promulgating the number of Dodd-Frank Act rulemakings, and we appreciate the transparency that they have provided in this process. We recommend, however, that the Commissions assure that their rulemaking processes allow for an iterative process between their staff and industry commentators, a complete assessment, an analysis of proposed rules potential impact on markets, firms, and the U.S. swaps and derivatives markets, and an orderly transition to this new regulatory regime.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Pickel follows:]

PREPARED STATEMENT OF ROBERT G. PICKEL, EXECUTIVE VICE CHAIRMAN, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Chairman Lucas, Ranking Member Peterson and Members of the Committee:

Thank you for the opportunity to testify today regarding implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Like all of you here today, ISDA is very supportive of efforts to build a more robust and ef-

fective financial regulatory framework. We fully share the goal of policymakers in the U.S. and around the world to enhance the safety and soundness of our financial markets. As you will hear, we are actively at work in key areas—such as reducing counterparty risk and increasing transparency—that support these goals. We are, however. concerned that the volume of and the compressed timeframe for finalizing the rules required under the Act may work against the law's essential purpose, impede the availability of hedging tools that U.S. companies need to manage their risks and adversely impact the competitiveness of the U.S.-based derivatives markets. We also are concerned that some of the proposed regulations go beyond the statutory requirements of the Dodd-Frank Act and will create new rules with that will adversely affect the existing swaps markets with little apparent benefit.

Introduction

The International Swaps and Derivatives Association, or ISDA, was chartered in 1985 and has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

ISDA's focus is primarily on making the OTC derivatives markets safe and efficient. Over its 25 year history, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

In the years leading up to and since the passage of the Dodd-Frank Act, ISDA, the major dealers, buy-side institutions and other industry associations have worked collaboratively to deliver structural improvements to the global over-the-counter (OTC) derivatives markets. These actions were undertaken as part of an ongoing dialogue with and commitments to global supervisors, including the Federal Reserve Bank of New York, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

Through this process, the industry has made and continues to make substantial progress in three key areas: reducing counterparty risk; increasing transparency and enhancing the operational infrastructure of the swaps and derivatives business.

As to the reduction in counterparty risk, the industry is making significant progress through both clearing and portfolio compression. Today, about $248 trillion of interest rate swaps, representing more than 40 percent of the market, is centrally cleared.[1] Another $106 trillion of interest rate swaps has been eliminated due to portfolio compression.[2] In the credit default swaps markets, more than $15 trillion has been centrally cleared.[3] Portfolio compression has eliminated more than $70 trillion of CDS.[4] In fact, by virtue of the combination of central clearing and portfolio compression, the size of the CDS market has been reduced by 75 percent in the past several years. We believe the volume of cleared swaps could double in the next 2 to 3 years.

As for our goal of increasing transparency, it is important to keep in mind that a distinction should be made between regulatory transparency and market transparency. Regulatory transparency means that regulators should have access to trade information on a timely basis in order to monitor market risk. ISDA fully supports this goal. The Association has helped establish trade repositories that provide global regulators with significant visibility into firm and counterparty risk exposures. This means that the uncertainties that occurred in the recent financial crisis regarding risk exposures of Lehman Brothers simply could not happen again.

Another aspect of transparency is market transparency, or price visibility for market participants. Recent ISDA surveys and tests demonstrate that users of most derivatives have tremendous pricing transparency and extremely competitive pricing. To obtain competitive pricing, the large majority of users receive price quotations from multiple dealers. Their concern is that these products remain available and affordable. A recent blind test of interest rate swap pricing for three American investment firms found tremendous price competition in both the dollar and Euro markets. When measured against a benchmark screen, these firms were able to obtain

---

[1] *http://www.lchclearnet.com/swaps/swapclear_for_clearing_members/.*
[2] *http://www.trioptima.com/services/triReduce.html.*
[3] *http://ir.theice.com/releasedetail.cfm?ReleaseID=545362.*
[4] *http://www.trioptima.com/services/triReduce/triReduce-credit.html.*

firm pricing on nearly $2 billion of swaps at a spread of 0.001% over the middle of the bid-offer on the screen. These swaps were for maturities from 2 to thirty years and for sizes up to $250 million.[5]

While the evidence indicates there is a significant level of price transparency in the OTC derivatives markets, the industry is actively exploring ways to improve further improve upon this and ISDA has sponsored research to this effect. We believe it is important that any efforts to build greater market transparency be done after careful analysis and evaluation of its benefits, its impact on liquidity and on the ability of end-users to use derivatives to manage their risks.

As to the operational infrastructure of the OTC derivatives business, over the past several years, the industry has made significant improvements in reducing backlogs, and improving and automating middle- and back-office processes.

Our commitment in these areas has been detailed in a series of letters, beginning in September 2005, to the group of global supervisors referenced above, the latest of which, dated March 1, 2010, is attached to this testimony.[6] These actions by ISDA, the major dealers, buy-side institutions and other industry associations have improved the way OTC derivatives are traded, processed and cleared and reflect significant investment of resources and capital. They are a powerful indication of the commitment the industry has made to improve the market infrastructure as a means to achieving the shared policy goals of reducing systemic risk and increasing transparency. The industry recently met again with global supervisors and is in discussions about an additional commitment letter that will provide a roadmap to achieving compliance with regulatory requirements both in the United States and elsewhere.

Dodd-Frank Rulemaking Process

The Dodd-Frank Act is a wide-ranging and comprehensive piece of legislation. As a result, all of the Federal financial regulatory agencies have been faced with an unprecedented level of obligated rulemaking. The CFTC and SEC, in particular, have an especially challenging task as they attempt to create a new regulatory regime for the OTC derivatives markets. Since the passage of the Dodd-Frank Act last July, ISDA has continued to work closely with various U.S. regulators with the goal of helping them develop rules that achieve the goals of the Act, while mitigating against any undesirable, unintended adverse consequences.

It is vital that this new regulatory regime create a framework that increases transparency and mitigates systemic risk, while preserving the ability of derivatives users to hedge and manage risk in a prudent and cost-effective manner. As the regulators attempt to strike this very difficult balance, we have several recommendations that we believe may be helpful regarding the rulemaking process that take into consideration key issues regarding the market's structure and liquidity, the costs and availability of derivatives and hedging for end-users, and the continued competitiveness of the U.S. firms in the global swaps and derivatives markets.

The Process

We applaud the efforts of the CFTC and SEC to create an open and transparent rulemaking process. The Commissions have diligently posted and reported all meetings with stakeholders and have held a series of public roundtables to consider a number of issues related to Dodd-Frank Act rulemakings. ISDA has taken part in this transparent rulemaking process and has filed approximately 30 formal comment letters. In addition, ISDA has had a number of discussions with the Chairpersons and Commissioners of the CFTC and SEC and the Staffs of both Commissions, and has participated in a number of public roundtables.

Of course, in addition to transparency, a key to the promulgation of effective and meaningful rulemaking is to allow for, in essence, an iterative process between the Commissions and commentators. We are concerned that the volume of proposed rulemakings and the Commissions' compressed statutory time frame for promulgating their new rules may impair such a process, and hamper the ability of commentators to provide thoughtful and comprehensive comments and of agency staff to digest and assess the comments that are submitted. Toward that end, ISDA and a number of trade associations jointly wrote to the Commissions to urge them to use their discretion to propose, adopt and implement rules in an appropriate sequence and timeframe.[7]

Some of the proposed rules, for example, contain or are based on standards or numbers that will be hardwired into the regulatory framework. This includes the

---

[5] *http://isda.org/media/pdf/ISDATestReport.pdf.*
[6] *http://www.newyorkfed.org/newsevents/news/markets/2010/100301_letter.pdf.*
[7] *http://www.isda.org/speeches/pdf/Comment-Letter-on-Regulatory-Process-and-Phase-In.pdf.*

requirement that trades below $250 million in notional principal be subject to real-time reporting requirements, a level that does not take into account the structure of the derivatives market. This proposed rule could disrupt risk transfer by American companies and impede the capital formation process that is essential to economic growth.

We also are concerned that some of the proposed regulations go beyond the statutory requirements of the Dodd-Frank Act and will create new obligations or set new standards that will fundamentally and negatively affect the existing swaps markets with little apparent benefit. For example, the CFTC's proposes to require that swaps execution facilities (SEFs) must have access to quotes from five dealers. There is to our knowledge no objective evidence that supports this decision or that indicates why five is the optimal number of dealers on a SEF. The law itself only specifies that such quotes be sent to multiple dealers.

Finally, we are encouraged that the agencies appear to recognize the need to phase-in the requirements of the Dodd-Frank Act and stress that the transition to this new regulatory regime occur incrementally in a way that ensures the continued viability of the market and that also protects overall liquidity.

Liquidity

As noted, ISDA strongly believes that consideration of the effects of any rule on market liquidity is critical in connection with the promulgation of new regulatory requirements. Liquidity is the lifeblood of the financial system; it is universally recognized as a key element of an efficient marketplace and necessary for financial markets to remain viable. A market's liquidity is a function of its structure. For example, despite its size, trading in the OTC derivatives markets is quite limited. Roughly 5,500 interest rate swap contracts are executed each day in over 20 currencies. This compares to the approximately 300,000 tickets per day in the U.S. Government and Eurodollar futures contracts traded at the CME Group. Daily OTC interest rate swap volume is two percent of the corresponding CME Group futures contracts. The daily volume of trades executed in U.S. dollars is less than one percent of the corresponding futures markets.[8]

Congress recognized the importance of liquidity throughout the Dodd-Frank Act. For example, when setting real-time reporting requirements, the CFTC and SEC are required to consider the effects on liquidity when setting block trading exemptions. This is important considering that the average size of a 10 year U.S. dollar interest rate swap was $75 million during 2010, whereas comparable transactions in futures and securities markets are substantially smaller ($2 million for 10 year U.S. Treasury Notes futures and $3 million for U.S. corporate bonds, respectively.)[9] ISDA believes that block trade thresholds should be set so that liquidity is not impaired, in order to ensure that these vital markets enable cost-effective risk-hedging, so vital to the preservation of economic stability. In addition, we do not believe that there is a "one size fits all" solution; rules should be tailored to products and markets. Rules for relatively less liquid products should be different from rules for more liquid products. Uniform rules that do not take into account the structure of the derivatives market will discourage the transfer of risks by U.S. companies, particularly during times of market stress. Firms will be extremely wary of offering firm quotes if they can not effectively hedge the risks they are taking on because of post-trade transparency rules.

The Commissions also are required to consider liquidity when determining which instruments should be subject to new clearing requirements. ISDA believes it is imperative that any new requirements do not impair existing liquidity. Failure to consider such impacts will hurt the fairness, stability and efficiency of the overall market and, in many instances, make it more difficult, or even impossible, to hedge or mitigate risk in an efficient and cost-effective way. We recommend that when considering aspects of the Dodd-Frank Act that could impact liquidity, such as appropriate exceptions to real-time reporting requirements for "block" trades, that the Commissions engage in robust market and impact analyses of these proposals prior to finalizing their rules. ISDA has conducted research on the structure of the interest rate, credit default and equity swaps markets and has sponsored a test on interest rate swaps pricing that is publicly available for review.

Another concern regarding the impact of the Dodd-Frank Act on the liquidity of the derivatives markets and the ability of end-users to hedge their risks relates to the foreign exchange (FX) market. Under the law, the Treasury Department has the ability to exempt FX swaps and forwards from the definition and related regulation of swaps under the law. The FX market is large, liquid, a vital part of the commer-

[8] *http://www.trioptima.com/repository.html.*
[9] *http://www.isda.org/c__and__a/pdf/EquitiesTransparency-Study.pdf.*

cial banking market and essential to economic activity. Classification of FX swaps and forwards as swaps would subject many FX transactions to clearing and execution requirements and would have significant adverse effects on the market for these transactions. For these reasons, ISDA urges the Treasury Department to use the exemptive authority that the Dodd-Frank Act provides to it.

Costs

Although adverse effects on liquidity can be avoided or mitigated in the implementation process, increased costs related to new regulations are often unavoidable. These costs are even higher when creating a new regulatory regime from whole cloth as is the case with the swaps markets; as a result, it is imperative that the Commission recognize the need to accurately assess all costs (both explicit and implicit) and mitigate these costs to the maximum extent possible. These costs can be alleviated by leveraging existing industry processes and practices and by ensuring that new regulations do not go beyond the mandate set by the Dodd-Frank Act.

U.S. Competitiveness

Perhaps most importantly, the implementing Commissions should consider the competitiveness of the U.S. financial markets and U.S. financial firms when setting new requirements. Over 90 percent of the largest U.S. companies use OTC derivatives to manage their business and financial risks. A broader survey of the top 2,200 American companies found that 65 percent use derivatives.[10]

We are concerned that overly restrictive requirements, coupled with increased and unnecessary costs, may result in transfers of businesses and, eventually, jobs overseas. Although the U.S. remains the most dynamic, innovative marketplace in the world, we note that transaction volume in London already exceeds that in New York. We also note that the five largest U.S.-based dealers reported a notional amount outstanding equal to only 37 percent of the total notional amount for interest rate, credit, and equity derivatives.[11] We strongly recommend that the CFTC and SEC engage in thorough market analyses before promulgating new requirements, to ensure that such requirements are not unduly burdensome or likely to create incentives to do business outside the U.S.

* * * * *

In conclusion, we applaud the efforts of the CFTC and SEC to promulgate the massive number of Dodd-Frank Act rulemakings and appreciate the transparency they have attempted to provide. We recommend, however, that the Commissions assure that their rulemaking processes allow for an iterative process between their staff and industry commentators, a complete assessment; an analysis of proposed rules' potential impacts on markets, firms and the U.S. swaps and derivatives markets; and an orderly transition to this new regulatory regime.

ATTACHMENT

March 1, 2010

Identical versions of this letter have been addressed directly to the heads of the primary supervisory agency of each of the regulated signatories.

Hon. WILLIAM C. DUDLEY,
President,
Federal Reserve Bank of New York,
New York, NY.

Dear Mr. Dudley,

The undersigned dealers (each, a G14 Member) and buy-side institutions continue to work collaboratively to deliver structural improvements to the global over-the-counter derivatives markets (OTC Derivatives Markets).[1] This effort is undertaken as part of our ongoing partnership with Supervisors, government departments, trade associations, industry utilities and private vendors. The purpose of this letter is to set forth goals and commitments the fulfillment of which will continue to move

[10] *http://papers.ssrn.com/sol3/papers.cfm?abstract__id=962942.*
[11] *http://www.isda.org/media/press/2010/press102510.html.*
[1] The commitments or undertakings described throughout this letter are subject to the applicable fiduciary responsibilities of signatory firms, including any and all client-specific duties, obligations and instructions.

the market to the standards of resilience and robustness envisaged by bodies such as the G20.[2]

The industry recognizes the significant work that lies ahead, and re-affirms its commitment to aggressively pursue improvements along five overarching themes:

- In order to increase transparency and better understand transparency needs in the OTC Derivatives Market, the signatories will: (a) continue to advance the development of global data repositories; (b) provide relevant Supervisors with: (i) an inventory of existing forms of transparency in OTC Derivatives Markets by product and asset class; (ii) a study which describes and evaluates the spectrum of methods that can be used to increase transparency, analyzes the benefits and costs and attempts to identify to whom such benefits and costs accrue and (iii) relevant transaction data to support the Supervisors' own analysis.
- In order to deliver robust, efficient and accessible central clearing to the OTC Derivatives Markets, the signatories make a strong commitment to increase: (a) the range of products eligible for clearing and (b) the proportion of open interest in the products that are cleared. In support of this commitment, where appropriate, the signatories will work towards the inclusion of users, either through direct access or through indirect client access, including extension of segregation and portability. In order to better reflect the composition of the credit default swap (CDS) market, the signatories who are participants on the ISDA Credit Derivatives Determinations Committees (each, a DC) will propose a framework to involve CDS central counterparties (each, a CCP) in the DC process.
- Drive a high level of product, processing and legal standardization in each asset class with a goal of securing operational efficiency, mitigating operational risk and increasing the netting and clearing potential for appropriate products (recognizing that standardization is only one of a number of criteria for clearing eligibility). Accordingly, workstreams have been established to analyze existing, and where appropriate, potential opportunities for further standardization by asset class and by product.
- Continue to work to enhance bilateral collateralization arrangements to ensure robust risk management, including strong legal and market practices and operational frameworks. In particular, continue the work on resolution procedures for variation margin disputes arising out of bilateral derivatives transactions, and on publication and adoption of best practices among the G14 Members and other signatories. Additionally, continue the consideration of the risks, mitigants and enhancements associated with initial margin.
- Build on improvements in operational performance, with a focus on driving 'electronification', straight-through-processing, and trade date matching, affirmation and processing.

Having recognized the need to act expeditiously to implement a robust and resilient framework for OTC derivatives risk management and market structure, and acknowledging the importance of OTC Derivatives Markets, we have laid out goals with specific targets to the Supervisors in five previous joint industry commitment letters. Since the June 2, 2009 letter, we have completed the following steps:

- Implementation of the industry governance model put forward by ISDA in 2009.
- Further standardization of Credit Derivatives.
- The successful launch of CDS clearing in Europe.
- Initial extension of clearing services to buy-side firms.
- Substantial progress in the implementation of global data repositories.
- Delivery of proposals for improvements to the OTC bilateral collateral processes.
- Continued improvement in industry infrastructure.

These commitment letters represent not only a powerful statement of intent but also evidence of positive action from the industry, and also reflect significant investment of resources and capital.

Contained in the attached Annexes are a series of further commitments which reflect these common themes, and which will support continued progress towards our shared goals of a resilient and robust OTC Derivatives Markets infrastructure. We believe that fulfillment of these commitments will deliver structural improvements

[2] Pursuant to this, we strongly support many of the goals and aspirations set out in relevant white papers and consultation documents published by, *inter alia*, the European Commission, the FRBNY and the UK Treasury/FSA.

to the OTC Derivatives Markets and will thus enable them to continue to perform their crucial function of risk management, while, where appropriate, retaining flexibility in terms of products and execution in a systemically sound construct.

We look forward to our continued collaboration and strong dialogue with the Supervisors and legislators as we drive forward with these fundamental industry initiatives.

From the Managements of:

AllianceBernstein;
Bank of America-Merrill Lynch;
Barclays Capital;
BlackRock, Inc.;
BlueMountain Capital Management LLC;
BNP Paribas;
Citadel Investment Group, L.L.C.;
Citi;
Credit Suisse;
Deutsche Bank AG;
D.E. Shaw & Co., L.P.;
DW Investment Management LP;
Goldman Sachs & Co.;
Goldman Sachs Asset Management, L.P.;
HSBC Group;
International Swaps and Derivatives Association, Inc.;
J.P.Morgan;
Managed Funds Association;
Morgan Stanley;
Pacific Investment Management Company, LLC;
The Royal Bank of Scotland Group;
Asset Management Group of the Securities Industry and Financial Markets Association;
Socíté Générale;
UBS AG;
Wachovia Bank, N.A.;
Wellington Management Company, LLP.

Identical versions of this letter have been addressed directly to the heads of the primary supervisory agency (each, a Supervisor) of each of the regulated signatories, including:

Board of Governors of the Federal Reserve System;
Connecticut State Banking Department;
Federal Deposit Insurance Corporation;
Federal Reserve Bank of New York;
Federal Reserve Bank of Richmond;
French Secretariat General de la Commission Bancaire;
German Federal Financial Supervisory Authority;
Japan Financial Services Agency;
New York State Banking Department;
Office of the Comptroller of the Currency;
Securities and Exchange Commission;
Swiss Financial Market Supervisory Authority;
United Kingdom Financial Services Authority.

CC:

Commodity Futures Trading Commission;
European Commission;
European Central Bank.

ANNEX A—RECENT ACHIEVEMENTS

1. The implementation of a revised and formal ISDA Governance framework, with increased participation of the buy-side in the strategic agenda, policy formation and decision-making process. The newly created ISDA Industry Governance Committee (IIGC), under the auspices of the ISDA Board, provides governance and strategic direction for the product level steering and working groups, and acts as a focal point for the Supervisors and legislators to engage effectively with the industry.

2. Significant progress on product standardization for Credit Derivatives, including, the completion of the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring CDS Protocol (often referred to as the "Small Bang"), which allowed existing Credit Derivative contracts to be modified to provide for Auction Settlement for Restructuring Credit Events.

3. The successful completion of the auction settlement process for Credit Derivatives that included the Modified Modified Restructuring Credit Event after the Thomson Restructuring.

4. The successful application of the DC External Review procedure for the Cemex S.A.B. de C.V. Restructuring Credit Event.

5. Meeting or exceeding clearing targets set in respect of dealer-to-dealer new and historic volume for clearing Eligible Trades[3] in Interest Rate and Credit Derivative products. In excess of 90% of new dealer-to-dealer volume in Eligible Trades of Interest Rate Derivative products, and total dealer-to-dealer volume in Eligible Trades of Credit Derivative products is now cleared through CCPs.

6. Twenty-six of the largest Interest Rates Derivative market makers are currently utilizing the LCH.Clearnet Ltd. SwapClear (LCH) service to clear Interest Rate Derivatives. Six new dealers joined the service in 2009 as direct clearing members and twelve eligible dealers are expected to join in 2010. The service was extended to support clearing of Overnight Index Swaps (OIS) in July 2009. By the end of 2009, the platform had $215 trillion notional and 1.57 million sides outstanding on the system.

7. The successful launch of CDS clearing in Europe and the recent launch of Single Name clearing in Europe and North America.

8. The initial extension of clearing services to the buy-side, with the launch of initial client access to the clearing of Credit Derivatives (ICE Trust on December 14, 2009 and CME on December 15, 2009) and Interest Rate Derivatives (LCH on December 17, 2009).

9. Significant progress in the implementation of global data repositories, with the successful launch of coverage for Credit Derivative and Interest Rate Derivative products. In addition, the selection process for the global data repository for Equity Derivative products has concluded, with launch anticipated on schedule on July 31, 2010.

10. Delivery of proposals for improvements to the OTC collateral process, through Dispute Resolution Procedures that would employ, *inter alia,* portfolio reconciliation, along with formal dispute resolution for intractable disputes.

11. Publication in 2009 of the Roadmap for Collateral Management, which is a forward-looking blueprint for evolving collateralization into a more efficient and effective counterparty credit risk reduction technique. Market participants have implemented several commitments outlined by the Roadmap to date; for example, a regime of daily portfolio reconciliations for collateralized portfolios, allowing firms to identify mismatches and achieve more complete collateralization of risk, and publication of an open standard to facilitate future electronic messaging of margin calls and automation of collateral processes.

12. Continued improvement in industry infrastructure, as measured by further reduction, and in some cases elimination, of unsigned transaction confirmation backlogs, and continued improvement in operating performance metrics.

ANNEX B—TRANSPARENCY

(1) Transparency Study

With respect to the Credit Derivatives, Interest Rate Derivatives and Equity Derivatives Markets, the signatories will deliver to the Supervisors:

- an inventory of existing forms of transparency in OTC Derivative Markets by product and asset class (1st Deliverable);
- a study which (a) describes the spectrum of methods that can be used to increase transparency, (b) analyzes the benefits and costs by product and asset class and (c) attempts to identify to whom the benefits accrue and to whom the costs accrue (2nd Deliverable); and
- relevant transaction data that can be used by the Supervisors to conduct analysis on post trade transparency (3rd Deliverable).

[3] "Eligible Trade" is defined in our prior commitment letter dated September 8, 2009.

The target dates with respect to Credit Derivatives, Interest Rate Derivatives and Equity Derivatives are:

	1st Deliverable	2nd Deliverable	3rd Deliverable
Credit Derivatives	March 31, 2010	June 30, 2010	July 31, 2010
Interest Rate Derivatives	March 31, 2010	August 31, 2010	September 30, 2010
Equity Derivatives	March 31, 2010	August 31, 2010	September 30, 2010

We commit to provide to the Supervisors, by March 31, 2010, a plan and timeline, including concrete milestones and target dates, for accomplishing the 3rd Deliverable.

Each of the Commodities and Foreign Exchange market participants will separately continue their dialogue relating to market transparency issues with the relevant regulators.

(2) Global Data Repositories

(a) Equity Derivatives

We re-affirm our commitment made in the June 2, 2009 letter to Supervisors to implement a centralized reporting infrastructure for all OTC Equity Derivatives by July 31, 2010, with launch currently anticipated on schedule. We will work with the Supervisors to implement a reporting process that is both practical and meets regulatory expectations in regard to the agreed information held in the Equity Derivatives Reporting Repository.

(b) Interest Rate Derivatives

The global Interest Rate Reporting Repository (IRRR) was launched on December 31, 2009, and the G14 Members are now providing monthly reporting from this global data repository on outstanding non-cleared trades to primary regulators. Since initial launch, enhancements have been made to normalize submissions between dealers,[4] and we will continue to work with regulators and the legal community to expand and enhance this reporting process. Our efforts will include the following:

- Include cleared trades in the submission scope by March 15, 2010.
- Expand regulators' reporting to include participant type (G14/CCP/Non-G14) by April 15, 2010.
- Provide public access to aggregate industry notional and trade count data on a monthly basis, in order to provide greater position transparency by April 30, 2010.
- Increase submission and reporting frequency to weekly beginning September 30, 2010.

ANNEX C—CENTRAL CLEARING

(1) Targets

(a) Submission Targets[5] [6]

[4] Since inception of the IRRR, G14 Members have been working with the service provider to ensure that the data aggregation process is as thorough as possible and does not double count trades where G14 Members face each other.

[5] "Eligible Trade" is defined in our prior commitment letter dated September 8, 2009.

[6] An example of why a dealer would want to exclude an Eligible Trade from clearing for counterparty risk management purposes would be where such dealer faces a counterparty bilaterally on two trades which offset each other from a net exposure perspective but where only one trade is an Eligible Trade. Moving the Eligible Trade to a CCP could immediately create a large uncollateralized payable from the counterparty to the dealer with respect to the uncleared (ineligible) trade, thereby increasing counterparty risk. In addition, even where the counterparty posted collateral with respect to such payable within the prescribed timeframe, the lack of the offsetting trade facing the counterparty would increase the dealer's jump to default risk with respect to such counterparty. This problem is magnified considerably where the analysis above is applied on a multi billion dollar OTC derivatives portfolio. With respect to accounting, regulatory capital and balance sheet issues, an example of why a dealer would want to exclude an Eligible Trade from clearing would be where the dealer is hedging an outstanding loan position with the Eligible Trade. The automatic compression that results from trades placed in clearing could effectively "remove" the matched offsetting CDS hedge from the dealer's book. Since the outstanding loan is no longer "paired" with an identifiable hedge (notwithstanding that the dealer's risk position has not changed), the hedge accounting treatment of the loan

Continued

(i) Credit Derivatives

On September 8, 2009, each G14 Member (individually) committed to submitting 95% of new Eligible Trades (calculated on the basis of previously agreed methodology) for clearing. We reaffirm this commitment. Each G14 Member will work with its primary regulator to assess its performance against this target by March 31, 2010. The G14 Members have agreed with the Supervisors to re-evaluate by June 30, 2010, the appropriate target percentage and definition of Eligible Trades to better reflect the need to preserve certain bilateral trades for counterparty risk management, accounting, regulatory capital, balance sheet and customer reasons.

(ii) Interest Rate Derivatives

On September 8, 2009 each G14 Member (individually) committed to submitting 90% of new Eligible Trades (calculated on a notional basis) for clearing. The G14 Members now commit to extend this target so that, each G14 Member (individually) commits to submitting 92% of new Eligible Trades (calculated on a notional basis) for clearing by June 30, 2010.

(b) Clearing Targets

(i) Credit Derivatives

On September 8, 2009, the G14 Members (collectively) committed to clearing 80% of new and historical Eligible Trades (calculated on the basis of previously agreed methodology). The G14 Members (collectively) increase their commitment to clearing from 80% of new and historical Eligible Trades (calculated on the basis of previously agreed methodology) to 85%.

(ii) Interest Rate Derivatives

On September 8, 2009 the G14 Members (collectively) committed to clearing 70% of new Eligible Trades (calculated on weighted average notional basis). The G14 Members (collectively) increase their commitment to clearing from 70% of new Eligible Trades (calculated on weighted average notional basis) to 90% by June 30, 2010.

On September 8, 2009 the G14 Members (collectively) committed to clearing 60% of historical Eligible Trades (calculated on a weighted average notional basis). The G14 Members (collectively) increase their commitment to clearing from 60% of historical Eligible Trades (calculated on weighted average notional basis) to 75% by June 30, 2010.

(2) Expansion of Products Eligible for Clearing

The signatories to this letter commit to continue to provide considerable risk, legal and operational resources and to actively engage with CCPs, regulators and Supervisors globally to broaden the set of OTC Derivatives eligible for clearing, taking into account risk, liquidity, default management and other processes.

Significant issues will need to be analyzed and addressed by CCPs, regulators and market participants in order to begin clearing additional products. The analysis must address risk, legal and operational issues as well as the constraints associated with liquidity, volumes, standardization and fungibility. The process is different at each CCP, but generally requires consultation by a CCP with one or more working groups, a recommendation from a CCP's risk manager, approval by the CCP's risk committee and consultation with or approval by the CCP's primary regulator.

(a) Credit Derivatives

To assist in this analysis, the signatories have asked the Depository Trust & Clearing Corporation (DTCC) to perform an analysis of all

---

could be impacted and the dealer could incur increased regulatory capital charges and detrimental balance sheet treatment.

CDS trades in the Warehouse Trust [7] which are on products not yet eligible for clearing. DTCC expects to deliver the completed analysis by April 15, 2010.

We will prioritize outstanding index transactions not already eligible and single name components of the indices. To that end, (i) the G14 Members have delivered to each relevant CCP (and commit to deliver on a monthly basis) a list of recommended launch targets for new products in order of priority, and (ii) the end-user signatories have delivered (and commit to deliver on a monthly basis) a substantially similar document to each relevant CCP. The signatories will encourage each relevant CCP to provide these lists together with their perspectives to the relevant Supervisors.

(b) Interest Rate Derivatives

We will work with CCPs to prioritize zero coupon swaps, single currency basis swaps and additional swap features utilized by end-users this year, including extending the maximum tenors that can be cleared. Further analysis is required to assist CCPs in prioritizing the next phase of product expansion but we are considering including Forward Rate Agreements, cross-currency swaps, caps, floors, European swaptions and inflation swaps. We commit to developing a plan for the next phase of product expansion before the end of 2010.

(3) Customer Access to Derivatives Clearing

Remaining impediments to the expansion of buy-side access to clearing include legal and regulatory, risk management, and operational issues. Pursuant to our prior commitments, the signatories commit to work together with each relevant CCP [8] to resolve these remaining impediments to the expansion of buy-side access to clearing and to collectively agree the timeframes for the resolution of each such impediment. The process and priorities for each asset class will be targeted to achieve the following goals:

- resolution of all risk, margin, default management, legal and regulatory issues as required to meet the product roll-out schedules established with each CCP, without volume or open interest caps;
- reasonable automated operational access, and completion of end-to-end testing, for qualifying clearing members and their buy-side customers to meet the product roll-out schedules established with each CCP; and
- reasonable access to facilities to allow backloading of trades in eligible products.

Upon the achievement of the above goals, the signatories will make reasonable efforts to work towards increasing utilization of client clearing services. We understand that the Supervisors will closely monitor the industry's progress against the goals above and that if in their monitoring, the Supervisors determine that progress in meeting those goals is unsatisfactory, they will work with industry participants and CCPs to establish concrete methods to ensure that a meaningful amount of open interest in buy-side transactions will be centrally cleared.

To the extent that any impediment requires regulatory action and/or legislative change, the signatories commit to proactively inform the relevant regulatory or legislative bodies.

(a) Credit Derivatives

Pursuant to our prior commitment, customer access to CDS clearing was initiated on December 14, 2009. While this launch represents a significant milestone, it is preliminary and requires further substantial work in order to effectively implement the prior commitment.

To that end, (i) the G14 Members have delivered to each relevant CCP (and commit to deliver on a bi-weekly basis) a current list of open items categorized by importance and priority, the suggested action

[7] DTCC is in the process of transferring the operations of the Trade Information Warehouse for CDS to a recently organized subsidiary, The Warehouse Trust Company LLC (Warehouse Trust).

[8] As per the June 2, 2009 commitment letter, a CCP that has (a) broad buy-side and dealer support and (b) a commitment to develop viable direct and indirect buy-side clearing models.

plan, responsible parties and target date for completion of all critical items and the current targets for launching new products as referenced above, and (ii) the end-user signatories have delivered (and commit to deliver on a monthly basis) a substantially similar document to each relevant CCP. The signatories will encourage each relevant CCP to provide these lists together with their perspectives to the relevant Supervisors expeditiously. In addition, the signatories commit to work with each relevant CCP to arrive at a unified list of open items and to encourage each relevant CCP to provide such lists to the Supervisors on an ongoing basis.

(b) Interest Rate Derivatives

Customer access to Interest Rate Derivatives clearing was initiated in the LCH service on December 17, 2009. This launch represents a significant milestone in extending clearing services to clients. Clients access the LCH CCP through the existing direct clearing members, and the eligible product set is aligned with those products that can currently be cleared through the existing inter-dealer service.

The signatories recognize the Supervisors' policy goal of making available to the buy-side the benefits of client clearing for Interest Rate Derivatives. The signatories commit to work together to make available to the industry an effective client clearing framework.

We commit to creating working groups for relevant CCPs (where they do not exist already) by March 31, 2010, encompassing key buy-side, sell-side and CCP representation. These CCP working groups will meet at least monthly and focus on identifying and resolving the barriers to clearing to the extent possible and will report progress back to Supervisors on an ongoing basis.

(4) CCP Involvement in ISDA Credit Derivatives Determinations Committees

Interim Regulatory Guidance on CCP Governance and Market Protocols issued by the CPSSIOSCO RCCP Working Group on December 15, 2009, states that CCPs' interests should be represented on the DCs as they participate in the Credit Derivatives Market by providing clearing services and are expected to adhere to market protocols. The signatories who are members of the various DCs agree to put forth by April 30, 2010 a specific proposed framework [9] to implement observer status for CCPs and will urge the various DCs to act promptly thereon. The signatories commit, from time to time upon the request of the CCPs, to ask the DCs, in consultation with Supervisors, to re-evaluate the CCPs' observer status to determine the appropriate membership role of CCPs.

ANNEX D—STANDARDIZATION

(1) Credit, Interest Rate and Equity Derivatives

We commit to drive a high level of product, processing and legal standardization in each asset class with a goal of securing operational efficiency, mitigating operational risk and increasing the netting and clearing potential for appropriate products (recognizing that standardization is only one of a number of criteria for clearing eligibility). Accordingly, workstreams have been established to analyze existing, and where appropriate, potential opportunities for further standardization, and a standardization matrix will be completed in partnership with the Supervisors.

(2) Equity Derivatives

A very significant portion of the Equity Derivatives market is highly standardized and is already traded on-exchange and settled through a clearing house. The OTC portion of the Equity Derivatives Market consists of a number of different products at varying levels of standardization, complexity, and customization. Documentation standardization improvements will therefore vary by product and region.

[9] Inclusion of CCPs active in credit default swap clearing as observers on various DCs will require amendments to the Credit Derivatives Determinations Committee Rules. Amendments of this type require a supermajority (80%) vote as well as a 7 day public consultation period. The signatories who are on the various DCs will consult with the regulators on preparation of this framework.

We re-affirm our commitment to review, update and expand the 2002 Equity Definitions by December 31, 2010 in accordance with the Equity Documentation framework document published on January 30, 2009.

The project is multifaceted and includes:

- consolidation, review and updating of the 2002 Equity Definitions and subsequent master confirmation agreement (MCA) publications;
- expansion of existing 2002 Equity Definitions coverage to include a wider set of product types, pay offs and underliers; and
- introduction of a menu approach to facilitate standardization of contractual terms and product flexibility.

During the 2011 implementation of the 2010 Equity Definitions, the signatories commit to using the range of menu items as published in the 2010 Equity Definitions to create matrices and MCAs for products agreed by the industry.

We commit to providing verbal updates to the Supervisors on 2010 Equity Definitions progress on a 6 weekly basis commencing March 31, 2010.

Alongside the 2010 Equity Definitions, we commit to complete the following MCA projects by April 30, 2010:

- European Interdealer Index Swap Annex (Annex EFIS);
- EMEA EM Options Annex (Interdealer); and
- European Interdealer Fair Value Swap Annex (Annex FVSS).

We will continue to monitor non-electronically eligible volume in order to identify product eligibility for documentation standardization, according to our previously committed 2% threshold. We will use this information to ensure that the products identified have appropriate coverage in the 2010 Equity Definitions so delivery of new MCAs can be prioritized after the 2010 Equity Definitions are published.

Furthermore, we commit, upon request from a relevant counterparty (dealer or buy-side), to review existing MCAs with the counterparty in order to determine if with respect to an existing MCA there exists a preference to have the relevant ISDA published MCA govern all relevant new transactions executed after an agreed future date *in lieu of* such existing MCA. If such preference exists, the parties commit to negotiate in good faith a new MCA utilizing the ISDA published MCA with such modifications as the parties may agree in good faith and will mutually agree whether to migrate existing transactions under the new MCA or to leave existing transactions under previously agreed MCAs until termination or maturity.

ANNEX E—COLLATERAL

In this letter we set out new goals in the areas of *Portfolio Reconciliations* and *Dispute Resolution.* We also commit to update the *Roadmap for Collateral Management.* In particular, addressing one of the top concerns of the Supervisors, we reaffirm our intention to develop an enhanced industry framework for resolving disputed margin calls. The industry has made good progress in developing and testing the initial Dispute Resolution Procedure (DRP). In addition to the DRP, which focuses on the resolution of disputes after they have occurred, market participants recognize that disputes must also be tackled by prevention and increased escalation to regulators. The new commitments below reflect a multi-pronged strategy to address margin disputes, including measures designed to prevent, detect, resolve and report them to regulators.

The signatories are pleased to make the following new commitments:

(1) Collateral Roadmap

We commit to update the Roadmap for Collateral Management by April 15, 2010 based on the recommendations from the Independent Amount white paper (March 1, 2010) and the Market Review of Collateralization (March 1, 2010). Because of the wide-ranging nature of those recommendations, we will seek engagement from dealers, end-users, custodians, regulators and legislators as appropriate in order to determine the best path towards implementation.

(2) Portfolio Reconciliation

The commitments already made by the industry with respect to Portfolio Reconciliation have proven effective at reducing the incidence and size of margin disputes.[10] In addition, ISDA has published a Feasibility Study for Extending Collateralized Portfolio Reconciliations (December 2009) and the follow-on Implementation Plan for Wider Market Roll-out (February 2010).[11] Consistent with those recent publications, we commit that:

(a) The signatories will undertake reconciliation (bilateral where possible and otherwise unilateral)[12] of collateralized portfolios with any OTC counterparty comprising more than 1,000 trades at least monthly by June 30, 2010.

(b) Signatory firms will expand the current monthly Portfolio Reconciliation reports submitted to the Supervisors to reflect the above commitment by July 31, 2010.

(3) Dispute Resolution

Market experience has shown that although disputed margin calls may need to be addressed by formal methods of dispute resolution in some rare circumstances, a larger proportion of dispute events can be addressed by prevention and escalation to regulators. Therefore we make the commitments below which reflect the three distinct ways in which the risks of disputed margin calls must be addressed:

(a) Preventing Disputes From Arising

As described above under "Portfolio Reconciliation".

(b) Detecting Disputes Early and Resolving Them Definitively

The DRP continues to undergo the process of testing and further refinement commenced in Q4 2009. We commit to provide regular updates for each phase of the DRP evolution with the intention to complete this process by September 30, 2010.

(c) Reporting Disputed Collateral and Exposure Amounts

We commit to develop consistent reporting that provides the Supervisors with the ability to assess the top margin disputes that potentially pose significant risk by May 31, 2010. We will provide a pro forma template for such reporting to the Supervisors by April 15, 2010 to seek their input on content and presentation.[13]

ANNEX F—OPERATIONAL EFFICIENCY TARGETS

(1) Credit Derivatives

(a) Central Settlement

---

[10] This is illustrated by the dispute reporting provided in private by firms to their regulators showing dispute levels significantly reduced from a year ago.

[11] These documents embody a response to recommendation V–10 of "Containing Systemic Risk: The Road to Reform" (CRMPG III, August 2008).

[12] The majority of smaller portfolios are between G14 Members and end-users, not all of whom are equipped to perform bilateral portfolio reconciliation (where both parties work together using a central reconciliation service to resolve trade level differences). Therefore, although bilateral reconciliation is preferred, as a fallback this commitment is based on a unilateral reconciliation performed by the dealer. In order to promote the extension of portfolio reconciliation discipline more deeply into the wider market, the only practical solution is for dealers to perform the reconciliation for both parties where necessary. In order for a dealer to perform a unilateral reconciliation, a dealer's counterparty needs to provide a data file representing such counterparty's view of the portfolio in a reconcilable and standard format. ISDA has published Collateralized Portfolio Reconciliation Best Practices and data Minimum Market Standards to guide the market in this respect. Dealers will use commercially reasonable efforts to gain the cooperation of their counterparts in obtaining these files. The degree to which these requests are satisfied will be made transparent in the expanded portfolio reconciliation reporting provided to regulators, and after a period of several months industry participants and regulators should review cooperation levels.

[13] Industry practitioners will work with regulators over coming weeks to establish the appropriate reporting criteria and thresholds. The intention is to identify margin disputes of significance. Included in this consideration for materiality are likely to be dispute scale (disputes exceeding an established amount) and dispute persistence (disputes aged over an established number of days).

The Credit Derivatives market has benefitted from the increased usage of central settlement,[14] and industry participants remain committed to settlement automation. The quality of the existing bilateral settlement mechanisms, coupled with the likely increased penetration of clearing into the Credit Derivatives market, limits the benefits associated with any additional central settlement service beyond the existing use of CLS. As a consequence, the industry's resources will focus on the resolution of the other commitments identified within this letter.

(b) Submission Timeliness/Matching

MarkitSERV remains the primary service provider within the Credit Derivatives realm, with more than 99% of electronically confirmed trades being processed on MarkitSERV and greater than 90% of these trades confirmed electronically on trade date. We reiterate our commitment to achieving T+0 submission and matching.

Given the significant architectural changes to the Credit Derivatives infrastructure in support of our efforts to achieve (i) interoperability with clearing solutions and (ii) trade date matching through improvements to the novation consent process and associated technology enhancements, we commit to an ongoing periodic review of existing commitments for both T+0 submission (currently 90%) and T+2 matching (currently 94%), for electronically eligible transactions, with the Supervisors.

(2) Equity Derivatives

(a) Electronic Eligibility

We re-affirm our commitment to set blended targets for electronically eligible OTC Equity Derivative transactions. For purposes of measuring targets, confirmations that are deemed eligible for inclusion (Electronically Eligible Confirmations) will include:

(i) confirmations for products (Electronically Eligible Products) that;

(A) have an ISDA published MCA (irrespective of whether such ISDApublished form or pre-existing bilateral form is used),[15] and

(B) can be matched on an electronic platform; and

(ii) confirmations of Confirmable Lifecycle Events[16] for transactions which were executed on an electronic platform under existing bilateral MCAs but for which an ISDA MCA is subsequently published and which are currently confirmable on an electronic platform will be deemed Electronically Eligible Confirmations as of the date that the relevant product becomes an Electronically Eligible Product. Confirmations of Confirmable Lifecycle Events for transactions that were originally confirmed on paper will not be deemed Electronically Eligible Confirmations.

(b) Electronic Confirmation Targets

We commit to processing, by June 30, 2010, 75% of Electronically Eligible Confirmations on an electronic platform. We further commit to increasing this target to 80% by September 30, 2010.

Furthermore, we commit to publishing an Electronic Eligibility Matrix[17] of Electronically Eligible Products and Confirmable Lifecycle Events by March 1, 2010 and will publish an updated version of this matrix on a quarterly basis.[18]

(c) Submission Timeliness/Matching

We commit to the following targets:

---

[14] 79% of all CDS trades in the Warehouse Trust were centrally settled for the December 2009 quarterly roll Electronic Confirmation Targets Submission.

[15] Products which do not have an ISDA published MCA will not be included in this target irrespective of whether a bilateral MCA exists.

[16] Confirmable Lifecycle Events will be identified in the Electronic Eligibility Matrix.

[17] The matrix will be published on the ISDA website on March 1, 2010 and on a quarterly basis thereafter.

[18] New products will be deemed Electronically Eligible Products 90 days following the date on which both an ISDA MCA has been published and such product is supported by an electronic platform.

- By June 30, 2010, 95% T+1 submission and 95% T+3 matching of global options and variance swaps between G14 Members for Electronically Eligible Confirmations processed on an electronic platform.
- By June 30, 2010, 70% T+1 submission and 75% T+5 matching of Discrete total return swaps [19] between G14 Members for Electronically Eligible Confirmations processed on an electronic platform.
- By September 30, 2010, 90% T+1 submission and 90% T+5 matching for G14 Members *versus* all counterparties for Electronically Eligible Confirmations processed on an electronic platform.

(d) Confirmation Backlog Reduction

By June 30, 2010, we commit that outstanding confirmations aged more than 30 calendar days are not to exceed 1 business day of trading volume based on average daily volume in the prior 3 months.

(e) Cash Flow Matching

We commit to publishing a cash flow matching implementation plan to the Supervisors by March 31, 2010 with a further commitment to deliver cash flow matching functionality by December 31, 2010.

(3) Interest Rate Derivatives

(a) Central Settlement

The increased penetration of central clearing into the Interest Rate Derivatives market in 2010 will significantly reduce the volume and size of bilateral settlements between market participants. This reduction in bilateral activity will take place against a backdrop of strong existing risk management practices where only 0.59% of gross settlements have post-value date discrepancy [20] and 0.1% of these issues persist 30 days after settlement date. As a consequence, the industry's resources will be focused on the delivery of the other commitments identified in this letter. We will continue to monitor the incidence of post value date issues of gross settlements over time to ensure no risk mitigating initiatives are required.

(b) Rates Allocation Commitment

MarkitSERV will deliver electronic allocation delivery functionality consistent with the requirements gathered at the Allocation Industry Working Group meetings. We will provide the Supervisors with a plan by March 31, 2010 to achieve this.

The scope of the project will include the ability for buy-side users to electronically submit allocations to dealers in either a single step, where allocations plus confirmation occur, or a two-step process, where electronic allocation delivery is distinct from confirmation. Further planned functionality caters to additional workflows where buy-side clients submit allocations directly on pending trades or where the system matches grouped allocations to dealer block trades. Confirmation of Independent Amount percentage at an allocation level will be in scope.

(c) Electronic Confirmation Targets

We commit to the following electronic confirmation targets:

- By June 30, 2010, 93% of electronically eligible confirmable events with G14 Members will be processed on electronic platforms, with a further commitment to achieve 95% by December 31, 2010; and
- By June 30, 2010, 60% of electronically eligible confirmable events with all other participants will be processed on electronic platforms with a further commitment to provide a plan

[19] As defined in the December 10, 2008 EFS Roadmap.

[20] A post-value date discrepancy may be defined as any mismatch in settlement amounts or value-date or a failure to settle funds on the date expected. Such discrepancies are typically investigated and resolved by operational control groups within the respective organizations.

for the implementation of a more streamlined process for low volume clients also by June 30, 2010.[21]

(d) Submission Timeliness/Matching

The launch of MarkitSERV's interoperable confirmation service enables market participants to use DTCC Deriv/SERV or Markitwire, regardless of what service their counterparty uses. Interoperability eliminates the requirement to process confirmations independently on Markitwire or DTCC/DerivSERV and we believe the process should be subject to new performance targets. With 87% of electronically confirmed trades being processed on Markitwire and greater than 98% of these trades confirmed on trade date, we commit to the following targets upon adoption of MarkitSERV interoperability, with a commitment to review and re-evaluate these targets with Supervisors on a quarterly basis to get to a steady state and progress toward T+0 submission and matching:

- Submit 90% of electronic confirmations no later than T+0 business days by September 30, 2010.
- Match 97% of electronic confirmations no later than T+2 business days by September 30, 2010.

(e) Confirmation Backlog Reduction

By April 30, 2010: We commit that electronic and paper outstanding confirmations aged more than 30 calendar days are not to exceed 0.20 business day of trading volume based on the prior 3 months rolling volume and we commit to continue reporting these targets on a monthly basis. We commit to review and re-evaluate this target with Supervisors on a quarterly basis to get to a steady state and progress towards T+0 matching.

The CHAIRMAN. Thank you, Mr. Pickel. Mr. Morrison for 5 minutes.

STATEMENT OF SCOTT C. MORRISON, SENIOR VICE PRESIDENT AND CFO, BALL CORPORATION; CHAIRMAN, NATIONAL ASSOCIATION OF CORPORATE TREASURERS, BROOMFIELD, CO; ON BEHALF OF THE COALITION FOR DERIVATIVES END-USERS

Mr. MORRISON. Thank you, Mr. Chairman, Ranking Member Peterson, and the Committee. My name is Scott Morrison. I am Senior Vice President and Chief Financial Officer of Ball Corporation, and Chairman of the National Association of Corporate Treasurers. Collectively, we are also members of the Coalition for Derivatives End-Users. The Coalition represents thousands of companies across the U.S. that employ derivatives to manage risks. It is a privilege to speak with you today.

Ball Corporation is based in Colorado, and we operate over 30 manufacturing locations in the U.S. We operate in nearly 70 percent of the states represented by the Agriculture Committee that I have the honor of addressing today. We are a 131 year-old publicly traded company with deep roots in supplying packaging to the food, beverage, and consumer product industries in the U.S. Approximately 65 percent of our 14,500 employees work in the United States. We support the efforts of this Committee to reduce systemic risk and increase transparency in the over-the-counter derivatives markets.

[21] The Rates Implementation Group is performing analysis on the non-G14 Member volume to understand the material impact of those customers executing four or fewer electronically eligible trades per month.

While I agree that the reckless and over-leveraged use of derivatives by systemically significant institutions can have dire consequences, the prudent use of derivatives by end-users like us should not be put into the same category. For end-users like ourselves, OTC derivatives provide a critical risk management tool to reduce commercial risk and volatility in our normal business operations, allowing us to create sustainable and prosperous businesses. I am here today to share with you our perspective on a couple of these matters.

Our use of derivatives is driven by the desire to reduce commercial risk associated with our business. Ball's largest business, beverage can manufacturing, involves buying over $3 billion of aluminum coils per year, converting those coils into cans, and selling them to large beverage and food companies. We are able to use OTC swaps to exactly match the prices and timing of when we buy coils of aluminum to when we sell the completed cans. This risk management technique allows us to prudently manage our costs and reduce volatility of price changes during the manufacturing process and over multi-year sales agreements. We have used this risk management process for over 15 years with no adverse consequences.

We believe a broad end-user exemption is a critical feature of derivatives legislation. During the regulatory process, we have sought to ensure that the exemption provided for by Congress would not be unduly narrowed. In particular, we have urged regulators to give thoughtful consideration to key definitions to ensure that end-users like us are not regulated as if we dealt in speculative swaps.

The second area I would like to address is that of margin to be posted on future or even previously entered into contracts. Such a requirement would be particularly troublesome to end-users like Ball. A requirement for end-users to post margin would have a serious impact on our ability to invest in and grow our business. For example, Ball is currently investing significant amounts of capital in plant expansions in Texas, Indiana, California, and Colorado, totaling well in excess of $150 million, and adding several hundred jobs when complete. Tying up capital for initial and variation margin could put those types of projects at risk at a time when our economy can ill afford it. The impact of posting initial margin for us can easily exceed $100 million, while the change in value on our trades over time could easily surpass $300 million. Diverting more than $400 million of working capital into margin accounts would have a direct and adverse impact on our ability to grow our business and create and maintain jobs.

In short, margin requirements will cost the communities in which we are located literally hundreds of good new jobs.

Additionally, because of the importance of this market to main street businesses like Ball, we believe it is critical to get the regulation right. The current rulemaking timeline is aggressive, and may force regulators to prioritize speed over quality. We would urge Congress to provide regulators with more time for rulemaking and for regulators to allow market participants sufficient time for implementation. This is critical to ensure that the market participants have ample opportunity to provide useful feedback and en-

suring this important market continues to function with minimal disruption.

As regulators go about the important work of finalizing the rules that address the lessons learned from the financial crisis, it is of the utmost importance that they do so in a manner that does not break those things that function well. Though it may be tempting to view all derivatives ask risky financial products that were central to the credit crisis, we must remember that these are important tools upon which thousands of companies like ours depend to manage risks in the economy.

Thank you for your time.

[The prepared statement of Mr. Morrison follows:]

PREPARED STATEMENT OF SCOTT C. MORRISON, SENIOR VICE PRESIDENT AND CFO, BALL CORPORATION; CHAIRMAN, NATIONAL ASSOCIATION OF CORPORATE TREASURERS, BROOMFIELD, CO; ON BEHALF OF COALITION FOR DERIVATIVES END-USERS

Good afternoon, my name is Scott Morrison. I am Senior Vice President and Chief Financial Officer of Ball Corporation and Chairman of the National Association of Corporate Treasurers ("NACT"), an organization of Treasury professionals of several hundred of the largest public and private companies in this country. Collectively, we are also a member of the Coalition for Derivatives End-Users ("Coalition"). The Coalition represents thousands of companies across the United States that employ derivatives to manage risks they face in connection with their day-to-day businesses. It is a privilege to have the opportunity to speak with you today on behalf of both our company, and the NACT about the new derivatives legislation. Ball Corporation is based in Colorado and we operate over 30 manufacturing locations in the U.S. We operate in nearly 70% of the states represented by the Agriculture Committee I am addressing today. We also operate another 25 locations around the world. We are a 131 year old publicly traded company with deep roots in supplying packaging to the food, beverage and consumer product industries in the U.S.; our customers include Coca-Cola, Pepsi, Miller Coors and Anheuser Busch InBev along with ConAgra Foods, Abbott Labs and numerous family-owned beverage fillers and food packers. Approximately 75% of our 14,500 employees reside in the United States.

We understand and support the efforts of this Committee to reduce systemic risk throughout the financial system to avoid the issues that contributed to the financial turmoil that boiled over in 2008 and also we applaud your efforts to increase transparency in the over-the-counter ("OTC") derivatives markets. While I would agree that the reckless and over-leveraged use of derivatives by systemically significant institutions can have dire consequences, the prudent use of derivatives by manufacturers such as ourselves and the vast majority of end-users like us should not be put into the same category. For end-users like ourselves the prudent use of derivatives provides us a critical risk management tool to reduce commercial risk and volatility in our normal business operations allowing us to create sustainable and prosperous businesses. I am here today to share with you our perspective on these matters and want to specifically address three areas of the legislation: an appropriate end-user exemption; margin requirements; and the need to avoid overly complex clearing and reporting. I would like to take a minute to address each in greater detail.

Our use of derivatives is driven by the desire to reduce commercial risk associated with our business. Ball's largest business (beverage can manufacturing) involves buying over $3 billion of aluminum coils per year, converting those coils into cans and selling them to large beverage and food companies mentioned earlier. As aluminum is an actively traded commodity, we are able to use OTC swaps to exactly match the prices and timing of when we buy coils of aluminum to when we sell the completed cans. This risk management technique allows us to prudently manage our costs and reduce volatility of price changes during the manufacturing process as well as over the life of multi-year contracts. We have used this risk management process for over 15 years with no adverse consequences. We clearly are not a trading operation. Our policies state that speculation is forbidden—a policy consistently applied by end-users generally. While our use of derivatives can be substantial, our hedges are executed to reduce commercial risk. Not executing the swaps would create more volatility in our business outcomes. We believe a broad end-user exemption is a critical feature of derivatives legislation. During the regulatory process, we have

sought to ensure that the exemption provided for by Congress would not be unduly narrowed. In particular, we have urged regulators to give thoughtful consideration to key definitions, including major swap participant and swap dealer, to ensure that manufacturers and other end-users like us are not regulated as if we dealt in speculative swaps.

The second area I would like to address is that of margin to be posted on future or even previously entered into contracts; this requirement would be particularly troublesome to end-users like Ball Corporation. Retroactive application of a margin requirement would upset the reasonable expectations we had when entering into existing risk management contracts. These expectations are negotiated extensively in ISDA agreements that we have with our financial counterparties. Those arrangements have already included a credit cost that we have paid, so retroactive application of margin requirements would essentially double our costs. A requirement for end-users like Ball Corporation to post margin to its counterparties would have a serious impact on our ability to invest in and grow our business. For example, Ball Corporation is currently investing significant amounts of capital in plant expansions we are currently executing in Texas, Indiana, California and Colorado. Those expansions alone are investments totaling well in excess of $150 million and will add several hundred jobs when complete. Tying up capital for initial and variation margin could put those types of projects at risk at a time when our economy can ill afford it. The impact of posting initial margin for us can easily exceed $100 million, while the change in value on our trades over time could easily surpass $300 million in required capital that would be removed from productive economic use. Notably, diverting more than $400M of working capital into margin accounts would have a direct and adverse impact on our ability to grow our business and create and maintain jobs. In short, margin requirements will cost the communities in which we are located literally hundreds of good, new jobs.

The third area to focus on is avoiding the creation of rigid and expensive trading requirements that could cause the unintended consequence of companies either retaining more risk or to seek risk management alternatives overseas. We are not a "trading house" our activity in derivatives is not daily or even weekly. In addition, by utilizing over-the-counter swaps we are able to customize our hedges to perfectly match the underlying exposure. If we were required to use only standardized or exchange traded hedge products we would not create the risk offset we currently achieve today and this would result in both accounting and real economic volatility. Though end-users are not directly subject to such requirements, excessive capital requirements imposed on our financial counterparties could significantly increase our costs. Though these capital requirements should be appropriate for the risk of the product, they should not be increased in such a manner so as to deter prudent use of uncleared over-the-counter derivatives by end-users. The end result and unintended consequence of margin requirements applied to end-users or excessive capital requirements applied to our financial counterparties could be to reduce the risk management activity of end-users, a result which would actually increase systemic risk or even push transactions offshore. Neither of these would be favorable to our economy.

Additionally, because of the importance of this market to main street businesses like Ball Corporation, we believe it is critical to get the regulation right. The current rulemaking timeline is aggressive, and may force regulators to prioritize speed over quality. Doing so could hurt companies' ability to manage their risks. We would urge Congress to provide regulators with more time for rulemaking, *and* for regulators to allow market participants sufficient time for implementation. This is critical to ensuring that market participants have ample opportunity to provide useful feedback, and to ensuring this important market continues to function with minimal disruption. Chairman Gensler has reached out to businesses for input on a realistic implementation timeline. That is a positive step and one that we appreciate greatly. However, developing a workable implementation timeline still would not fix the problem of too many rules being promulgated over too little time. The statutory effective date must be extended for end-users to be able to participate meaningfully in the regulatory development process.

As regulators go about the important work of finalizing the rules that address the lessons learned of the financial crisis, it is of the utmost importance that they do so in a manner that does not break those things that functioned well. I am confident that the way in which these products are utilized by our company, and end-users generally, provides important benefits to the economy, including reduced volatility and greater stability to a significant sector of the economy. Though it may be tempting to view all derivatives as risky financial products that were central to the credit crisis, we must remember that these are important tools upon which thousands of

companies depend to managing risks in the real economy. Thank you for your time and I am happy to answer any questions that you have.

The CHAIRMAN. Thank you, Mr. Morrison. Mr. Olesky? Did I butcher your name?

Mr. OLESKY. Olesky.

The CHAIRMAN. Olesky, sorry about that.

STATEMENT OF LEE OLESKY, CHIEF EXECUTIVE OFFICER, TRADEWEB, NEW YORK, NY

Mr. OLESKY. Thank you, Mr. Chairman, Ranking Member Peterson, and Members of the Committee. Good afternoon. Thank you for inviting me to participate in this hearing. My name is Lee Olesky. I am Chief Executive Officer of Tradeweb, and I appreciate the opportunity to testify today about the implementation of Title VII of the Dodd-Frank Act.

For the last 12 years, Tradeweb has been on the forefront of creating electronic trading solutions for the bond markets. Before platforms like Tradeweb were established, institutional clients picked up the phone and spoke to one or more dealers in order to buy or sell U.S. Treasury government bonds. In 1998, Tradeweb established an electronic marketplace for U.S. Treasury securities and transformed a phone-based opaque government bond market into a more transparent and efficient market.

As a result of this evolution, institutional clients such as asset managers and pension funds now have access to regulated trading systems that provide greater price transparency and more efficient execution, which has the added benefit of reducing operational risk, the very goals of Title VII of Dodd-Frank.

Several years ago, Tradeweb expanded into derivatives and began offering an execution facility for interest rate and credit derivatives. So when Congress passed Dodd-Frank and created a new type of registered trade execution venue, a swap execution facility, or SEF, Tradeweb was extremely well-positioned to become a SEF and meet the stated policy objectives for SEFs to improve price transparency, and promote the trading of swaps on regulated electronic markets.

Whether it is for government bonds or any other instrument traded on the 20 markets we operate around the world, our focus has always been on using technology to create products and services for our clients. This has resulted in more transparent and efficient bond markets globally.

What we have learned in the last 12 years is how important it is to evolve our technology based on our client's current and future needs. Thus, while Tradeweb is supportive of the goals of the Act, Congress and the regulators should understand and give due consideration to the needs of the market participants. We believe the key for achieving the policy objectives for SEFs, which is greater transparency and promoting the trading of swaps on regulated markets, is to provide for flexibility in the way that market participants can trade swaps on those regulated markets.

By ensuring that the rules retain sufficient flexibility for market participants, clients can trade in a manner that suits their trading strategies and risk profiles. Some institutions will want to transact on live prices, some will want to use a disclosed request for quote

model, known as an RFQ, others will still want to transact through an anonymous order book, which is similar to an exchange. We believe regulators should not mandate that clients pick one model to trade on. They must be flexible to achieve the goals of the Act without materially disrupting the market. Creating arbitrary or artificially prescriptive limitations on the manner in which market participants interact and trade could result in liquidity drying up, and add increased costs to trade swaps. This could move participants away from executing in the swap markets, which we know is not the goal of Title VII, Congress, or the regulators.

Along the same lines, overly prescriptive ownership limits or governance requirements for SEFs or DCMs will impact the ability to attract investment capital in new or existing platforms. A careful balance needs to be reached between mitigating conflicts and encouraging private enterprise, which will encourage investment and innovation. For example, it would have been very difficult for Tradeweb to have raised its seed capital in future investments if investors were told that more than half of our Board would be made up of independent directors with no ties to the company.

In conclusion, we are supportive of the goals to reform the derivatives markets, and indeed, we provide the very solutions the regulations seek to achieve, but we are concerned the Commissions may overreach in their interpretation and implementation of Dodd-Frank, and in doing so, create unintended consequences for market participants and the marketplace as a whole.

We hope that our experience in the electronic markets can be helpful and instructive as Congress and the regulators take on the great challenge of implementing Title VII of Dodd-Frank. Thank you.

[The prepared statement of Mr. Olesky follows:]

PREPARED STATEMENT OF LEE OLESKY, CHIEF EXECUTIVE OFFICER, TRADEWEB, NEW YORK, NY

Tradeweb Markets LLC (“***Tradeweb***”) appreciates the opportunity to provide testimony to the House Agriculture Committee with respect to swap execution facilities (“***SEFs***”) and the impact of the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) under the proposed regulations from the Commodity Futures Trading Commission (“***CFTC***”) and U.S. Securities and Exchange Commission (“SEC”, together with the CFTC, the “Commissions”).

I. Background on Tradeweb

Tradeweb is a leading global provider of electronic trading platforms and related data services for the OTC fixed income and derivatives marketplaces. Tradeweb operates three separate electronic trading platforms: (i) a global electronic multi-dealer to institutional customer platform through which institutional investors access market information, request bids and offers, and effect transactions with, dealers that are active market makers in fixed income securities and derivatives, (ii) an inter-dealer platform, called Dealerweb, for U.S. Government bonds and mortgage securities, and (iii) a platform for retail-sized fixed income securities.[1]

[1] Tradeweb operates the dealer-to-customer and odd-lot platforms through its registered broker-dealer, Tradeweb LLC, which is also registered as an alternative trading system (“ATS”) under Regulation ATS promulgated by the SEC under the Securities Exchange Act of 1934. Tradeweb operates its inter-dealer platform through its subsidiary, Hilliard Farber & Co., Inc., which is also a registered broker-dealer and operates Dealerweb as an ATS. In Europe, Tradeweb offers its institutional dealer-to-customer platform through Tradeweb Europe Limited, which is authorized and regulated by the UK Financial Services Authority as an investment firm with permission to operate as a Multilateral Trading Facility. In addition, Tradeweb Eu-

Founded as a multi-dealer online marketplace for U.S. Treasury securities in 1998, Tradeweb has been a pioneer in providing market data, electronic trading and trade processing in OTC marketplaces for over 10 years, and has offered electronic trading in OTC derivatives on its institutional dealer-to-customer platform since 2005. Active in 20 global fixed income, money market and derivatives markets, with an average daily trading volume of more than $250 billion, Tradeweb's leading institutional dealer-to-customer platform enables 2,000 institutional buy-side clients to access liquidity from more than 40 sell-side liquidity providers by putting the liquidity providers in real-time competition for client business in a fully-disclosed auction process. These buy-side clients comprise the majority of the world's leading asset managers, pension funds, and insurance companies, as well as most of the major central banks.

Since the launch of interest rate swap ("***IRS***") trading in 2005, the notional amount of interest rate derivatives traded on Tradeweb has exceeded $5 trillion from more than 65,000 trades. Tradeweb has spent the last 5 years building on its derivatives functionality to enhance real-time execution, provide greater price transparency and reduce operational risk. Today, the Tradeweb system provides its institutional clients with the ability to (i) view live, real-time IRS (in six currencies, including U.S., Euro, Sterling, Yen), and Credit Default Swap Indices (CDX and iTraxx) prices from swap dealers throughout the day; (ii) participate in live, competitive auctions with multiple dealers at the same time, and execute an array of trade types (*e.g.,* outrights, spread trades, or rates switches); and (iii) automate their entire workflow with integration to Tradeweb so that trades can be processed in real-time from Tradeweb to customers' middle and back offices, to third-party affirmation services like Markitwire and DTCC Deriv/SERV, and to all the major derivatives clearing organizations. Indeed, in November 2010, Tradeweb served as the execution facility for the first fully electronic dealer-to-customer interest rate swap trade to be cleared in the U.S. Tradeweb's existing technology maintains a permanent audit trail of the millisecond-by-millisecond details of each trade negotiation and all completed transactions, and allows parties (and will allow SDRs) to receive trade details and access post-trade affirmation and clearing venues.

With such tools and functionality in place, Tradeweb is providing the OTC marketplace with a front-end swap execution facility. Moreover, given that it has the benefit of offering electronic trading solutions to the buy-side and sell-side, Tradeweb believes that it can provide the Commissions with a unique and valuable perspective on the proposed rules.

As additional background, Tradeweb was established in 1998 with financial backing from four global banks that were active in, and interested in expanding and fostering innovation in, fixed income (U.S. Government bond) trading. After 6 years of growth and expansion into 15 markets globally, in 2004, Tradeweb's bank-owners (which had grown from four to eight over that time) sold Tradeweb to The Thomson Corporation, which wholly-owned it until January 2008. Although the original bank-owners continued to be a resource for Tradeweb from 2004 to 2008, The Thomson Corporation recognized that bank ownership was an important catalyst of Tradeweb's development and sold through a series of transactions a strategic interest in Tradeweb to a consortium comprised of ten global bank owners. Today, Tradeweb is majority owned by Thomson Reuters Corporation (successor to The Thomson Corporation) and minority stakes are held by the bank consortium and Tradeweb management. Accordingly, Tradeweb was launched by market participants and has benefitted from their investment of capital, market expertise and efforts to develop and foster more transparent and efficient markets. With the support of its ownership and its board comprised of market and non-market participants, Tradeweb has, since its inception, brought transparency and efficiency to the OTC fixed income and derivatives marketplace.

II. Summary

With the goal of increasing transparency and efficiency, and reducing systemic risk, in the derivatives markets, Congress passed Title VII of the Dodd-Frank Act, and in doing so, created a new type of registered entity—known as a swap execution facility or "SEF." Congress expressly created SEFs to promote the trading of swaps on regulated markets, and provide a broader level of price transparency for end-users of swaps. While the definition of a SEF has been the subject of much debate and speculation, the plain language of the Dodd-Frank Act requires the Commissions to recognize the distinction between SEF's on the one hand and designated contract markets ("***DCMs***") or exchanges on the other. There was a recognition by

---

rope Limited has registered branch offices in Hong Kong, Singapore and Japan and holds an exemption from registration in Australia.

Congress that alternatives to traditional DCMs and exchanges were necessary, particularly in light of the current working market structure and manner in which OTC derivatives trade. We applaud the direction of the regulation, but want to ensure that the Commissions adopt rules that are clear and allow for flexibility in the manner of execution for market participants.[2] This will give the end-users choices, confidence and liquidity, and will do so in a regulated framework that promotes the trading of swaps, in an efficient and transparent manner on regulated markets.

Since 1998, Tradeweb has been operating a regulated marketplace for the OTC fixed income marketplace and has played an important role in providing greater transparency and improving the efficiency of the trading of fixed income securities and derivatives. Indeed, Tradeweb has been at the forefront of creating electronic trading solutions which support price transparency and reduce systemic risk, the hallmarks of Title VII of the Dodd-Frank Act. Accordingly, Tradeweb is supportive of the Act and its stated goals, and while our existing electronic trading capabilities will allow us to readily adapt to the trading, clearing and reporting rules ultimately promulgated by the CFTC and SEC, it is important for this Committee, Congress as a whole and the regulators to understand and give due consideration to the needs of market participants. The aim must be to achieve the goals of the Act without materially disrupting the market and the liquidity it provides to end-users who use derivatives to manage their varying risk profiles. Market participants need confidence to participate in these markets and if careful consideration is not given to what the rules say and how they will ultimately be implemented, we fear that this confidence could be materially shaken.

To that end, the rules relating to Title VII must be flexible enough so as not to deter the trading of swaps on regulated platforms. By ensuring that the rules retain sufficient flexibility to allow end-users to elect where and how they transact business, it provides for the most competitive execution of trades. The Act clearly recognizes the existence and importance of electronic platforms in achieving these objectives, and we believe regulation should foster the benefits these venues provide, rather than inhibit them. Accordingly, the rules should not limit the choices of trading protocols available for end-users to efficiently and effectively manage their risks.

For example, if the rules regarding how market participants must interact with each other from a trading perspective and accessing liquidity are arbitrary and artificially prescriptive, and thus not flexible enough to accommodate the varying methods of execution, market participants simply will not participate and will seek alternative, less efficient markets to manage their risk. We certainly do not believe that is the ultimate goal of Title VII.

Similarly, arbitrary or artificially prescriptive ownership limits or governance requirements will deter investment of capital in new or existing platforms. A careful balance needs to be reached between safeguarding the system and encouraging private enterprise, which will allow end-users access to choose among robust trading venues and clearing organizations. To be clear, we favor having an independent voice on the Board of registered entities, but the rules should not go so far as to make that the predominant voice—one that creates a conflict of interest on the opposite extreme.

It is important in this regard, and for other reasons, that there is a consistent approach between regulators, both in the U.S. and globally, as overly rigid regulation in one jurisdiction will materially impact how other regulators promulgate rules in an effort to maintain a harmonized approach to overseeing the derivatives markets. The potential result is a movement of the market outside the U.S., and that would likewise be an unfortunate unintended consequence.

Accordingly, we believe it is important that the implementation of the new regulations be conducted in a flexible manner. An overly hasty or ill thought-out timetable for implementation could directly impact the health of the derivatives markets by disenfranchising the inter-connected members of this complex ecosystem. In short, implementing these regulations in one "big bang" is unrealistic and as such, we favor a phased-in approach.

Tradeweb is supportive of the goals to reform the derivatives markets and indeed we provide the very solutions the regulation seeks to achieve, but we are concerned

---

[2] The term 'swap execution facility' has been defined in the Dodd-Frank Act 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. The Dodd-Frank Act amends Section 1a of the Commodities Exchange Act with a new paragraph (50, and Section 761(a)(6) of the Dodd-Frank Act amends Section 3(a) of the Securities Exchange Act of 1934 by adding a new paragraph (77) (defining a "security-based swap execution facility"). We refer to both as a SEF in this submission.

that the Commissions may overreach in their interpretation and implementation of Dodd-Frank, and in doing so create unintended consequences for end-users and the marketplace as a whole.

III. Background on the OTC Rates and Credit Derivatives Marketplace

There are generally two institutional marketplaces for over-the-counter (OTC) credit and rates derivatives: the dealer-to-customer market (institutional) and the interdealer market (wholesale). In the institutional market, certain dealers act as market makers and buy and sell derivatives with their institutional customers (*e.g.,* asset managers, corporations, pension funds, *etc.*) on a fully-disclosed and principal basis. In the institutional market, the provision of liquidity is essential for corporations, municipalities and government organizations (*i.e.,* end-users), which have numerous different asset and liability profiles to manage. The need for customized risk management solutions has led to a market that relies on flexibility—so end-users can adequately hedge interest rate exposure—and liquidity providers, who have the ability to absorb the varied risk profiles of end-users by trading standard and customized derivatives. These market makers then often look to the wholesale market—the market wherein dealers trade derivatives with one another—to obtain liquidity or offset risk as a result of transactions effected in the institutional market or simply to hedge the risk in their portfolios.

In the wholesale or inter-dealer market, brokers ("***IDBs***") act as intermediaries working to facilitate transactions between dealers. There is no centralized exchange (*i.e.,* derivatives are traded over-the-counter), and as a result, dealers look to IDBs to obtain information and liquidity while at the same time preserving anonymity in their trades. Currently, in the United States, these trades are primarily accomplished bilaterally through voice brokering. By providing a service through which the largest and most active dealers can trade anonymously, IDBs prevent other dealers from discerning a particular dealer's trading strategies, which in turn (i) reduces the costs associated with the market knowing a particular dealer is looking to buy or sell a certain quantity of derivatives, (ii) allows the dealer to buy or sell derivatives in varying sizes, providing stability to the marketplace, and (iii) enhances liquidity in the marketplace.

Both the wholesale and institutional derivatives markets trade primarily through bilateral voice trading, with less than 5% of the institutional business trading electronically. In these markets, trades are often booked manually into back office systems and trades are confirmed manually (by fax or other writing), and some (but not all) derivatives trades are cleared.

With the implementation of the Dodd-Frank Act, we expect that most of the interest rate and credit derivatives markets will be subject to mandatory clearing, and therefore be traded on a regulated swap market. Accordingly, with increased electronic trading, the credit and rates derivatives markets will be much more transparent (with increased pre-trade price transparency) and efficient, and systemic risk will be greatly reduced as the regulated swaps markets will have direct links to designated clearing organizations ("***DCOs***") and swap data repositories ("***SDRs***").

In light of the foregoing and with the forthcoming business conduct standards, we believe the trading mandate was not intended to be and does not need to be artificially and arbitrarily prescriptive to achieve the goals of the Dodd-Frank Act. Indeed, to do so, would undermine these goals. For example, by mandating a minimum of five liquidity providers from which a market participant can seek prices would likely reduce liquidity and effectively reduce the ability for end-users to adequately manage their risk. In short, regulated swap market trading (without regard to trading model but with the appropriate transparency and regulatory oversight) and clearing is what will accomplish the policy goals without hurting liquidity and disrupting the market. It is critical that the Commissions do not propose rules that artificially and unnecessarily hurt the market and undermine the goals of the Dodd-Frank Act.

IV. Key Considerations for SEF Rulemaking

SEFs

As noted above, it is imperative that the Commissions adopt rules that are clear and allow for flexibility in the manner of execution for market participants. This will give the market choices, confidence and liquidity, and will do so in a regulated framework that promotes the trading of swaps, in an efficient and transparent manner.

Consistent with the goals of the Dodd-Frank Act, for institutional users, a SEF should (i) provide pre-trade price transparency through any appropriate mechanism that allows for screen-based quotes that provide an adequate snapshot of the market (*e.g.,* through streaming prices for standardized transactions and competitive real

time quotes for larger or more customized transactions), (ii) incorporate a facility through which multiple participants can trade with each other (*i.e.,* must have competition among liquidity providers), (iii) have objective standards for participation that maintain the structure of liquidity providers (like swap dealers) providing liquidity to liquidity takers (institutional buy-side clients), (iv) have the ability to adhere to the core principles that are determined to be applicable to SEFs, (v) provide access to a broad range of participants in the OTC derivatives market, allowing such participants to have access to trades with a broad range of dealers and a broad range of DCOs; (vi) allow for equal and fair access to all the DCOs and allow market participants the choice of DCO on a per trade basis, and (vii) have direct connectivity to all the SDRs.

In order to register and operate as a SEF, the "trading system or platform" must comply with the enumerated Core Principles in the Dodd-Frank Act applicable to SEFs. Regulators have the authority to determine the manner in which a SEF complies with the statutory core principles, and there is discretion for the Commissions to retain distinct regulatory characteristics for SEFs *versus* DCMs. It is critically important for the Commissions to apply the principles with flexibility given the market structure in which swaps are traded. Accordingly, regulators should interpret core principles in a way in which SEF's can actually comply with them. While many of the SEF Core Principles are broad, principle-based concepts—which make sense given the potential for different types of SEFs and trading models—some of the Core Principles are potentially problematic for SEFs that do not operate a central limit order book or clearing.[3]

Ownership and Governance

As noted above, Tradeweb was launched by market participants, and has benefitted from their investment of capital, market expertise, and efforts to foster the development of more transparent and efficient markets. With the help of its board, comprised of market and non-market participants, Tradeweb has since its inception brought transparency and efficiency to the fixed income and derivatives marketplace.

The success story of Tradeweb may not have been possible if overly prescriptive governance and ownership limits had been imposed at the time. It was highly unlikely that under those circumstances, any of the banks would have made an investment. Moreover, beyond the initial seed capital, the banks' participation also allowed Tradeweb to continue to invest in its infrastructure and evolve with the market—thus building the robust and scalable architecture that has allowed it to expand to 20 markets, technologically survive 9/11 (Tradeweb's U.S. office was in the North Tower of the World Trade Center), and develop connectivity with over 2000 institutions globally. Under the proposed rules of the CFTC and the SEC, ownership and independent director limits will be imposed on the different registered entities that will provide the technological infrastructure to the swaps market—from trading to clearing. Tradeweb believes that independent directors are a very good idea, in terms of bringing an independent perspective to the governing board, but their duties must be consistent with other board members. However, artificial caps on ownership or excessive requirements for independent directors on the board (such as 51% of the voting power) go too far. As a practical matter, ownership limits will impair registered entities such trading platforms and clearing organizations from raising capital, and overly restrictive director requirements will likewise hurt investment because investors will lack a sufficient say in how their investment will be governed. Moreover, Dodd-Frank provides other, more direct, ways in which to mitigate conflicts of interest, and employing each of these tools in a reasonable fashion will, in the aggregate, address the potential conflicts of interest without negatively impacting investment of capital and innovation in the marketplace.

Finally, in terms of oversight, Tradeweb asks that the Committee consider the substantial expense and burden that regulatory oversight departments can create on entities. Tradeweb ironically may be the beneficiary of stricter rules, because it would deter new entrants into the marketplace, but this would not be best for competition, and the end-user would suffer. Additionally, if costs mount for SEFs, these will inevitably be passed on to the end-user. Along with other costs resulting from

[3] For example, the *Position Limits or Accountability* Core Principle continues to be a big issue in terms of a SEF's ability to know and react to the parties' positions (*i.e.,* each SEF will need a full market view to have the appropriate transparency to monitor this issue). This would require cooperation among all the venues (SEFs, DCMs and DCOs), including position information sharing agreements, so that if a position was exceeded, the SEF could block any execution. This might work in a futures exchange environment where contracts are particular to the exchange; this will be significantly problematic where multiple venues (SEFs and/or DCMs) will trade the same products.

the Dodd-Frank Act, such as central clearing, the result could be that derivatives themselves become less attractive vehicles for managing risk.

For these reasons, we urge legislators and regulators to consider a more reasoned approach to mitigating conflicts of interest.

Implementation

Because of its technological experience and expertise, Tradeweb will be in a position to implement whatever trading rules are imposed by the CFTC and SEC for SEFs shortly after registration. However, as we note above, the implementation of Title VII of the Dodd-Frank Act will require cooperation between regulators (both domestically and abroad) in their rulemaking and implementation plan, as well as the cooperation and investment of market participants. It is critical therefore that in the first instance, the rulemaking is flexible but clear, and that each facet is implementation is thought through—because a lack of confidence in implementation will result in a lack of confidence in the marketplace, the result of which would be a marketplace which would not best serve the interests of the end-user.

* * * * *

In sum, while we are supportive of the goals of the Dodd-Frank Act and believe increased regulatory oversight is good for the derivatives market, we want to emphasize that flexibility in trading models for execution platforms are critically important to maintain market structure so end-users can manage their risks in a flexible manner. If you have any questions concerning our comments, please feel free to contact us. We welcome the opportunity to discuss these issues further with the Committee and their members.

The CHAIRMAN. Thank you, Mr. Olesky. I appreciate that. We will now go to questions from the Committee, and I will yield my time to Mr. Hultgren at the front, who was way down on the list the first time around. Mr. Hultgren for 5 minutes.

Mr. HULTGREN. Thank you. It pays to stick around. Thank you very much. I appreciate all of you being here. I really appreciate your very extensive testimony today, but also the testimony that you have given to us to work with.

I hear some very common themes through your testimony of real concern of overreach from Dodd-Frank, and impact on all of our economy, *albeit* specifically the work that you are doing.

So I have quick questions I would like to ask for each of you in my time available, so I would ask if you can respond quickly, that would be terrific.

First for Mr. Gallagher, what will be the impact of procedures if they can no longer—excuse me, of producers if they can no longer access their customized hedges through the co-op?

Mr. GALLAGHER. The opportunity for them to mitigate their risk will likely be diminished. For the most part, large swap dealers generally do not have an interest in dealing with individual farms because of their lack of understanding about the financials on the farms, and the small net worth that they may have, and so they are—our member's opportunities are through aggregate and through cooperative DFA or Dairylea or other national council members, in order to access the swap markets on their behalf.

Mr. HULTGREN. Thank you. Mr. Duffy, what is your view on the concerns we have heard today regarding the special speed and sequence with which the CFTC is issuing rules, and to be able to maybe provide some specific examples of how that speed of rules is affecting the Chicago Mercantile Exchange and others?

Mr. DUFFY. Yes, I think the speed of rules, as I said in my testimony, concerns us for a lot of different reasons. One, because they are going more from a principles-based regime looking to go into more of a rules-based regime, and they are also coming out with—

we have a big legal team at the CME Group, and we have external legal folks. They are having a very hard time keeping up with it, so we are concerned how in the world can the rest of the Commissioners actually have an opportunity to look at this information and analyze it and make good decisions. So, we are overwhelmed on our side. We don't know how we are going to get good responses into the CFTC so they can make a good analysis of the public comments, going forward.

So that is one of the big things that concerns us.

Mr. HULTGREN. Mr. Pickel, in your testimony you expressed concerns regarding the proposed metric for determining block trades. How does the CFTC proposal fall short in this regard, and how would you propose that we could revise that?

Mr. PICKEL. I think our principle focus—and we did a study which we filed as part of our comment letter that looked at experiences in other markets with transparency and block trades, and we just—we feel that the thresholds that they are talking about are far too high. Keep in mind that as much as those requirements are there for dealers, they are also there for end-users. We have heard from a lot of larger asset management firms who will do a large trade with their dealer and put the burden effectively on the dealer to parcel that out into the marketplace. If that trade, large as it may be, is still below the block trading thresholds, then the dealer may be reluctant to take on that burden because as soon as that trade is done with the asset manager, that will need to be disclosed to the marketplace.

So we are focusing very much on those thresholds, trying to get the information, and then urging the Commission to in turn—both Commissions, actually, because they both have rules regarding block trading—but both Commissions to do studies to analyze the effects on liquidity. Because once you have dealers pulling back, you have a much less liquid market and effectively, you have put the burden on the asset manager in that circumstance to do smaller trades, which may be not as efficient for them.

Mr. HULTGREN. Thank you. Mr. Morrison, if I could ask you a quick question. How would you respond to the claim that clearing and exchange trading is in the best interest of end-users because it prevents dealers from charging them high prices to engage in OTC transactions, especially reflective from Chairman Gensler's remarks today?

Mr. MORRISON. We feel that we have good transparency today in terms of the markets and in terms of the prices. There are numerous information services, whether it is Bloomberg or Reuters or bank trading systems or direct links to the LME which we trade on, and so we are not concerned. We use multiple counterparties, and so we think we have sufficient transparency today in terms of the prices and credit spreads and things that we are paying.

Mr. HULTGREN. Thanks. Just to wrap up, Mr. Olesky, as you know, the SEC and CFTC proposals for SEFs have significant differences. How would this lack of harmonization impact SEFs and their customers?

Mr. OLESKY. Well, as much as possible we like to see consistency, but I don't think the differences are the issue. I think the key is, again, how we phase in these rules, how flexible they are, and how

much they take into consideration the market participation and the impact it is going to have on the market as a whole.

Mr. HULTGREN. Well thank you all very much. I really do appreciate you being here today. I appreciate your testimony. We are going to need your help, going forward, as we work though this, so it really does mean a lot to me and the rest of my colleagues that you are here.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. Mr. Peterson for 5 minutes.

Mr. PETERSON. Thank you, Mr. Chairman. Mr. Duffy, your clearinghouse, you launched clearing for interest rate swaps and credit swaps, apparently, but you are not showing much volume, I guess, at the moment. Is that correct?

Mr. DUFFY. That is correct.

Mr. PETERSON. And do you believe that the big dealers of these swaps are resisting clearing in general, or your clearinghouse in particular?

Mr. DUFFY. I think, personally, the large dealer community is waiting for some of these rules to be written to see exactly where they are going to be at. They know that they have alternatives in clearing swaps, whether it be at CME Group, ICE Trust, LCH, or whoever else decides they are going to open up a swaps clearing entity. So I think they know they have the ability to ramp up very quickly from a technology standpoint to have the pipes go to these clearinghouses, so I think they are actually waiting as long as possible to see where the rules come out.

We have been dealing with—we have about 925 million cleared interest rate swaps to date, and we started the initiative back in December, so for the most part, it is a situation to your point, sir.

Mr. PETERSON. How much do you think this reporting here that they are getting together, these big guys and this secret cabal in New York has to do with this?

Mr. DUFFY. If you are asking me, I don't think it has anything to do with it. I don't think there is a cabal at all amongst the dealers in this.

Mr. PETERSON. They are not trying to keep control of this for themselves?

Mr. DUFFY. No, I think what the dealers are looking at, they have the most to lose because they are the largest influx of cash entities, clearing entities, so when you have a smaller participant come in with a large transaction, he could take down somebody who put up all the money, so I think that they are a little concerned that that wouldn't be an appropriate thing to have happen. I agree with what Chairman Gensler said earlier about that they should put up small capital, they should be able to do small transactions. You know, I am sure the banks are trying to work with some of these other clients to figure out how that waterfall system would work. But their main concern is, and I don't blame them, is that they would have a transaction coming into that clearing entity that they have put all the money up for that is not well capitalized that has a tremendous amount of risk associated with it.

Mr. PETERSON. All right. Mr. Gallagher and Mr. Morrison, do your—do you, when you are doing these over-the-counter swaps that are not standardized, I assume you do some of that——

Mr. GALLAGHER. Yes.

Mr. PETERSON. How does it work? Do you have six of these big banks that you go and give this out, or is there just one entity that you normally do business with, or how does that work?

Mr. GALLAGHER. I can comment on how DFA operates. We have a number of entities, I believe only two of them may be banks, but a number of entities who we have ISDA agreements with that we can do swap transactions with, and we will contact them looking to see which one we can get the best pricing at.

Mr. PETERSON. So you lay out the terms of the swap and you send it to these folks, and you take the best——

Mr. GALLAGHER. If we have enough time to do that, we do. Some of what we do, for instance, one of the swap transactions we may do would be for a Class IV price, and there is a futures contract on the Class IV price, but the volume is very limited and sometimes it is easier for us to get that trade done on behalf of a member by writing a swap with an entity, and so there may be one or two or three entities we know that would consider that, and so we would contact them and see what their pricing is. In some cases, we go there just because we can't get the volume done on the futures exchange.

Mr. PETERSON. And are you in the school that doesn't think that the transparency that they are trying to get going here is going to actually give you more information so you are going to be able to get better deals?

Mr. GALLAGHER. We think transparency will always lead to better information. The degree of the value of that I am uncertain with yet because I am not sure what types of things will be posted for public information.

Mr. PETERSON. It depends on how it is set up?

Mr. GALLAGHER. That is right. If it is limited to what is currently the Commitment of Traders Report, I am not sure there would be much additional value.

Mr. PETERSON. Mr. Morrison, is it a similar situation?

Mr. MORRISON. Similar in that we use multiple information sources where we can see live prices, and then we have approximately ten different counterparties that we can use. So we know exactly what kind of credit spread we are paying, and so we think we have sufficient transparency today.

Mr. PETERSON. That is for your company?

Mr. MORRISON. That is for our company.

Mr. PETERSON. But there is probably other companies out there that don't have the information, from what I can tell. I am not, you know——

Mr. MORRISON. Perhaps very small companies that don't do a lot of this, that could be the case.

Mr. PETERSON. But wouldn't you agree, as Mr. Gallagher said, that the more information that is out there, the better prices you are going to get? You know, if you believe in the free market and——

Mr. MORRISON. I am worried about the unintended consequence of some of the transparency. Having to report trades real-time and the—I believe that will reduce liquidity in certain markets, especially longer dated markets. So I think that will actually drive costs up.

Mr. PETERSON. Well, I am not sure we would know it until we actually tried it, but if I might, Mr. Chairman, I just wanted—what—I forgot what I was going to ask now, so maybe it will have to wait until later. Thank you.

The CHAIRMAN. The gentleman yields back. Mr. Johnson, 5 minutes.

Mr. JOHNSON. Mr. Duffy, if I could ask you, I think it is apparent that these regulations and the compliance process with Dodd-Frank is going to be very costly. I think it is also at least apparent to me that the volume that you are to be expected to address of new swaps under this Act is going to be gigantic. I also think it is apparent, without trying to prejudice your answer, that this is going to have an effect—large or maybe less than large—on the competitiveness of U.S. financial markets with European and otherwise.

Can you just address some of those issues in particular as to how it is going to impact you, because I think it is also obvious that virtually every district in the country, and certainly ours, is going to be dramatically impacted by regulations that affect you that in turn affect us. So I am just concerned about what this is going to do to us in a competitive structure, and also what it is going to do in terms of costs of compliance that inevitably are going to have to be passed along to somewhere else.

Mr. DUFFY. I think the latter part of your question is the more important and relevant one, sir, and that is the costs associated with it, because what—some of the things we are seeing coming out of the rulemaking process under the agency is basically duplicating what an SRO or a self-regulatory organization already does today. CME Group already does these things today, so what it appears to us what the agency is doing is just creating a duplicate process which is adding tax and burden—adding the burden to the taxpayers to fund that particular entity when we can do it. They already have the ability, sir. If we are not acting appropriately, they can come in and obviously have the oversight of our business. But at the same time, we have what is called a principles-based regime which was put into place in 2000 by this Congress under the Commodity Futures Modernization Act so we can grow and prosper throughout the world. That is being taken away and it is being done with prescriptive rules that were not to be put in place for the futures exchanges.

So yes, I am very concerned about the competitiveness of U.S. entities as we go forward.

Mr. JOHNSON. In terms of the process that—the process by which the CFTC issues rules, do you think that they are sequentially and in a timely manner issuing rules or do you think there are problems? And if so, could you maybe give us a few examples of where you see issues that have arisen?

Mr. DUFFY. You know, I think what we are going to try to do—and I talked to the Chairman the other day. He called and asked me something very similar to that, and I think on a sequential

basis as the rules come out, we want to put a very thoughtful process into place and give him our best opinion, and I didn't want to do that in that conversation with him, so to answer your question, Congressman Johnson, we are actually formulating all that data now for a meeting with the agency next week about the implementation and the timing of those rules, how they should come out.

Mr. JOHNSON. As you probably know, Mr. Duffy, today and tomorrow the full House is addressing issues of what some people see as regulatory excesses. I don't necessarily expect or want you to engage in that debate, but I am assuming that CME has been either victimized by or at least affected by regulatory excesses, perhaps in excess, so to speak, of what the Congress ever intended. Do you think it is——

Mr. DUFFY. That is an excellent summary, sir. When you have a history—and I heard Mr. Morrison talk about they have been a publicly traded company for 139 years. We have been around for 156 years. We have never had a customer lose a penny due to one of our clearing member defaults. I think that is a pretty stellar record, and something that we cherish very much. We weren't the cause of the 2008 crisis, yet we seem to be the bright shiny object in the room, so let us try to implement a bunch of new rules on futures houses and clearinghouses associated with them. It doesn't make a bit of sense to me. They should be focusing on what put us into this situation, not what has helped preserve the stability of the financial markets.

Mr. JOHNSON. Speaking only for myself, but I believe this probably would reflect the viewpoint of some other Members of this Committee and Congress generally, I would welcome hearing from you and your colleagues in the panel and related entities about what we can do as a Congress to be able to address some of those issues that you face along the way, because I believe the current law as it is being implemented is going far too far, if you will, and that we really need your help in being able to address the practical effects of these things and how we can work with you to make the world better for all of us, so to speak.

Mr. DUFFY. If I may just give two quick examples, Mr. Chairman, if you will allow me to?

The CHAIRMAN. Absolutely.

Mr. DUFFY. You know, to that point, sir, we have new contracts that we put up every day, and some are successful. Most are not. We have to put these up in a way that makes sense for the end-users of our product line, so a lot of times we will put them up as an OTC contract because they trade very, very little, and if they ever get a higher volume then we migrate them onto our central limit order book, and that is the way we do it.

The CFTC is now saying if you don't have that liquidity, or 85 percent of that liquidity traded on your central limit order book, that product needs to go away. Well, I have contracts that have listed for 5 years with no volume, but all of a sudden, they trade one million contracts. Why? Because the world changes. Maybe our timing was a little off. So that is one example.

Another example is they want to have the ability to decide who is on my nominating committee, because they think they have a better—what is in the best interest of my shareholders about what

is the composition of that. These are things that are way overreaching from a regulator into our business and into other businesses.

So I look forward to the opportunity to work with you and other Members, sir.

Mr. JOHNSON. Thanks so much for your help.

The CHAIRMAN. The gentleman yields back. Mr. Boswell for 5 minutes.

Mr. BOSWELL. Thank you, Mr. Chairman. I appreciate everyone being with us today and I think this is good. Early on, I think we discussed, if you didn't cause the problem, why are you in so much oversight? But again, we are trying to protect the public so I appreciate you being here.

I think I will start with Mr. Morrison and Mr. Gallagher. You heard in Chairman Gensler's testimony a statement of transactions involving non-financial entities do not present the same risk to the financial system, as those solely between financial entities. Therefore, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users. Does this statement address your concerns about margin requirements for swap dealers and major swap participants for their transactions with your members?

Mr. GALLAGHER. I believe it can. I would like to read what comes out. Right now, we have a concern on margins because that is part of—we have to margin, we have to utilize working capital. Others have testified how if you have to—if you don't have to use your working capital now to margin some of your swaps and you do later on, that you are taking that working capital away from doing other things in your business that, in our specific part of the economy, is going eventually come back to providing less opportunity for farmers. So I would like to be able to see what they are writing, because sometimes I think they may think that they are excluding us, but the way they write things maybe captures us, so I would like to see it in writing before I——

Mr. BOSWELL. I think your point is valid. Long-time Chairman of the local board, I appreciate that working capital concern and it depends on time of year and a number of things.

Mr. MORRISON. I have a similar concern. If end-users are exempt from posting margin, what I would be concerned with is if we conduct a trade with a bank, for instance, and that bank then offsets that exposure with another bank, does that require margin somewhere in the system? And my concern is that if there is margin required somewhere in the system on that trade, it is going to come back to me in higher costs.

Mr. BOSWELL. Okay, let us move along. Mr. Gallagher, in your testimony you expressed concern that the CFTC may impose overexcessive margin requirements. Is that part of what you are referring to?

Mr. GALLAGHER. Yes, certainly. One of the things right now is we aggregate the risk of our member-owners, and then we go into the market as the swap entity. Depending on how they define what a swap dealer is, we could easily fall into that, just the notion that we act like one——

Mr. BOSWELL. Do you think Mr. Gensler kind of set that aside for you in his statement, or are you still concerned?

Mr. GALLAGHER. I am still concerned about how we will be viewed as we call up different entities saying we have some risk on something like buttermilk powder, where there is no market for—no futures market for, we call up different entities. Are we going to be considered a swap dealer because we are calling up different entities, and then are we going to be a swap dealer because we have to do this more than 20 times a year, and we—to mitigate our risk, we are doing it with ten different entities? I would hope that wouldn't qualify us as a swap dealer.

Mr. BOSWELL. Well, I think we can monitor that and see how that gets defined.

Thank you. I yield back.

The CHAIRMAN. The gentleman yields back. Mr. Stutzman, 5 minutes.

Mr. STUTZMAN. Thank you, Mr. Chairman, and I appreciate you all coming in here today. I apologize that I wasn't here for most of the testimony. I have had a budget committee meeting going on simultaneously, so—but I have been trying to read through some of your testimony. Coming from northeast Indiana and an agricultural community, a manufacturing community, of course Ball being in Indiana, we are very familiar with you all and appreciate the business that you do there.

I guess what I want to start out with, the testimony that Mr. Gallagher gave. Being in small town America, we are very familiar with co-ops. I guess my initial question is what distinguishes a co-op and the services they provide to their members from a swap dealer?

Mr. GALLAGHER. Cooperatives have a governance structure, much like the House of Representatives, where they have farmers that are elected to boards. Boards govern the management of the organization, and any earnings that may accumulate at the business end eventually come back to the member-owners. So there is a significant difference between what agricultural cooperatives do and how they are managed, and how they pass back earnings is probably different than any other business entity.

Mr. STUTZMAN. I grew up on a dairy, and thankfully my dad had decided not to continue on as us boys got older and just focused mostly on grain, but what would the impact on producers be if co-ops or if they can no longer access their customized hedges through the co-op?

Mr. GALLAGHER. Okay. One of the things that we are doing right now is that because of the extraordinary explosion in grain prices, feed is the single biggest input cost on a dairy farm. So we are customizing our forward contracts so that they can not only manage a milk price, but they can manage that feed price, all in context as a milk price. In order for us to do that, we have to go to the swap market to lay that risk off, because typically we have farmers that—they don't utilize 5,000 bushels of feed in a month, or they may need that contract to carry out every single month, and the futures market doesn't trade feed every single month. So they need our help customizing that for them so that we can then lay that risk off for them on a swap basis in the swap market. And if some-

thing happens where we are prevented—if we get regulated as a swap dealer, I am not sure we would continue offering that particular program, and then I am afraid that because of the size of the farms and their ability to get working capital on the farm, that they come to us because they don't have the working capital to have their own futures account. We provide that working capital for them through our forward contracting process. I am concerned that they will not have the ability to manage that significant input price risk if they are taking on right now—and that will reduce their profitability in the long term.

Mr. STUTZMAN. And I am not, I guess, aware of any problems before Dodd-Frank in particular. Do you know of any problems that were, I guess, maybe publicized? I am a freshman here in Congress, so I mean, you know—I guess kind of how did you get brought into this? What is kind of the history of—behind Dodd-Frank and you all and why you are kind of pulled into this situation?

Mr. GALLAGHER. Okay. We have had—forward contracts have been excluded and we want them to continue to be excluded. There have been certain information in some of the stuff coming out of the CFTC rulemaking that suggests maybe they are going to regulate options that are imbedded in—price options that are imbedded in forward contracts. That would be a travesty for agriculture if that happened.

We then are concerned because we have been building these swap books to help our members mitigate their risks. My colleagues in some of the other organizations use swaps far more than my organization does, and for some of the things that they are doing, if something happens where they get regulated as—we get regulated as swap dealers and we have to margin, we are not sure we are going to have the working capital to be able to provide the same benefits that we have been providing in the past. So we are concerned that this—as this rolls out, it rolls out the right way and that right now, it seems like at least the stuff we have read today, that the mesh on that net is pretty tight, and it is capturing a lot of fish that probably don't need to be captured. So we need a little bit of a wider mesh to capture the big fish and not harm the small fish.

Mr. STUTZMAN. Can you quick just answer, how is this going to affect a smaller dairy, which I have more smaller dairies, even though we have large dairies in Indiana as well?

Mr. GALLAGHER. We wouldn't be able to—we would likely not be able to help them hedge their feed.

The CHAIRMAN. The gentleman yields back. Mr. Welch for 5 minutes.

Mr. WELCH. Thank you, Mr. Chairman. I will follow up on some of the questions Mr. Stutzman was asking. Vermont is a dairy state, so we have some of the challenges that you were just asking about and answering.

The goal here is to try to get the regulation right. Something bad happened as you indicated, Mr. Duffy, but we are getting it right means that we don't blame the folks who were doing it right in the first place. So I am just going to ask a couple of questions.

Let me start with you, Mr. Olesky. The AIG problem was brutal, and it ended up costing every taxpayer about $600. As I understand it, it was their overexposure in the derivatives market that led to their downfall and the taxpayer rescue. What were the specific failures that led to that default?

Mr. OLESKY. I am not sure of all the specifics with respect to AIG. I do think, though, that the regulation and the legislation that has been—the legislation has passed and the regulation has been proposed, is going to bring an awful lot of transparency into the marketplace. We wholly support that. In addition to transparency, we think it is going to lead to more electronic trading, risk reduction, certainly systemic risk reduction through using central counterparties, and a lot more information in the hands of regulators on a real-time basis.

Mr. WELCH. All right, so let me just interrupt. This is helpful. I mean, I have a lot of community bankers who are very upset about some of the regulatory impacts of Dodd-Frank, and they were not the ones that caused the problem, but they acknowledged that a problem is there and has to be corrected. So that is what I think is a mutual goal here, to try to get it right.

Mr. Duffy, you were describing your situation, and you have this incredible record of 156 years without losing anybody a nickel. That is pretty—how do we invest, by the way. But what are the specifics that did need to be attended to that we saw in AIG that Mr. Olesky was speaking about?

Mr. DUFFY. Well first of all, you can lose money, we don't lose money because of our risk management.

Mr. WELCH. Right, I got that.

Mr. DUFFY. So we have a stellar record of risk management to make sure that you don't lose your money.

You know, I have testified in front of this Committee over the last couple years, and maybe against our own book when I said that I didn't think clearing should be mandatory. I thought that clearing should be an incentive to be done, so the end-users, if they want to use it, they should have a capital charge of X if they don't clear and Y if they do clear. So that is what my whole stance has been all along. You know I was the one that appeared to be the winner in this, because we already had the largest clearinghouse in the United States and we would get all this supposed business. I didn't see it that way because I can see it as business either not getting done, or being forced overseas. So we have never subscribed to this mandatory law of clearing, and I still am not going to subscribe to it, even though it is law today, so we will comply.

As far as AIG goes, sir, in all due respect it is no different than an options trader who is selling premium because when you sell premium on an options transaction, you receive the cash and your exposure gets bigger and bigger and you have nothing to back it up with.

Mr. WELCH. All right, but there was a total lack of regulation. They didn't have any margin requirements, and it led to outsize risk taking.

Mr. DUFFY. There was no margin. There was capital and they were—you know, what is capital? So they were adding up everything in a room and calling it capital and putting a value on it, and

that is the way they were backing up the positions with a balance sheet.

Mr. WELCH. Right, and they nearly blew up the financial system.

Mr. DUFFY. I am well aware what happened.

Mr. WELCH. Right, so what steps would we need to take in order to protect, in effect, not just the taxpayers who ended up having to bail them out, but a lot of main street businesses that needed stability in the credit markets?

Mr. PICKEL. If I——

Mr. WELCH. Mr. Pickel, go ahead.

Mr. PICKEL. If I might jump in there, I think that—first of all, that AIG utilized derivatives to take exposure to real estate. That is what they did with their derivatives. They also used secured lending to take that exposure. So ultimately, that was the driver there.

I think, though, that let us look at what is in the law and let us look at what is, going forward, to deal with the AIG situation. This major swap participant definition is a critical piece of that, and when it was first proposed, it was proposed as that to catch the next AIG. And so I think that is why people are very concerned about where that definition goes because if it is drawn narrowly to catch whatever that next AIG might be, everybody is in agreement. Let us do that. And I think that Chairman Gensler today gave an indication that they would expect a fairly small number of entities to fall into that definition. So that is very helpful, but if it were defined more broadly, I think it would go beyond the intended purpose.

The other thing is a couple things regarding AIG. First of all, with these data repositories which were in existence before Dodd-Frank, but obviously given greater relevance in Dodd-Frank, there is more information to the regulators about the exposures that are building up in the system, particularly in the credit default swap world. That is the most mature of these data repositories to date. So that information will be available to regulators around the world.

There is also—because of the major swap participants, there is greater regulation of that entity. AIG was overseen by the Office of Thrift Supervision, but you know, obviously not every effectively and so that was one of the reasons that they had the problems that they did.

There would also be greater use of collateral. Collateral was used by AIG, but its policies were such that it aggravated the situation in a sense, because it was not used from day one, it was only used when AIG was downgraded, which led to kind of cliff effects and liquidity effects for AIG.

The other thing, just to mention, is the trades that they did there were very customized. They are not going to lend themselves to clearing via the CME platform, any of the other platforms that exist for clearing credit default swaps. It is more customized and therefore needs greater scrutiny by the regulator.

Mr. WELCH. Okay, thank you. I see my time has expired and I yield back. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Just a couple of questions to finish off with.

Let me pose a question that I asked to Mr. Gensler with respect to these high frequency algorhythmic trading systems that are in exchange environments today. Will someone have an opportunity to do that in the exchanges that are being contemplated with respect to these derivatives? Anybody on the panel want to answer?

Mr. DUFFY. Well, the question being will the new products that are listed for trade, OTC products listed for trade, will the high frequency or algorhythmic trader have access to them, is that the question?

The CHAIRMAN. Yes, I mean will we create a new arena for that technique to be used by pushing all these derivatives on an exchange——

Mr. DUFFY. I think we have to wait for the CFTC to come out with a definition of what a SEF is and who qualifies for a SEF, which is a swaps execution facility, which these products will be traded on. So, if the banks get to have their own SEF, I may not have access to it as a high frequency trader, because I may not meet their qualifications to trade on their SEF. I guess it is yet to be completely determined what a SEF is going to look like.

The CHAIRMAN. Yes, but you have to push your side of the trade 15 seconds before you execute, doesn't that open up a window of opportunity for computer-driven mischief?

Mr. DUFFY. I don't believe so, no.

Mr. PICKEL. Mr. Chairman, I think that it really is a question—and I know Mr. Olesky will comment as well, he is ready to push the button. It really is a question of how these SEFs develop. I mentioned in my remarks at the opening that the number of trades done—and we are talking about standardized trades—2,000 standardized trades currently done around the world in the most liquid products, U.S. dollar swaps, 10 year swaps, maybe 400 over the course of a day around the world. So we are not at that kind of volume that would lend itself to that. Now if SEFs are successful and there are more transactions being done on those platforms, perhaps down the road, but that is certainly something I think we will have some time to see how it develops, although the definitions are certainly critical.

The CHAIRMAN. Sure.

Mr. OLESKY. I would just add that this is a key point for us. We think it is incredibly important for market participants that the rules allow for sufficient flexibility to give the participants what they need. So if you are an end-user, if you are an asset manager, you need to be able to access liquidity in a way where it is not going to be impeded, where you can go and get your business done without interference. And that has been core to our position is that there should be real flexibility in the rules so that you have a variety of different places to execute these businesses on regulated markets, such as SEFs. But it is that flexibility that is key.

The CHAIRMAN. Thank you. The cost estimates a year ago when Dodd-Frank was being kicked around *versus* the cost estimates today are dramatically different. In terms of your compliance, the CFTC's side, have you guys been able to make any kind of an analysis at this early stage as to where those increased costs are going to wind up *versus* the shrinking and spreads from the transparency

that may occur? Who is going to—if we are just going to create more costs for no benefit, we ought to address that, obviously.

Mr. PICKEL. I think that that is yet to be determined. We have not done a thorough study. We did, at the time that the bill was passed, point out that because of the lack of clarity on the application of the margin requirements to end-users, potentially it could have under various assumptions and scenarios, cost end-users as much as $1 trillion. Now obviously, that is very——

The CHAIRMAN. Subjective.

Mr. PICKEL.—different—well, it is based on some numbers and makes a certain amount of assumptions. We can share that with the Committee. But I think it is very important and noteworthy that the indication from Chairman Gensler today is that that will not be a requirement, so that is very helpful.

The CHAIRMAN. Right. Mr. Gallagher, what are the—I am sorry, go ahead.

Mr. OLESKY. I was just going to—one quick point is that frankly the longer there is a lack of clarity and the longer the whole process goes on, the more expensive it is. So I can just say for our business it is a complex situation. We are building technology to try to be responsive, but all of us in the marketplace I think suffer from the uncertainty, and the longer it goes on, the more challenging it is and the more expensive it ends up being.

The CHAIRMAN. All right, thank you for that.

Mr. Gallagher, one of the center points for Dodd-Frank was to be able to identify systemic risk or systemic risk players in the market. Can you—would your co-op, in your mind, ever remotely be a systemic risk as a swap dealer, if you wind up being tagged with that definition? Can you create the kind of volume for your membership that would be a systemic risk as we understand that happening?

Mr. GALLAGHER. I can't see DFA or Dairylea or for that matter, and probably any of the members of the national council, having enough volume to create systemic risk that we could cause any type of damage to the U.S. economy. I can't envision that right now.

The CHAIRMAN. All right. Thank you, gentlemen, I appreciate it, Mr. Duffy, one last thing.

Mr. DUFFY. Just one comment on the cost side of this. A rush to judgment, I understand, can be even a bigger cost in my opinion than getting some clarity on this. I appreciate what the gentleman said about it is costing us—so we don't understand that, but if we don't get this right, I assure you the cost will be the least of our problems. If you looked at some of the announcements that happened yesterday between some of the major exchanges in Germany and coming into the U.S. to do a deal with the New York Stock Exchange, this is what I have been talking about for years with this Committee, about how business is going to go overseas, and this is another way they can do it, do it by mergers and acquisitions.

So by getting these rules right, it is just as important as the cost burden today. Let us get the rules right so—to my testimony I would hope that this Committee would remind the CFTC that this is a very important rulemaking process.

The CHAIRMAN. Well thank you. We are constantly—we will have another hearing next week. Just one word, in a conversation that the Ranking Member and I had with Mr. Gensler ahead of the meeting, he assured us that he had all the flexibility he needed for a common sense implementation phase. In other words, he has legal restrictions on creating the rules, but yet he has all the flexibility he needs to implement this in a way that makes sense. So be thinking about that statement that he made in y'all's analysis—he obviously has legal counsel that gets paid—you know, feeds his family making those judgments, but it would be helpful next week if you thought about—due to the fact they have—the law is in effect and the rules are going to be in place. You guys have to comply with them whether they get the rules right or not, and so you have the cost of doing business as a risk. You may or may not be able to lay off some swap market with another regulator that you have to comply with the law during this timeframe.

So again, thank you all for coming. I appreciate your time, and with no other comments, we are adjourned.

[Whereupon, at 1:00 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTIONS

Response from Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission *

Questions Submitted by Hon. K. Michael Conaway, a Representative in Congress from Texas

Major Swap Participant

Question 1. I believe that various companies are interested in understanding whether the Commission believes the hedging of financial or balance sheet risks are included in the definition of commercial risk. In particular, would the definition allow for the hedging of debt or duration mismatches? Are there particular hedging strategies that the Commission believed should be excluded?

Question 2. Although the Commission proposed to subtract collateral when assessing whether a person has substantial position, the Commission also requested comment on whether collateral should indeed be excluded. It has been suggested to me that companies believe that posting collateral fundamentally reduces or eliminates a risk position. Do you affirm that it is appropriate for the Commission to have subtracted collateral?

Swap Dealer

Question 3. As you may know, some end users, including non-financial end users, centralize certain treasury functions, including hedging operations, out of one or more entities that execute trades with the dealer banks and then document an offsetting transaction with the affiliate entity or entities, under the same parent company, that require the hedge. I have been made aware that these end users have several concerns over whether these trades could subject them to a variety of new regulatory burdens, including the following:

(1) The market-facing entity could be considered to be a swap dealer;

(2) The market-facing and inter-affiliate transactions could be counted toward the major swap participant thresholds;

(3) The inter-affiliate transactions could be subject to the clearing and trading requirements; and

(4) The inter-affiliate transactions could be subject to the reporting requirements.

Can you please comment on whether these inter-affiliate transactions will be treated the same as the market-facing transactions?

Swap Dealer

Question 4. Do you intend to apply margin requirements to non-cleared swaps that market participants have negotiated and entered into before Title VII becomes effective?

Question 5. Is it the Commission's intent that margin requirements should apply to firms that are neither swap dealers nor major swap participants?

Question 6. Do you believe that the Dodd-Lincoln letter and subsequent Frank-Peterson colloquy make clear Congress' intent with respect to whether margin should be imposed on end-users?

*There was no response from the witness by the time this hearing went to press.

HEARING TO REVIEW IMPLEMENTATION OF TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

TUESDAY, FEBRUARY 15, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 1:00 p.m., in Room 1300, Longworth House Office Building, Hon. K. Michael Conaway [Chairman of the Subcommittee] presiding.

Members present: Representatives Conaway, Neugebauer, Schmidt, Gibbs, Huelskamp, Ellmers, Hultgren, Schilling, Boswell, Kissell, McGovern, David Scott of Georgia, Courtney, Welch, and Sewell.

Staff present: Tamara Hinton, John Konya, Kevin J. Kramp, Ryan McKee, Debbie Smith, Clark Ogilvie, and Jamie W. Mitchell.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

The CHAIRMAN. Good afternoon. We will start the hearing.

Just for the witnesses' knowledge, we have votes called at approximately 1:20, but we will go through our opening statements and we will start with yours and then go vote. And then if you could please stay and wait, we will come back and resume the hearing as soon as we get clear of the votes.

With that, good afternoon. Welcome to the first hearing of the Subcommittee on General Farm Commodities and Risk Management for the 112th Congress. I am honored to hold the gavel and look forward to a productive Congress.

We are here today to continue examination of the impact of the multitude of new rules proposed by the Commodity Futures Trading Commission pursuant to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

We have several new Members to the Subcommittee, and I am looking forward to their full participation.

Dodd-Frank requires the promulgation of a extraordinary number of new regulations governing our financial markets, and much of that overhaul has fallen on the shoulders of leadership and staff of the CFTC to implement.

To say that Congress has set high expectations for the CFTC is an understatement. For the Commission it means a dramatic expansion of authority and discretion over the markets under its control.

Last week we focused on the process the Commission undertook and what data they utilized in drafting their proposals. Our work today, while similar, is focused on what these new rules mean to market participants.

By the end of this hearing, I hope to have a better understanding of how much compliance will cost, what business practices will have to be altered, and how much the new regulatory burdens will impact economic growth. As discussed here last week, many Members of this Committee, including myself, remain worried about the burdens of these new rules on businesses and individuals alike.

Chairman Lucas and I have repeatedly requested Chairman Gensler voluntarily to submit to the Committee the principles established in the President's recent Executive Order on approving regulation and regulatory review, which include comprehensive cost-benefit analysis and the use of both quantitative and qualitative data in rulemaking.

For the time being, the Chairman has refused to fully embrace the President's call, citing a conflict with the law.

Having examined his claims, I am uncertain how existing law precludes them from full compliance, but I will continue to request that the Commission adhere to the President's Executive Order in full rather than just in principle.

I believe the law of unintended consequences is the hallmark of hastily considered rules and ill-conceived regulation. There is significant concern that the CFTC's process for implementing Dodd-Frank has been just that: Rules have been proposed in an irrational sequence; industry groups have complained that the CFTC has underestimated certain compliance costs by a factor of two or three and as much as 63 for some; and the commissioners appear to be stretching the regulatory mandates far beyond the intent of Congress.

I am pleased to welcome a broad spectrum of market participants this afternoon to share with us how they view the pending regulations and what their suggestions are for improving the process and the output of the CFTC rulemaking. Also with our witnesses today, Glenn English has submitted testimony to the Committee on behalf of the National Rural Electric Cooperative Association.

I ask unanimous consent to insert that into the record.

[The document referred to is located on p. 193.]

The CHAIRMAN. For my own part, I have supported the CFTC's collaborative regulatory process. For over 30 years, the consultative light-handed principles-based approach to regulating the commodities and derivatives markets have served our nation well. In that time, new markets and new financial products have flourished, creating innovative ways for participants to plan for the future.

Without question, these financial instruments have been a blessing to agriculture producers and manufacturers and many others. It is these business and investment strategies, those that were once novel but are today routine that this Committee must protect as we oversee the implementation of Dodd-Frank.

In the last 10 years, our financial markets have grown more complex and participants in the market have grown more savvy. New financial instruments have unlocked capital and reduced risks for millions of investors. These innovations cannot be rolled back. Eliminating or restricting them will serve only to increase the relative costs of doing business in the United States. It is incumbent on this Committee to ensure that the rules proposed by the CFTC are not overly burdensome and do not choke off legitimate financial instruments with onerous rules or heavy compliance costs.

I look forward to this opportunity to hear from our panelists today as we discuss the many rules proposed by the CFTC over the past year. I hope they can each share with us where the Commission did it right and where our panelists think the commissioners need to go back and rewrite their proposals.

Thank you each for being here today, and I look forward to an informative and productive hearing.

With that, I ask the Ranking Member for his comments.

OPENING STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM IOWA

Mr. BOSWELL. Thank you, and I have no quarrel with what you said. I could stop there, but I am going to make a couple of remarks.

First off, I appreciate and congratulate you for having the chairmanship of this Committee, and I look forward to us continuing our work together, and I am confident we will.

Just to reflect a little bit. You know, when we went through this debacle, if you will, we handled this bipartisanly with our bosses, our chairs and us together, we recognized it was a SEC challenge, not CFTC. And we think we somewhat brought that to daylight, and we are glad we were able to do that.

But the goal of the legislation was and is to give transparency to the over-the-counter derivatives market and, at the same time, not to hinder the ability of folks like yourselves and those out there that I have said over and over and over that if I have a bias, it is towards that producer out there. And I guess I will confess that is still where it is. You have to be able to use the tools because it is so capital intensive. There is so much risk involved. So they have to have the tools. So I want us to do that. And I think that is our goal.

And to meet the ends that are set forth in the Dodd-Frank legislation, the Title VII goals of transparency, we must—I think we have to have transparency. And I have said before I came into this environment and never intended to do it—maybe you have had it on your wish list; it wasn't on mine—but you know don't be afraid to put daylight on it, transparency. And if you are doing it right, keep doing it right. If you are not doing it right, then be courageous and make the adjustments.

So I think we went through their process, and I think there is still some stuff right, I would guess, from the field, if you will. We are going to find some things that probably could be more right or not good. But your suggestions, your positive workable attainable suggestions that we can deal with is very important to what we want to do here.

So I welcome the Committee and the witnesses and take us to school and just be straight with us. And I think you will. Just be straight with us. What do you really need to be transparent, and you know, you have to be competitive I understand that. But if we don't have anything to hide, then let us just get right out there and grow this country and grow those markets and do what we need to do. And actually, the CFTC has been pretty successful overall. And we need to remember that, too.

So, with that, I yield back and look forward to what is next.

[The prepared statement of Mr. Boswell follows:]

PREPARED STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM IOWA

I would like to thank everyone for joining us here today as we review the state of the implementation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I would especially like to thank our witnesses today as this Committee looks forward to hearing your valuable insight.

The goal of this legislation is to bring greater transparency to Wall Street and the over-the-counter derivatives markets. In doing so, we must ensure that we provide necessary oversight of these markets without hindering legitimate consumers from operating within them.

In regulating over-the-counter derivatives, Congress made certain exceptions for end-users who utilize swaps to hedge risk and keep their businesses stable. I believe it is imperative that the regulations implemented reflect the true intent of Congress. Our goal should not punish the end-users who, like consumers, were victims in the financial crisis. Our efforts instead should focus on preventing the markets from being manipulated by a few players, and making sure that never again are American taxpayers left with the bill.

To truly meet the ends set forth in the Dodd-Frank legislation and title seven's goals of transparency and competition, we must have transparency in our regulatory process and ensure that the rules and definitions fit the needs of the markets and stakeholders, and the aims of this legislation.

I think all of us on this Subcommittee would agree that the CFTC and SEC must take the time to get this right. However, these commissions must also move quickly to ensure that individuals who use these markets for *bona fide* hedging purposes can have confidence that these markets are fair markets. Confidence in these markets is critical.

I look forward to hearing from the witnesses today, and gathering insight and expertise on this issue from a variety of industries. I am committed to working with you and the Commissions to ensure the regulations being crafted regulate this market with efficiency and transparency without hindering its practical uses. Your thoughts and submitted comments on this matter are appreciated. Thank you.

The CHAIRMAN. Thank you, Ranking Member.

I, too, look forward to working with you on this Committee.

I would ask unanimous consent to insert a letter from the National Cattleman's Beef Association, and National Corn Growers Association, and Natural Gas Supply Association into the record.

[The documents referred to are located on p. 196.]

The CHAIRMAN. With that, we now go to our witnesses.

And our first is Shawn Bernardo, Managing Director of Americas Head of Electronic Broking, Tullett Prebon, and Vice Chairman, Wholesale Markets Brokers Association, Americas, Jersey City, New Jersey.

Mr. Bernardo.

STATEMENT OF SHAWN BERNARDO, MANAGING DIRECTOR, AMERICAS HEAD OF ELECTRONIC BROKING, TULLETT PREBON; VICE CHAIRMAN, WHOLESALE MARKETS' BROKERS ASSOCIATION, AMERICAS, JERSEY CITY, NJ

Mr. BERNARDO. Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee. Thank you for providing me this opportunity to participate in today's hearing.

My name is Shawn Bernardo. I am a Managing Director and a member of the Americas Executive Committee for Tullett Prebon, the leading global interdealer broker of over-the-counter financial products.

I am also the Vice Chairman of the Wholesale Markets Brokers Association, Americas, an independent industry body whose membership includes the largest North American inter-dealer brokers.

Tullett Prebon's acts as intermediary in the wholesale financial markets where we execute trades on behalf of our customers. Our business covers a wide variety of products including U.S. Treasuries, interest rate derivatives, energy and credit, and offers voice, hybrid, and electronic broking solutions for these products.

I am here today as a practitioner in the formation of liquidity, transparency, and execution in over-the-counter markets. I began my career in the inter-dealer broker industry in 1996 as a U.S. Treasuries broker. At that time, the U.S. Treasury market was brokered predominantly in an open outcry pit where trades were executed by voice commands.

Today, the secondary market in U.S. Treasuries is an exclusively over-the-counter market but has evolved to include both electronic and voice trading and stands as an example as one of most liquid and efficient markets in the world.

My experience as a broker allowed me to help create electronic broking systems for U.S. Treasuries and CDS Index products. And I have spent the vast majority of the past 15 years building various electronic and hybrid broking platforms to promote more efficient markets.

Title VII of the Dodd-Frank Act seeks to reengineer the U.S. swaps market on two key pillars: central counterparty clearing and mandatory execution of clearable trades through registered intermediaries, such as swap execution facilities, or SEFs. Wholesale brokers are today's essential marketplaces in the global swaps market and, as such, are the prototype of these new entities being called SEFs.

We are experts in forcing liquidity and transparency in global swaps markets by utilizing trade execution methodologies that feature a hybrid blend of knowledgeable and qualified brokers as well as sophisticated electronic technology.

Tullett and the WMBA support Dodd-Frank's attempts to ensure regulatory transparency and compliance but are concerned that the regulatory agencies may interpret these goals in such a way that hinders the creation of liquidity for market participants.

Such a result will impose increased costs, particularly for end-users, or potentially render OTC derivatives markets ineffective for the purpose of hedging commercial risks.

In considering appropriate regulations, it is important to remember that liquidity in today's swaps markets is fundamentally dif-

ferent than liquidity in futures and equities markets. While some swaps are standardized, the general deal flow for swaps is not continuous. Wholesale brokers' varied execution methodologies are specifically tailored to the unique liquidity characteristics of particular swaps markets. This is why Congress permits SEFs to execute trades through any means of interstate commerce.

From the perspective of the inter-dealer broker community, it is critical that the regulators gain a thorough understanding of the many modes of execution currently deployed by wholesale brokers and then accommodate those methods and practices in their SEF rulemaking.

While the Commissions and staffs of the relevant agencies have worked extremely hard and have been attempting to better understand these markets, because of the tight time frames mandated by the Dodd-Frank Act, regulators at the SEC and CFTC have not had sufficient time and/or opportunity to properly study and understand the unique nature of the markets they are now endeavoring to write rules on and regulate.

As a result, too many of the SEC's and CFTC's proposed rules are derived directly from rules governing the equities and futures markets and are ill-suited for the fundamentally different liquidity characteristics of the swaps markets. I would suggest that there are four critical elements regulators need to get right.

First, SEFs must be able to use the multiple modes of trade execution successfully used today to execute swap transactions. Second, the goal of pre-trade transparency must be realized through means that do not destroy market liquidity from market participants and end-users. Third, the final rules for derivatives clearing organizations must comply with the nondiscriminatory access provision of the Dodd-Frank Act. And finally, regulators need to carefully structure a public trade reporting regime that takes into account the unique challenges of fostering liquidity in a diverse range of swaps markets.

I thank you for your time and look forward to answering any questions you may have.

[The prepared statement of Mr. Bernardo follows:]

PREPARED STATEMENT OF SHAWN BERNARDO, SENIOR MANAGING DIRECTOR, AMERICAS HEAD OF ELECTRONIC BROKING, TULLETT PREBON; VICE CHAIRMAN, WHOLESALE MARKETS BROKERS ASSOCIATION, AMERICAS, JERSEY CITY, NJ

Chairman Conaway, Ranking Member Boswell and Members of the Subcommittee, thank you for providing this opportunity to participate in today's hearing.

My name is Shawn Bernardo. I am a Senior Managing Director and a member of the Americas executive committee for Tullett Prebon, a leading global inter-dealer broker of over-the-counter financial products.[1] I am also the Vice Chairman of the Wholesale Markets Brokers Association, Americas (the "WMBAA"), an independent

[1] Tullett Prebon (LSE: TLPR) (*www.tullettprebon.com*) is one of the world's largest inter-dealer brokers and operates as an intermediary in wholesale financial markets facilitating the trading activities of its clients, in particular commercial and investment banks. The business now covers seven major product groups: Rates, Volatility, Treasury, Non Banking, Energy and Commodities, Credit and Equities. Tullett Prebon Electronic Broking offers electronic solutions for these products. In addition to its brokerage services, Tullett Prebon offers a variety of market information services through its IDB Market Data division, Tullett Prebon Information. Tullett Prebon has its principal offices in London, New Jersey, Hong Kong, Singapore and Tokyo, with other offices, joint ventures and affiliates in Bahrain, Bangkok, Frankfurt, Houston (Texas), Jakarta, Luxembourg, Manila, Mumbai, New York, Paris, Seoul, Shanghai, Sydney, Toronto, Warsaw and Zurich.

industry body whose membership includes the largest North American inter-dealer brokers.[2]

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

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

I welcome this opportunity to discuss with you implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "DFA") from the perspective of the primary intermediaries of over-the-counter swaps operating today here in the United States and across the globe.

In my written testimony, I plan to cover the following points:

- Wholesale brokers are today's central marketplaces in the global swaps markets and, as such, are the prototype of swap execution facilities or "SEFs."
- Wholesale brokers are experts in fostering liquidity and transparency in global swaps markets by utilizing trade execution methodologies that feature a hybrid blend of knowledgeable and qualified brokers as well as sophisticated electronic technology.
- Liquidity in today's swaps markets is fundamentally different than liquidity in futures and equities markets and the unique characteristics of this liquidity are what naturally determine the optimal mode of market transparency and trade execution.
- Wholesale brokers' methodologies for price dissemination and trade execution are specifically tailored to the unique liquidity characteristics of particular swaps markets.
- It is critical that regulators gain a thorough understanding of the many modes of swaps trade execution currently deployed by wholesale brokers and how these methods accommodate the variety of markets in which we operate. In the extremely tight time frames mandated by the DFA, regulators at the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have not had sufficient opportunity to properly study and understand the unique nature of the markets they are now endeavoring to write rules on and regulate.
- As a result, too many of the SEC's and CFTC's Title VII proposals seem to rely heavily on rules governing the equities and futures markets and are ill-suited for the fundamentally different liquidity characteristics of today's swaps markets.
- Three critical elements that regulators need to get right under Title VII are:
  - SEFs must not be restricted from deploying the many varied and beneficial trade execution methodologies and technologies successfully used today to execute swaps transactions;
  - The "goal" of pre-trade transparency must be realized through means that do not destroy market liquidity for market participants and end-users; and
  - Regulators need to carefully structure a public trade reporting regime that is not "one size fits all", but rather takes into account the unique challenges of fostering liquidity in the diverse range of swaps markets.

---

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

- As the WMBAA has proposed in formal comment letters with the SEC and CFTC,[3] a block trade standards advisory board (the "Swaps Standards Advisory Board") should be established and made up of recognized experts and representatives of registered SDRs and SEFs to make recommendations to the SEC and CFTC for appropriate block trade thresholds for swaps and security-based swaps.
- Congress can assist with technical corrections to Dodd-Frank and, crucially, by providing regulators with adequate time and resources to thoroughly understand the challenges and current solutions to garnering trading liquidity in the swaps markets.
- Taking adequate time to get the Title VII regulations right will expedite the implementation of the worthy goals of Dodd-Frank: central counterparty clearing and effective trade execution by regulated intermediaries in order to provide end-users with more competitive pricing, increased transparency and deeper trading liquidity for their risk management needs.

Background on Tullett Prebon and Wholesale Brokers

My firm, Tullett Prebon, has a presence in over 20 countries and employs over 2,400 people. In the United States, we have operations in New York, New Jersey, Alabama, and Texas, employing nearly 500 brokers and 700 total employees at these locations. Tullett Prebon's history stretches back to 1868 in England as one of the first money brokers in the City of London and, though we have grown through various mergers over the years, we have maintained a proud tradition of brokering on behalf of our clients and providing transparency and liquidity in the over-the-counter markets through world-class expertise and service.

We provide a marketplace for a relatively small number of sophisticated institutional buyers and sellers of OTC financial products where their trading needs can be matched with other sophisticated counterparties having reciprocal interests in a transparent, yet anonymous, environment. To persons unfamiliar with our business, I often describe interdealer brokers as something of a virtual trading floor where large financial institutions buy and sell financial products that are not suited to and, therefore, rarely trade on an exchange.

As we sit here today, interdealer brokers are facilitating the execution of hundreds of thousands of OTC trades corresponding to an average of $5 trillion in notional size across the range of foreign exchange, interest rate, Treasury, credit, equity and commodity asset classes in both cash and derivative instruments. We are wholesale brokers (sometimes called "inter-dealer" brokers). WMBAA member firms account for over 90% of intermediated swaps transactions taking place around the world today. Our industry does not serve household or retail customers. Rather, we operate at the center of the global wholesale financial markets by aggregating and disseminating prices, providing price transparency and fostering trading liquidity for financial institutions around the world. The roots of our industry go back over a century in the world's major financial centers. Our activities in most of the markets we serve today are highly regulated.

Wholesale brokers provide highly specialized trade execution services, combining teams of traditional "voice" brokers with sophisticated electronic trading and matching systems. As in virtually every sector of the financial services industry in existence over the past 50 years, wholesale brokers and their dealer clients began connecting with their customers by telephone. As technologies advanced and markets grew larger, more efficient, more diverse and global, these systems have advanced to meet the changing needs of the market. Today, we refer to this integration of voice brokers with electronic brokerage systems as "hybrid brokerage". Wholesale brokers, while providing liquidity for markets and creating an open and transparent environment for trade execution for their market participants, do not operate as single silo and monopolistic "exchanges." Instead, we operate as competing execution venues, where wholesale brokers vie with each other to win their customers' business through better price, provision of superior market information and analysis, deeper liquidity and better service. Our customers include large national and money center banks and investment banks, major industrial firms, integrated energy and major oil companies and utilities.

Increasingly, the efficiencies of the market have inevitably led to a demand for better trading technology. To that end, we develop and deploy sophisticated trade execution and support technology that is tailored to the unique qualities of each specific market. For example, Tullett Prebon's customers in certain of our more complex, less commoditized markets may choose among utilizing our tpCreditdeal™,

[3] *See* Comment Letter from WMBAA (January 18, 2011) ("1/18/11 WMBAA Letter").

tpEnergytrade™, tpMatch™ or TradeBlade® electronic brokerage platforms to trade a range of fixed income derivatives, interest rate derivatives, foreign exchange options, repurchase agreements and energy derivatives entirely on screen or they can execute the same transaction through instant messaging devices or over the telephone with qualified Tullett Prebon brokers supported by sophisticated electronic technology. It is important to note that the migration of certain products to electronic execution was not and has never been because of regulatory or legal mandate but simply part of the natural evolution and development of greater market efficiencies in particular markets.

The electronic platforms mentioned above serve our customers needs in various ways. Some of the platforms are hybrid where the customer has the choice of speaking with a broker to bid, offer or execute or the customer can execute directly on the screen. While other platforms are fully electronic and there is no broker intervention, the customers bid, offer and execute on their own behalf. These systems have evolved over time to meet the demands of the markets and need of the customers. At no time in my experience on Wall Street has there been a regulatory or legal mandate that helped these markets evolve. There are times when we have attempted to migrate markets onto an electronic system prematurely and were unsuccessful because the market was not ready.

The critical point is that competition in the marketplace for transaction services has led interdealer brokers to develop highly sophisticated transaction services and technologies that are well tailored to the unique trading characteristics of the broad range of swaps and other financial instruments that trade in the over-the-counter markets today. Unlike futures exchanges, we enjoy no execution monopoly over the products traded by our customers. Therefore, our success depends on making each of our trading methods and systems right for each particular market we serve. From our decades of competing for the business of the worlds' largest financial institutions, we can confirm that there is no "one size fits all" method of executing swaps transactions.

Fostering Liquidity in Swaps Markets

The essential role of a wholesale broker is to enhance trading liquidity. In essence, liquidity is the degree to which a financial instrument is easy to buy or sell quickly with minimal price disturbance. The liquidity of a market for a particular financial product or instrument depends on several factors, including the parameters of the particular instrument such as tenor and duration of a swap, the degree of standardization of instrument terms, the number of market participants and facilitators of liquidity, and the volume of trading activity. Liquid markets are characterized by substantial price competition, efficient execution and high trading volume.

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

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

In stark contrast, most swaps markets and other less commoditized cash markets feature a far broader offering of less-standardized products and larger-sized orders that are traded by far fewer counterparties, almost all of which are institutional and not retail. Trading in these markets is characterized by sporadic or *non-continuous liquidity.* To offer one simple example, of the over 4,500 corporate reference entities

in the credit default swaps market, 80% trade less than five contracts per day.[4] Such thin liquidity can often be episodic, with liquidity peaks and troughs that are often related to key events such as unemployment reports, meetings of the Federal Reserve and tied to external market economic and geopolitical conditions (*e.g.,* many credit and interest rate products).

General Comparison of OTC Swaps Markets to Listed Futures Markets[5]

Characteristic	OTC Swaps	Listed Futures
Trading Counterparties	10s–100s (no retail)	100,000s (incl. retail)
Daily Trading Volume	1,000s	100,000s
Tradable Instruments	100,000s[6]	1,000s
Trade Size	Very large	Small

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

The effect of these very different trading characteristics results in fairly continuous liquidity in futures and equities compared with limited or episodic liquidity in swaps. There is richness in those differences, because taken together, this market structure has created appropriate venues for trade execution for a wide variety of financial products and a wide variety of market participants. But the difference is fundamental and a thorough understanding of it must be at the heart of any effective rule making under Title VII of DFA. The distinct nature of swaps liquidity has been the subject of several studies and comment letters presented to the CFTC and the SEC.[7]

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

Dodd-Frank Impact on Swaps Market Structure: Clearing and Competing Execution

Title VII of Dodd-Frank was an earnest and commendable effort by Congress to reform certain aspects of the OTC swaps market. The DFA's core provisions concerning swaps are: one, replacing bilateral trading where feasible with central counterparty clearing, and two, requiring that cleared swaps transactions between swaps dealers and major swaps participants be intermediated by qualified and regulated trading facilities, including those operating under the definition of "Swap Execution Facilities (SEFs)" through 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 . . ."[8] These two operative provisions seek to limit the current market structure where swaps and the underlying counterparty risk may be traded directly between counterparties without the use of trading intermediaries or clearing, and to replace it for most

[4] ISDA & SIFMA, "Block Trade Reporting for Over-the-Counter Derivatives Markets," January 18, 2011, ("ISDA/SIFMA Block Trade Study"). Available at *http://www.isda.org/speeches/pdf/Block-Trade-Reporting.pdf.*

[5] *See* ISDA/SIFMA Block Trade Study.

[6] Inclusive of all tenors, strikes and duration.

[7] ISDA/SIFMA Block Trade Study; Comment Letter of JPMorgan (January 12, 2011) ("JP Morgan Letter").

[8] *See* Commodity Exchange Act ("CEA") Section 1a(50).

transactions with a market structure in which a central clearing facility acts as the single counterparty to each market participant (*i.e.,* buyer to each seller and seller to each buyer) and where those cleared transactions must be traded through SEFs and other intermediaries and not directly between the counterparties.

In enacting these structural changes, DFA wisely rejected the anti-competitive, single silo, exchange model of the futures industry, in which clearing and execution are intertwined thereby giving the exchange an effective execution monopoly over the products that it clears.[9] Rather, by requiring central clearing counterparties to provide non-discriminatory access to unaffiliated execution facilities, DFA promotes a market structure in which competing SEFs and exchanges will vigorously compete with each other to provide better services at lower cost in order to win the execution business of sophisticated market participants. In this regard, DFA preserves the best competitive element in the existing swaps landscape: competing wholesale brokers.

Tullett Prebon and the WMBAA members heartily support Dodd-Frank's twin requirements of clearing and intermediation. Their advocacy of swaps intermediation is fundamental to their business success in fostering liquidity, providing price transparency, developing and deploying sophisticated trading technology tools and systems and operating efficient marketplaces in global markets for swaps and other financial products.

Wholesale Brokers Will Serve as Responsible SEFs

As noted, interdealer brokers actively deploy a range of execution services, technologies and other "means of interstate commerce" to display prices to "multiple participants" to connect them with other "multiple participants" in billions of dollars of daily swaps trades. As such, wholesale brokers are the true prototype for prospective independent and competitive SEFs under DFA.

More importantly, Tullett Prebon and other members of the WMBAA look forward to performing our designated roles as SEFs under DFA. The wholesale brokerage industry is working hard and collaboratively with the two Commissions to inform and comment on proposed rules to implement DFA. The WMBAA has submitted several comment letters[10] (copies attached) and expects to provide further written comments to the CFTC and SEC. The WMBAA has also hosted the first conference, SEFCON 1[11], dedicated specifically to SEFs. Further, the WMBAA has conducted numerous meetings with Commissioners and staffs. We and the wholesale brokerage industry are determined to play a constructive role in helping the SEC and the CFTC to get the new regulations under Title VII of DFA right.

Three Critical Elements To Get Right

There are many things to get right under DFA. Given that DFA requires all clearable trades to be transacted through an intermediary (either an exchange or a Swap Execution Facility), three critical elements are:

1. Permitted Modes of Swaps Execution.
2. Pre-Trade Price Discovery & Transparency for Market Participants.
3. Post-Trade Price Transparency & Reporting.

1. Permitted Modes of Execution

As stated, DFA defines SEFs as utilizing "any means of interstate commerce" to match swaps counterparties. This is an appropriate allowance by Congress as the

---

[9] As the Justice Department observed in a 2008 comment letter to the Treasury Department, where a central counterparty clearing facility is affiliated with an execution exchange (such as in the case of U.S. futures), vertical integration has hindered competition in execution platforms that would otherwise have been expected to: result in greater innovation in exchange systems, lower trading fees, reduced ticket size and tighter spreads, leading to increased trading volume and benefits to investors. As noted by the Justice Department, "the control exercised by futures exchanges over clearing services . . . has made it difficult for exchanges to enter and compete." In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. The absence of vertical integration has facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads and high trading volume. See Comments of the Department of Justice before the Department of the Treasury Review of the Regulatory Structure Associated With Financial Institutions, January 31, 2008. Available at *http://www.justice.gov/atr/public/comments/229911.htm.*

[10] *See* Comment Letter from WMBAA (November 19, 2010) ("11/19/10 WMBAA Letter"); Comment Letter from WMBAA (November 30, 2010) ("11/30/2010 WMBAA Letter"); 1/18/11 WMBAA Letter; Comment Letter from WMBAA (February 7, 2011) ("2/7/11 WMBAA Letter").

[11] SEFCON 1 was held in Washington, D.C. on October 4, 2010. The keynote address was given by CFTC Commissioner Gary Gensler.

optimal means of interaction in particular swaps markets varies across the swaps landscape. Congress recognized that it was best left to the marketplace to determine the best modes of execution for various swaps and, thereby, foster technological innovation and development. Congress specifically did not choose to impose a Federally mandated "one-size-fits-all" transaction methodology on the regulated swaps market.

As the swaps market has developed, it has naturally taken on different trading, liquidity and counterparty characteristics for its many separate markets. For example, in more liquid swaps markets with more institutional participants, such as certain U.S. Treasury, foreign exchange and energy products, wholesale brokers operate fully interactive electronic trading platforms, where counterparties can view prices and act directly through a trading screen and also conduct a range of pre- and post-trade activities like on-line price analysis and trade confirmation. These electronic capabilities reduce the need for actual voice-to-voice participant interaction for certain functions, such as negotiation of specific terms, and allow human brokers to focus on providing market intelligence and assistance in the execution process. And yet, even with such technical capabilities, the blend of electronic and voice assisted trading methods still varies for different contracts within the same asset class.

In markets for less commoditized products where liquidity is not continuous, Tullett Prebon and its competitors provide a range of liquidity fostering methodologies and technologies. These include hybrid modes of: (a) broker work up methods of broadcasting completed trades and attracting others to "join the trade" and (b) auction-based methods, such as matching and fixing sessions. In other swaps markets, brokers conduct operations that are similar to traditional "open outcry" trading pits where qualified brokers communicate bids and offers to counterparties in real time through a combination of electronic display screens and hundreds of installed, always-open phone lines, as well as through other e-mail and instant messaging technologies. In every case, the technology and methodology used is well calibrated to disseminate customer bids and offers to the widest extent and foster the greatest degree of liquidity for the particular market.

The WMBAA has been active in seeking to educate U.S. regulators about the multiple modes of execution utilized in the swaps markets today. We have given technology demonstrations to regulators in their offices and hosted tours of our New York brokerage operations to CFTC Commissioners O'Malia and Chilton. We are in the process of trying to schedule these educational tours for other CFTC and SEC Commissioners and staff who are actually writing the rules, the majority of whom have never seen an actual swaps trade transacted. We understand that budget constraints currently facing these agencies may be a hindrance for additional tours and demonstrations. *Yet, we believe it is critical that the CFTC and SEC completely understand these markets and familiarize themselves with the many modes of execution currently deployed in the marketplace to accommodate the varying characteristics of different swaps markets* ***before*** *finalizing the rules governing trade execution.*

CFTC Commissioner Bart Chilton had this to say about a recent visit he made to one of the WMBAA member's New York brokerage floor, "I was surprised by what I didn't know . . . Well, these are big, dynamic operations, not just a couple of guys in a back room with a phone. I don't think we have a full appreciation of the OTC markets yet." [12]

It is vitally important that SEF rules promulgated by the CFTC and SEC encompass the many varied and beneficial trading methodologies that are used today to execute swaps in these very competitive swap markets. Under Dodd-Frank, Congress wisely permitted SEFs to utilize "any means of interstate commerce" to transact swaps. Congress recognized that restricting methods of execution of swaps instruments with non-continuous liquidity could do substantial harm to the orderly operation of U.S. swaps markets overall, to the detriment of those market participants who need to manage risk. There is no basis in Dodd-Frank for regulations designed to restrict or promote any one component or other of the hybrid means of swaps execution utilized by wholesale brokers and SEFs. Moreover, we believe it would be detrimental to liquidity in the swaps markets for the CFTC or SEC to mandate unduly restrictive or prescriptive transaction methodologies. Similarly, we believe it would be harmful to liquidity for the CFTC or SEC to mandate swaps trading methodologies taken from the highly commoditized equities or futures markets that are inappropriate and ill suited for the multiple and varied U.S. swaps

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

markets. We are highly concerned about seemingly artificial and arbitrary divisions between electronic and human-assisted modes of swaps execution that would be imposed under the CFTC's SEF proposals.

The WMBAA is currently drafting comment letters on the CFTC and SEC SEF proposals. We will be happy to provide this Committee copies as soon as those letters are filed. At this stage we are concerned that the rules have not provided enough flexibility or sufficient guidance to ensure that all modes of trade execution utilizing "any means of interstate commerce" will be embraced, a very clear directive of the DFA. We believed this is rooted in a lack of sufficient exposure and understanding as to how trades are currently executed in the wholesale markets in a way that employs a wide array of technology to provide a vibrant and transparent market for "multiple participants [to] have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system."

It is worth noting that European regulators do not appear to be considering rules with similarly proscriptive limits on trade execution methodology. We are not aware of any significant regulatory efforts in Europe to mandate electronic execution of cleared swaps by institutional market participants. In a world of competing regulatory regimes, business naturally flows to the market place that has the best regulations—not necessarily the most lenient, but certainly the ones that have the optimal balance of liquidity, execution flexibility and participant protections. In a market without retail participants, we question what useful protections are afforded to large institutions (required to transact swaps on SEFs) by proposed U.S. regulations that would limit the methods by which market participants may execute their orders. Rather, U.S. regulations need to be in harmony with regulations from foreign jurisdictions to avoid driving trading liquidity away from U.S. markets towards markets offering greater flexibility in modes of trade execution.

2. Pre-Trade Price Transparency

The SEF provisions in Dodd-Frank contain a rule of construction for their operation: "to promote pre-trade price transparency in the swaps market."[13] Not surprisingly, interdealer brokers operate in furtherance of that goal. Our business model is driven by revenues from commissions paid on transactions. Our goal is to complete more transactions with more customers. Therefore, it is in each of our firm's economic interest to naturally and consistently disseminate trade bids and offers to the widest practical range of customers with the express purpose of price discovery and the matching of buyers and sellers. We employ a number of means of pre-trade transparency from software pricing analytics to electronic and voice price dissemination to electronic price work up technology. There is no reason we should be required to or would wish to curtail these transparency techniques upon qualification as SEFs. We endorse and currently promote the goal of pre-trade price transparency by providing market information by voice and electronic means to multiple market participants to create greater trading liquidity, the natural activity of intermediaries.

We are concerned, however, that this pre-trade price transparency rule of construction not be used as the basis for the imposition of artificial and, somewhat, experimental restrictions on market activity. For example, the CFTC's SEF proposals require "a minimum pause of 15 seconds between entry of two potentially matching customer-broker swap orders or two potentially matching customer-customer orders"[14] (Referred to below as the "15 Second Rule"). We are concerned that this provision could have a potentially devastating impact on liquidity in most swaps markets and we intend to address it in formal comments to the CFTC.

As noted earlier, buy-side customers often look to swaps dealers to undertake the liquidity risk of trading in swaps for which there is non-continuous liquidity. Under DFA, the dealer would take on that risk by placing both the customer's sale order and the dealer's buy order into a SEF for execution. One adverse impact of the proposed 15 Second Rule may be that the dealer will not know until the expiration of 15 seconds whether it will have completed both sides of the trade or whether another market participant will have taken one side. Therefore, at the time of receiving the customer order the dealer has no way of knowing whether it will ultimately serve as its customer's principal counterparty or merely as its executing agent. The result will be greater uncertainly for the dealer in the use of its capital and, possibly, the reduction of dealer activities leading, in turn, to diminished liquidity in and competitiveness of U.S. markets with detrimental results for buy-side customers and end-users.

---

[13] *See* CEA Section 5h(e).

[14] Core Principles and Other Requirements for Swap Execution Facilities, 76 FR 1214 (January 7, 2011).

As a general matter, we note the conflict between, on the one hand, a rule of construction to promote pre-trade price transparency and, on the other hand, the express mandate under Dodd-Frank to allow delayed reporting of trade information for block trades because of the impact disclosure would have on liquidity in the market. In the first case, there are no operative provisions for pre-trade price transparency in Dodd-Frank that correspond to the non-binding rule of construction. In the second case, DFA specifically requires delayed reporting of block trades to preserve market liquidity and counterparty anonymity. We believe the specific DFA requirement for delayed block trade reporting takes precedence in implementation over the non-binding rule of construction to promote pre-trade transparency. We believe the Commissions should place great emphasis on complying with the operative requirements [15] of Dodd-Frank regarding block trading, ensuring liquidity of markets and preserving anonymity of parties to a trade as they relate to public reporting of trade information and ensuring that those requirements are not conflicted in the arbitrary pursuit of a "goal" of pre-trade transparency. We do not believe that the goal of pre-trade transparency justifies imposing on SEF's experimental trade execution mechanisms that are ill-suited for the unique characteristics of the swaps markets.

3. Post-Trade Price Reporting & Transparency

It is certainly true that the right measure of pre and post trade transparency can benefit market liquidity. Yet, it is also true that absolute transparency can harm liquidity. The objective must be to strike the right balance. The impact on market liquidity of the CFTC and SEC's proposals on swaps trade reporting and transparency depend on finding the right balance in the final rules governing large block trading. If the rules do not properly define block trade size and thresholds in the context of the unique characteristics of various swaps markets, then the trade reporting of blocks could negatively impact market liquidity, disturbing businesses' ability to hedge commercial risk, to appropriately plan for the future and, ultimately, stifle economic growth and job creation.

Brokers have long recognized that in the less liquid swaps markets where a smaller number of primary dealers and market makers cross larger size transactions, the disclosure of the intention of a major institution to buy or sell could disrupt the market and lead to poor pricing. If a provider of liquidity to the market perceives greater danger in supplying liquidity, it will step away from providing tight spreads and leave those reliant on that liquidity with poorer hedging opportunities. From a market structure standpoint, liquidity "takers" benefit from liquidity providers acting in a competitive environment. The liquidity providers compete with each other, often deriving reasonably small profits per trade from a large volume of transactions. By relying on their ability to warehouse trades and post capital to make markets and using their distribution and professional know-how to offer competitive prices to their customer base, dealers and market makers provide liquidity essential to the execution of hedging and other risk management strategies.

By imposing a regulatory regime where the market is quickly alerted whenever providers of liquidity take on risk, it becomes difficult for the risk takers to offset such risk without significant loss. The effect is greater risk, higher costs and, ultimately, less liquidity. Disseminating the precise notional amount of a particular large transaction could jeopardize the anonymity of the counterparties to such trades, making counterparties less willing to engage in transactions of size. Similarly, the effect of having no delay, or only a short dissemination delay, for a block trade report that includes the full notional size will discourage market makers from committing capital and providing liquidity to the broader market. For these reasons, having either no delay or a short dissemination delay will actually erode price discovery and the level of price efficiency in the market. We note and echo the concerns expressed by the Coalition for Derivatives End-Users that, "An across-the-board 15 minute time delay that does not account for the instrument type and market conditions is too simplistic to be effective for the derivatives market." [16]

There are historical examples of markets that have sought to achieve full post-trade transparency without adequate block trade exemptions. The results were not positive. In 1986, the London Stock Exchange ("LSE") enacted post trade reporting rules designed for total transparency with no exceptions for block sizes. What ensued was a sharp drop in trading liquidity as market makers withdrew from the

[15] Section 727 of the Dodd-Frank Act; Section 763(i) of the Dodd-Frank Act.

[16] Comment Letter from Coalition for Derivatives End-Users (February 7, 2011) ("2/7/11 Coalition Letter").

market due to increased trading risk.[17] The LSE thereafter engaged in a series of amendments to make its block trade rules more flexible and detailed over time.

Achieving the right balance in block trade rules for swaps markets requires recognition that the thresholds and reporting delay must be different by asset class and instrument and need to be tailored with the greatest of precision. A "one-size-fits-all" approach will not work. The elements of trade size, delay period and disclosed information set should be individually established based upon the unique liquidity requirements of particular instruments and markets. It is vitally important that block trade thresholds and reporting periods be matched properly to the markets to which they apply; otherwise, the markets will adversely adapt to arbitrary rules leading to all manner of dislocation and misuse.

It is worth noting that the trade reporting regime that is often cited positively as a model for swaps trade reporting is the TRACE system for U.S. corporate bonds. That system was phased in over 3 years. We believe that markets as complex as the swaps markets require at least as long a phase-in period to be cautious and make sure the formulas and mechanisms work properly. Furthermore, as with TRACE, during the phase-in period, there should be appropriate study of the effects on market liquidity, as required by the statute.

We also note that because of the fundamental differences in liquidity in the swaps markets from those in the futures and equities markets, those markets provide inadequate and inappropriate models for the swaps markets for block trade calculations of size, content and time delay. As a result of the unique non-continuous nature of liquidity in certain swaps markets (with fewer participants), we believe that the CFTC and SEC need to carefully structure a public trade reporting regime that is not "one size fits all", but rather takes into account the unique challenges of fostering liquidity in the diverse range of swaps markets, provides for the transacting of larger transactions without unnecessary regulatory burdens, and does not materially reduce market liquidity.

The WMBAA has proposed[18] the formation of a block trade standards advisory board (the "Swaps Standards Advisory Board") made up of recognized experts and representatives of registered SDRs and SEFs to make recommendations to the Commissions for appropriate block trade thresholds for swaps and security based swaps. (Copy attached.) The WMBAA cites the role of existing CFTC advisory committees, such as the in Agricultural Advisory Committee, Global Markets Advisory Committee, Energy and Environmental Markets Advisory Committee, and the Technology Advisory Committee, which serve to receive market participant input and recommendations related to regulatory and market issues. While the Commission is authorized under Dodd-Frank to establish block trade standards on its own, we believe that a Swaps Standards Advisory Board, similar to the above-referenced advisory committees, could provide the Commission with meaningful statistics and metrics from a broad range of contract markets, SDRs and SEFs to be considered in any ongoing rulemakings in this area.

A Swaps Standards Advisory Board would work with the Commissions to establish and maintain written policies and procedures for calculating and publicizing block trade thresholds for all swaps reported to the registered SDR in accordance with the criteria and formula for determining block size specified by the Commissions. The Swaps Standards Advisory Board would also undertake the market studies and research at industry expense that is necessary to help establish such standards. This arrangement would permit SEFs, as the entities most closely related to block trade execution, to provide essential input into the Commission's block trade determinations and work with registered SDRs to distribute the resulting threshold levels to SEFs. Further, the proposed regulatory structure would reduce the burden on SDRs, remove the possibility of miscommunication between SDRs and SEFs, and ensure that SEFs do not rely upon dated or incorrect block trade thresholds in their trade execution activities.

Areas Where Congress Can Help

In this testimony, I have called on the CFTC and SEC to better understand the distinct nature of the swaps markets and not align their rulemaking with familiar and inappropriate models of the futures and equities markets simply because they do not have the time necessary to understand the unique nature of how the swaps market works due to the arbitrary time constraints set forth in the DFA. I have criticized a specific rule proposal (the 15 Second Rule) and arbitrary limits on SEFs' use of "any means of interstate commerce" to transact customer orders.

---

[17] ISDA/SIFMA Block Trade Study, p. 8.
[18] 1/18/11 WMBAA Letter.

I commend the two Commissions (SEC and CFTC) and their staffs for their evident good faith and determination. They are working very hard to get this right. I and many colleagues in the wholesale brokerage industry are optimistic that, given enough time, we can work with the regulators to fine tune rules regarding modes of intermediation, transparency and non-discrimination towards SEFs. That said, there are two areas where Congress can help.

Time Frames: In proscribing specific rule promulgation dates, DFA did not give regulators enough time to complete an orderly transformation of the multi-trillion Dollar U.S. swaps market to a cleared and intermediated structure. The mandated time frames are just too tight to get the details right. CFTC Commissioner Scott O'Malia has called them "unrealistic."[19] They are indeed unrealistic and put an unreasonable burden on the staff of the regulatory commissions to sufficiently familiarize themselves with the workings of the OTC swaps markets. Yet, such familiarity and, indeed, expertise, is absolutely necessary since heretofore neither agency had direct regulatory authority or involvement with these markets. Without the time or the resources to understand these markets, each agency will have the natural tendency to fall back on the familiarity of the markets they already regulate. The CFTC's proposals rely heavily on the futures exchange market model and the SEC's rules more prone to a securities market model. Not only is the swap market and its diverse elements unique, but it is critically important that there be consistency between the two agencies. More time and resources would surely give both agencies a better chance to first, do no harm and second, reach the right outcome.

Several days after viewing a WMBAA member's New York brokerage operations, CFTC Commissioner Bart Chilton put it thus in a speech: ". . . We are also working, in the crafting of SEF rules, to ensure that we do not mess up platforms that are currently working well. This is a delicate balancing act, and we need to hear from market participants that have the expertise and interest in this area to make sure we get it right."[20] Commissioner Chilton is exactly correct that in crafting SEF rules, regulators must better understand platforms that are currently working well so as not to mess them up.

What is needed is for Congress to give regulators the necessary time to understand more precisely those swaps platforms that are currently working well and discourage them from "ready, fire, aim" approach to the regulation. Commissioners like Bart Chilton and responsible regulators must have the opportunity to better consider how existing intermediaries function, how they deploy technology, how they promote price transparency and how they use many means of execution to connect multiple to multiple market participants. From an understanding of the effectiveness of these systems for the markets they serve, regulators may gain comfort to more fully endorse working execution models rather than having to impose artificial models or those from distinct markets. Market research and further studies may be required to provide the thorough knowledge necessary to craft workable, effective and appropriate rules and regulations, and this will take time.

If regulators are given sufficient time and, frankly, resources to craft SEF rules that are well tailored to the existing trading methods in the swaps markets, a benefit may be a shorter and more effective implementation period by the swaps industry. Rushing the rules will make implementation slower, harder and more costly. Taking the time to make the rules reflect the way the swaps markets actually work will speed implementation and save money. As the adage goes, "Measure twice, cut once."

Industry Efforts: Second, DFA failed to dot a few 'i's and cross a few 't's. For example, Dodd-Frank sets up a framework of competing SEFs and DCMs, yet in its core principles requires that each SEF monitor and enforce counterparty position limits and manipulative trading practices.[21] The requirement presumes that each SEF has sufficient market and customer knowledge to comply. However, as competing execution facilities, SEFs will rarely handle or be aware of a counterparty's entire trading activity, which will be directed most likely to numerous SEFs depending on best execution, price and liquidity. Because SEFs are not structured as Designated Clearing Organizations or Swap Data Repositories, they will have no way of knowing the aggregate position limits or composite trading strategies of their customers and will fail to comply with the respective Core Principles.

---

[19] Keynote Address by Commissioner Scott D. O'Malia at Tabb Forum Conference (January 25, 2011).

[20] Speech of Commissioner Bart Chilton to the American Public Gas Association Winter Conference, Fort Myers, Florida, (February 1, 2011).

[21] CEA Section 5h(f)(6); *See* Section 733 of the Dodd-Frank Act.

Another practical impossibility is presented by Core Principle 4 which requires SEFs to monitor trading and trade processing.[22] This requirement provides that when a swap is settled by reference to the price of an instrument traded in another venue the SEF must also monitor trading in the market to which the swap is referenced. In other words, a SEF that executes a trade of a credit default swap on a Ford Motor Company bond must also monitor trading in Ford Motor Company bonds. Yet, while SEFs certainly have the ability to monitor trades that they execute, they are not in a position to independently and effectively monitor positions and trading that takes place in other markets.

As the CFTC states on their website[23] regarding their trade surveillance program, only it can "consolidate data from multiple exchanges and foreign regulators to create a seamless, fully-surveilled marketplace" due to the Commission's unique space in the regulatory arena. The surveillance "requires access to multiple streams of proprietary information from competing exchanges, and as such, can only be performed by the Commission or other national regulators". The CFTC correctly states that the surveillance "can not be filled by foreign and domestic exchanges offering related competing products", and there is no reason to believe a SEF would be better situated. And yet, unless each SEF fills this sort of surveillance function, it will be in violation of SEF core principles.

A further issue is that SEFs ideally should be able to delegate relevant functions to a self-regulatory organization ("SRO"). Unfortunately DFA does not expressly contemplate such delegation as, for example, the CEA permits for other types of registered entities.[24] Further, it is not clear that even if permitted, SEFs would voluntarily delegate responsibilities to the existing SROs.

What is clear is that the proposed SEF rules create a host of new obligations for SEFs, as well as for the CFTC and the SEC. It also appears that the SEC and CFTC lack the resources necessary to implement and enforce the new rules. And if projections of 50–100 SEFs are correct, a new regulatory structure to facilitate compliance by SEFs with the applicable laws and regulations will need to be developed.

To address some of these issues, the WMBAA proposes the establishment of a common regulatory organization (CRO)[25] that will facilitate compliance with the core principles by each of its members as well as for any other SEF that agrees to follow its rules. The CRO would not itself have any direct regulatory responsibilities, but it would, by way of contractual obligations, assist its members by addressing compliance issues that are common to all SEFs. This solution would be industry and not taxpayer financed. However, this solution is not expressly authorized by DFA and would benefit from a Congressional mandate to confirm its utility.

Conclusion

Dodd-Frank seeks to reengineer the U.S. swaps market on two key pillars: central counterparty clearing and mandatory intermediation of clearable trades through registered intermediaries such as SEFs. Wholesale brokers are today's central marketplaces in the global swaps markets and, as such, are the prototype of swap execution facilities.

Liquidity in today's swaps markets is fundamentally different than liquidity in futures and equities markets and naturally determines the optimal mode of market transparency and trade execution. Wholesale brokers are experts in fostering liquidity in non-commoditized instruments by utilizing methodologies for price dissemination and trade execution that feature a hybrid blend of knowledgeable qualified voice brokers and sophisticated electronic technology. Wholesale brokers' varied execution methodologies are specifically tailored to the unique liquidity characteristics of particular swaps markets.

It is critical that regulators gain a thorough understanding of the many modes of swaps trade execution currently deployed by wholesale brokers and accommodate those methods and practices in their SEF rulemaking. Too many of the SEC's and CFTC's Title VII proposals are based off of rules governing the equities and futures markets and are ill-suited for the fundamentally different liquidity characteristics of today's swaps markets.

---

[22] CEA Section 5h(f)(4); *See* Section 733 of the Dodd-Frank Act.

[23] CFTC Market Surveillance Program. *Available* at *http://www.cftc.gov/IndustryOversight/MarketSurveillance/CFTCMarketSurveillanceProgram/tradepracticesurveillance.html.*

[24] See 7 U.S.C. § 7a–2(b).

[25] Distinguished from an SRO to avoid confusion with the legal and regulatory implications of an SRO.

Regulators are undoubtedly working hard to put in place appropriate rules under Title VII. They have their work cut out for them and there are at least three critical elements for success:

1. SEFs must not be restricted from deploying the many varied and beneficial trade price dissemination and trade execution methodologies and technologies successfully used today to execute swaps.

2. The "goal" of pre-trade transparency must be realized through means that do not destroy market liquidity for market participants and end-users.

3. Regulators need to carefully structure a public trade reporting regime that is not "one size fits all", but rather takes into account the unique challenges of fostering liquidity in the diverse range of swaps markets.

Congress can assist with technical corrections to Dodd-Frank and, crucially, by providing regulators with adequate time and resources to thoroughly understand the challenges and current solutions to garnering trading liquidity in the swaps markets. Rushing the rule making process and getting things wrong will negatively impact market liquidity in the U.S. swaps markets, disturbing businesses' ability to hedge commercial risk, to appropriately plan for the future and, ultimately, stifle economic growth and job creation.

Taking adequate time to get the Title VII regulations right will expedite the implementation of the worthy goals of Dodd-Frank: central counterparty clearing and effective trade execution by regulated intermediaries in order to provide end-users with more competitive pricing, increased transparency and deeper trading liquidity for their risk management needs. With Congress' help, and the input and support of the swaps industry, regulators can continue their dedicated efforts at well crafted rule making. If we are successful, our U.S. financial system, including the U.S. swaps markets, can once again be the well ordered marketplace where the world comes to trade.

Thank you for your consideration. I look forward to answering any questions that you may have.

ATTACHMENTS

November 19, 2010

Hon. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission,
Washington, D.C.

Hon. MARY SCHAPIRO,
Chairman,
Securities and Exchange Commission,
Washington, D.C.

Dear Chairmen Gensler and Schapiro,

The Wholesale Markets Brokers Association, Americas ("WMBAA" or "Association") appreciates the opportunity to submit to the U.S. Commodity Futures Trading Commission ("CFTC") and the U.S. Securities and Exchange Commission ("SEC" and, collectively with the CFTC, the "Commissions") general comments for your consideration. We appreciate the great efforts of both Commissions to implement regulations under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and are supportive of steps taken to ensure stability in over-the-counter ("OTC") derivatives markets.

As you and your fellow Commissioners discuss staff proposals for rules governing swap execution facilities and security-based swap execution facilities ("SEFs") and other related issues, the WMBAA offers the following comments for your consideration.

Pre-trade Transparency

The SEF provisions in the Dodd-Frank Act contain a rule of construction that the goal is, in part, "to promote pre-trade transparency in the swaps market." Currently, the WMBAA member firms each operate trading facilities that thrive as competitive sources of liquidity because each facility naturally and consistently disseminates market information to all its participants, with the express purpose of matching buyers and sellers. As these fundamental principles are applied to the establishment of SEFs, which themselves permit multiple participants to accept bids and offers made by multiple participants in the facility, the notion of intermediaries pro-

viding market information to participants in an effort to create liquidity is one that the WMBAA recognizes as essential to the vitality of OTC derivatives markets.

WMBAA members are supportive of providing information to their participants through multiple modes of communication, depending on the depth of liquidity and trading frequency of the asset class, to ensure access to competitive pricing for counterparties. Further, the WMBAA recognizes the required compliance with core principles that include a mandate to (i) establish and comply with trading procedures for entering and executing large notional swap or security-based swap transactions (block trades) traded on the facility and (ii) comply with the Commission-established time delay for reporting block trades. In addition, the provisions in the Dodd-Frank Act related to the public reporting of swap and security-based swap transaction data require that, with respect to the providing for the public availability of transaction and pricing data, rules promulgated by each Commission must protect the identity of counterparties and take into account whether public disclosure will materially reduce market liquidity. The WMBAA believes that the Commissions should work carefully to ensure that any reporting regime, whether for pre- or post-trade information, adequately protects these interests and does not jeopardize OTC derivatives as an effective source of liquidity.

The WMBAA urges the Commissions to consider the difficulties associated with complying with pre-trade price transparency requirements, on the one hand, and delayed reporting of trade information for those transactions that qualify as block trades. The publication of pre-trade price information does not comport with the notion that, in certain instances, trade information should be reported on a delayed basis to protect trade information and counterparty anonymity. In addition, in reviewing the organization of the Dodd-Frank Act, the WMBAA respectfully submits that the block trade reporting delay, an obligation specifically enumerated in the Dodd-Frank Act, takes precedence in implementation when compared with the rule of construction provision which indicates that a goal of the legislation is to merely promote pre-trade transparency. For that reason, the WMBAA believes the Commissions should place great emphasis on complying with the "requirements" of Sections 727 and 763(i) with regard to block trading, ensuring liquidity of markets and preserving anonymity of parties to a trade as they relate to public reporting of trade information and ensuring that those requirements are not conflicted in the pursuit of a "goal" of pre-trade transparency as described in a rule of construction in the Dodd-Frank Act.

Multiple Modes of Execution

A SEF, by definition, may facilitate the trading or execution of swaps and security-based swaps "through any means of interstate commerce." The WMBAA strongly supports the use of electronic, voice and hybrid trading methods to bring parties together and foster a competitive OTC derivatives market. This flexibility allows U.S. markets to stay competitive, and provides greater options in servicing the needs of market participants. The WMBAA embraces technological advances that provide future advances in communication methods, furthering transparency and liquidity to as many market participants as is warranted.

The availability of multiple modes of execution widens the scope of products which can be traded more frequently, broadening the base of buyers and sellers participating in even deeper markets. This increased trading activity results in higher trade volumes and more standardized transactions, which will ultimately bring more clearable trades, and thus accomplishing one of the primary objectives of the Dodd-Frank Act.

Nondiscriminatory Access to Clearing

As competitive swap execution facilities, the WMBAA members firmly believe that the nondiscriminatory access to central clearinghouses provided by the Dodd-Frank Act is necessary to the foundation of competitive, liquid markets that provide affordable access to OTC derivatives products. Any restrictions imposed on market participants' access to clearing will result in disparate levels of transparency and preclude certain derivatives counterparties from the benefits of efficient markets.

Public Reporting of Transaction Data; Treatment of Block Trades

As previously discussed, both Commissions are authorized to write rules to facilitate block trades. In general, the WMBAA is supportive of trade reporting for all trades as soon as technologically practicable. The Association believes that all trade reporting, regardless of size, should be reported to the swap data repositories.

As interdealer brokers involved in the formulation and execution of large derivatives transactions between swap and security-based swap dealers, the distinction between block and non-block trades is vital to ensure OTC derivatives markets can continue to provide liquidity to and be a source for risk mitigation for businesses.

Further, the CFTC and SEC need to carefully structure a clearing and reporting regime for block trades that protects counterparties' identities and provides for the transacting of larger transactions without unnecessary regulatory burdens.

While the WMBAA believes that each asset class has a threshold amount that could be calculated and used to distinguish between typical and block trades, its primary concern is that the block trade exception be set at such a level that trading may continue without impacting market participants' ability to exit or hedge their trades. In addition, while the appropriate threshold amount will differ by asset class, the notion of a block trade involves more than merely the size of a transaction. A block trade is frequently assembled through a series of actions. The WMBAA believes it is appropriate to provide regulators with necessary market information for oversight purposes, but the public dissemination of incremental activity that would otherwise constitute a block trade could jeopardize identification of counterparties and materially reduce market liquidity, which does not comport with the reporting goals enumerated in the Dodd-Frank Act.

Finally, the WMBAA is committed to any regulatory regime promulgated with electronic trade reporting requirements. As the WMBAA's member firms have historically demonstrated through successful Trade Reporting and Compliance Engine ("TRACE") reporting, these firms have the capabilities to comply with any requirement for reporting swap and security-based swap transaction data as soon as technologically practicable. Further, WMBAA members are willing to report this information to any entity designated by each Commission, including a swap/security-based swap data repository or the Commission itself.

SEF Rule Enforcement

In order to ensure that SEFs establish and enforce consistent rules with each other, it has been suggested that a self-regulatory organization ("SRO") would be established (or contracted with) to ensure uniformity in investigations and enforcement. The WMBAA supports ensuring that competitive SEFs are equal in enforcing trading rules, but believes that any SRO must demonstrate adequate independence in its organization and enforcement of rules in order to carry out this important function. Furthermore, the WMBAA believes that while the regulatory compliance responsibility cannot be shifted from a SEF to a separate SRO, SEFs should be permitted to contract with an SRO to provide regulatory services to help ensure consistent application of rules under Core Principle number two.

Impartial Access

The SEF core principles in the Dodd-Frank Act require SEFs to "establish and enforce trading, trade processing, and participation rules that will deter abuses and have the capacity to detect, investigate, and enforce those rules," including means "to provide ***market participants*** with impartial access to the market [emphasis added]." The WMBAA member firms fully expect that, under the Dodd-Frank Act, each facility's participants should and will have impartial access to the facility.

However, any expansion of the impartial access requirement beyond market participants should be considered to be outside of the text of the Dodd-Frank Act. Requiring that each SEF provide impartial access to other SEFs, which are intermediaries and not market participants, would have a stifling effect on competition, to the ultimate detriment of SEF participants. Because these trading platforms compete to offer superior service, technology, liquidity and commission prices to each other, allowing SEFs knowledge of each other's price quotes would allow facilities with lower quality services to exploit this information for their gain and potentially cause a "race to the bottom." The end result would be that SEFs would only match the lowest common denominator with respect to facility characteristics, to the detriment of market participants who currently benefit from the fruits of a competitive marketplace. Rules implementing the SEF core principles should foster the environment of competitive, aggressive facilities to ensure affordable access to and readily-available liquidity for various asset classes. The WMBAA agrees that SEFs should provide "impartial access" to market participants, but not to competing SEFs.

We would like to thank both of you, your fellow Commissioners, and the staffs at the Commissions for being so willing to consider our opinions and for conducting an open and transparent rulemaking process. We appreciate the opportunity to share our opinions with you and are available to discuss with you and your staffs at any time.

Sincerely,

JULIAN HARDING,

Chairman.

Hon. MICHAEL DUNN, *Commissioner,* CFTC;
Hon. JILL SOMMERS, *Commissioner,* CFTC;
Hon. BART CHILTON, *Commissioner,* CFTC;
Hon. SCOTT O'MALIA, *Commissioner,* CFTC;

Hon. KATHLEEN CASEY, *Commissioner,* SEC;
Hon. ELISSE WALTER, *Commissioner,* SEC;
Hon. LUIS AGUILAR, *Commissioner,* SEC;
Hon. TROY PAREDES, *Commissioner,* SEC.

November 30, 2010

Hon. GARY GENSLER,
Chairman,
Commodity Futures Trading Commission,
Washington, D.C.

Hon. MARY SCHAPIRO,
Chairman,
Securities and Exchange Commission,
Washington, D.C.

Re: *Self-Regulation and Swap Execution Facilities*

Dear Chairman Gensler and Chairman Schapiro:

As you know, on July 29, 2010, the Wholesale Markets Brokers' Association Americas[1] ("WMBAA") submitted to the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") a Discussion Draft of Model Core Principles for Swap Execution Facilities ("SEFs"). Since then the SEC and CFTC have begun an ambitious process to write the rules to regulate the swaps marketplace, including rules necessary to regulate swap execution facilities and security based swap execution facilities (collectively referred to herein as "SEFs.")

The Dodd-Frank Act ("DFA") establishes a series of core principles for SEFs that are in many cases the same or substantially the same as the core principles for designated contract markets. These include requirements to (i) establish, investigate and enforce rules, and (ii) monitor trading and obtain information necessary to prevent manipulation. Such requirements are typical for exchanges and self-regulatory organizations.

However, many of the entities that will seek to become registered as SEFs, including the WMBAA's members, are not exchanges. They operate today as futures commission merchants ("FCMs"), broker-dealers and, where applicable, as alternative trading systems ("ATS"). These entities are required to join and follow the rules of one or more self-regulatory organizations, such as FINRA or the NFA, which together with the SEC and the CFTC, perform many of the regulatory functions assigned by DFA to SEFs. In fact, the regulatory status of a SEF seems to most closely resemble that of an ATS, which is defined as any organization, association, person, group of persons, or system that brings together purchasers and sellers of securities, but that does not (i) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on the alternative trading system; or (ii) discipline subscribers other than by exclusion from trading.[2]

Ideally SEFs would be able to delegate relevant functions to an exchange or an SRO. Unfortunately DFA does not expressly contemplate such delegation as, for example, the Commodity Exchange Act permits for other types of registered entities.[3]

---

[1] The Wholesale Markets Brokers' Association Americas (WMBA Americas) is an independent industry body representing the largest inter-dealer brokers ("IDBs") operating in the North American wholesale markets across a broad range of financial products. The WMBA and its member firms have developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets*. Using these *Principles* as a guide, the Association seeks to work with Congress, regulators, and key public policymakers on future regulation and oversight of over-the-counter (OTC) markets and their participants. By working with regulators to make OTC markets more efficient, robust and transparent, the Association sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country's capital markets.

[2] See 17 CFR § 242.300(a)

[3] See 7 U.S.C. § 7a–2(b).

Further, it is not clear that even if permitted, SEFs would voluntarily delegate responsibilities to the existing SROs.[4]

However, it is clear that the new rules will create a host of new obligations for swap execution facilities, as well as for the CFTC and the SEC. It is also becoming clear that the SEC and CFTC lack the resources necessary to implement and enforce the new rules. And if projections of 50–100 SEFs are correct, it will become clear that a new regulatory structure to facilitate compliance by SEFs with the applicable laws and regulations will need to be developed.

To address these issues, members of the WMBAA and possibly others propose to establish a common regulatory organization ("CRO")[5] that will facilitate compliance with the core principles by each of its members as well as for any other SEF that agrees to follow its rules. The CRO would not itself have any direct regulatory responsibilities, but it would, by way of contractual obligations, assist its members by addressing compliance issues that are common to all SEFs, including the following:

1. establishing and maintaining model provisions for each SEF's rule book that would be adopted by each of its SEF members with regard to core principles on investigations, enforcement authority, trade monitoring and obtaining information.

2. on behalf of its members, enter into one or more regulatory services agreements with existing SROs pursuant to which the CRO will have the capacity to detect, investigate, and enforce those rules for its members. These services would including:

   a. monitoring trading to prevent manipulation.

   b. enforcing position limitations.

   c. investigating possible violations of SEF, CFTC, SEC rules, or other applicable laws.

   d. establishing a code of procedure for administering discipline for rule violations and conducting hearings when necessary to determine if a violation may have occurred.

3. on behalf of its members, establish and enforce rules that will allow the facility to obtain any necessary information from other SEFs, other market participants and other markets to perform any of the functions required by the core principles.

4. Review associated persons of each SEF to ensure that that are not statutorily disqualified to be associated with a SEF.

Membership in the CRO would initially be open to any entity that intended to register as a SEF. Membership in this CRO would be voluntary, but members would be contractually bound to abide by the rules. Upon implementation of the CFTC and SEC rules, membership would become open to any entity that agreed to adopt the CRO's rules that was either registered with the SEC or CFTC as a SEF, or intended to file for registration with the SEC or CFTC to become a SEF.

The benefits to creating a CRO are several. First, it creates a platform to ensure that certain key rules for SEFs are written fairly and establish a uniform standard of conduct. This in turn would also make it easier and more efficient for the SEC and CFTC to review potential SEF applications in accordance with the above mentioned core principles as any SEF that was a member of the CRO would agree to implement the model provisions for their rule books, and would agree to utilize the services offered by the CRO to aid with satisfying many of their obligations under the core principles. Moreover, by acting as an intermediary for compliance by its members, the CRO would simplify the CFTC's and SEC's oversight responsibilities for SEFs.

Such a scheme would appear to be permissible under DFA, which provides SEFs with "reasonable discretion" in establishing the manner in which they comply with

---

[4] It is possible that SRO membership could indirectly be required if CFTC and SEC regulations were to require that SEFs also register as FCMs and broker-dealers. Such regulations, however, would have unintended consequences. First, it would create a conflicting web of overlapping responsibilities as SEFs reconcile their obligations under DFA with their obligations as members of the respective SROs. In addition, mandatory broker-dealer or FCM registration for SEFs would likely cause prospective SEFs to file new broker-dealer and FCM applications rather than use existing registered entities that would become subject to SEF regulations on ownership and conflicts of interest. If projections of 50–100 SEF applications are correct, and each SEF also files for registration as an FCM or broker-dealer, the result could cause as many as 200–400 regulatory applications associated with SEFs.

[5] Distinguished from an SRO to avoid confusion with the legal and regulatory implications of an SRO.

the core principles.[6] Further, as a voluntary organization, the CRO would not necessarily need legislative or rule making authority to proceed. However the ambiguity caused by the lack of an express Congressional mandate suggests that some degree of authorization in the rulemaking process for a CRO would be desirable

Otherwise the CRO could presumably be organized today with a mandate from its originating members to provide services in accordance with the core principles that could be implemented as soon as its members agree, and not necessarily wait for the implementation of the DFA (although any rules adopted may have to be revised to be consistent with the CFTC and SEC rules). It would start by drafting rules, identifying the resources, systems and agreements necessary to become operational and conducting preliminary discussions with NFA, FINRA or others to provide regulatory services where appropriate.

The result would be an entity that could help address the operating issues created for SEFs by the DFA, and through the establishment of uniform standards for its members, make their investigation, surveillance and enforcement efforts more effective. It might also allow the SEC and CFTC to perform their oversight duties with respect to SEFs in a more efficient manner.

Sincerely,

JULIAN HARDING,
Chairman.

January 18, 2011

ELIZABETH MURPHY,
Secretary,
Securities and Exchange Commission,
Washington, D.C.

Re: *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information (File Number S7–34–10)*

Dear Ms. Murphy:

The Wholesale Market Brokers' Association, Americas ("WMBAA" or "Association")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on the proposed Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information ("Regulation SBSR") under the Securities Exchange Act of 1934 ("Exchange Act").[2]

Summary of Response

As the Commission contemplates an appropriate regulatory regime for reporting and dissemination of security-based swap ("SBS") information, the WMBAA believes it is incumbent upon the Commission to follow the direction given in section 13(m)(1)(E) of the Exchange Act, which requires that the Commission's rule providing for the public availability of SBS transaction and pricing data contain provisions that take into account whether public disclosure will materially reduce market liquidity. The WMBAA, as an association representing the largest inter-dealer brokers in OTC markets, believes that the impact of these rules on market liquidity is highly dependent on how the policy governing large block trading is finalized. If the policy governing block trades does not properly define such a trade, the WMBAA remains very concerned that possible rules related to the calculation of a block trade threshold and trade reporting could negatively impact market liquidity, disturbing businesses' ability to hedge commercial risk, to appropriately plan for the future and, ultimately, stifle economic growth and job creation.

---

[6] See 7 U.S.C. § 7b–3(f)(1)(B).

[1] The WMBAA is an independent industry body representing the largest inter-dealer brokers ("IDBs") operating in the North American wholesale markets across a broad range of financial products. The WMBAA and its member firms have developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets.* Using these *Principles* as a guide, the WMBAA seeks to work with Congress, regulators, and key public policymakers on future regulation and oversight of over-the-counter ("OTC") markets and their participants. By working with regulators to make OTC markets more efficient, robust and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country's capital markets.

[2] *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 *Fed. Reg.* 75208 (December 2, 2010).

The WMBAA is pleased to offer its comments related to: (i) appropriate methods to calculate block trade thresholds; (ii) appropriate entities to calculate and publish block trade thresholds; (iii) post-trade dissemination of block trades; and (iv) the publication of market data by market participants.

Discussion of Proposed Regulation SBSR

As interdealer brokers involved in the formulation and execution of large derivatives transactions between swap and security-based swap dealers, the distinction between block and non-block trades is vital to ensure OTC derivatives markets can continue to provide liquidity to and be a source for risk mitigation for end-users.

It is important that the Commission recognize that OTC derivatives markets are different than financial markets that have significant retail participation.[3] While the relationship between exchange-traded and OTC markets generally has been complimentary, as each market typically provides unique services to different trading constituencies for products with distinctive characteristics and liquidity needs, the nature of trading liquidity in the exchange-traded and OTC markets is fairly different. Liquidity is the degree to which a financial instrument is easy to buy or sell quickly with minimal price disturbance. The liquidity of a market for a particular financial product or instrument depends on several factors, including: the number of market participants and facilitators of liquidity, the degree of standardization of instrument terms, and the volume of trading activity.

Highly liquid markets exist for both commoditized, exchange-traded products, and more standardized OTC instruments, such as the market for U.S. treasury securities, equities and certain commodity derivatives. Exchange-traded markets provide a trading venue for fairly simple and commoditized instruments that are based on standard characteristics and single key measures or parameters. Exchange-traded markets rely on relatively active order submission by buyers and sellers and generally high transaction flow. These markets allow a broad base of trading customers meeting relatively modest margin requirements to transact standardized contracts in a relatively liquid market. As a result of the high number of market participants and the relatively small number of standardized instruments traded, liquidity in exchange-traded markets is relatively continuous in character.

In comparison, many swaps markets feature a broader array of less-commoditized products and larger-sized orders that are traded by fewer counterparties. Trading in these markets is characterized by variable or non-continuous liquidity. Such liquidity can be said to be episodic, with liquidity peaks and troughs that are seasonal (certain energy products) or more volatile and tied to external market conditions (certain credit products).

As a result of the episodic nature of liquidity in certain swaps markets with fewer participants, we believe that the CFTC and SEC need to carefully structure a clearing and reporting regime for block trades that is not a "one size fits all" approach, but rather takes into account the unique challenges of fostering liquidity in the broad range of swaps markets, provides for the transacting of larger transactions without unnecessary regulatory burdens, and does not materially reduce market liquidity.

Formulation of Block Trade Threshold

While the WMBAA believes that each asset class and each swaps instrument has a threshold amount that could be calculated and used to distinguish between typical and block trades, its primary concern is that the block trade exceptions be individually set for the unique liquidity requirements of the broad range of swaps instruments so that the process of completing a block trade is appropriately defined and trading may continue without adversely impacting market participants' ability to place, exit or hedge their trades.

With respect to block trade thresholds, while the appropriate threshold amount will differ by asset class and instrument, the notion of a block trade involves more than merely the size of a transaction. The WMBAA member firms have witnessed an evolution in interdealer markets with the development of a process referred to as "work-up." In this model, once a price is agreed for trading, the resultant trade is reported to market participants and they are offered the opportunity to join the trade and increase liquidity. Work-up enables traders to assess the markets in real-time and make real-time decisions on trading activity, without the fear of moving

---

[3] *See, e.g.,* Comments from Yuhno Song, Merrill Lynch, ("I think one of the distinctions we have is a market that may be more smaller in retail based *versus* a market that is with far small number of participant and that's institutional based.") Public Roundtable to Discuss Swap Data, Swap Data Repositories, and Real Time Reporting, September 14, 2010 ("Roundtable Transcript") at 332–333. *Available* at: *http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative18sub091410.pdf.*

the market one way or another. It is vital that any block trade calculation recognize the role work-up plays in forming liquidity. This is done to allow the market to find the appropriate pricing levels to optimally complete the transaction without prematurely causing the market impact of a large block.

The WMBAA believes it is appropriate to provide regulators with necessary market information for oversight purposes, but the public dissemination of incremental activity that would otherwise constitute a block trade could jeopardize identification of counterparties and materially reduce market liquidity, which does not comport with the reporting goals enumerated in the Dodd-Frank Wall Street Reform and Consumer Protection Act.[4]

Congress recognized the importance of tailored block trade thresholds specific to an asset class and instrument.[5] The WMBAA advocates, as an example, a tiered solution for SBS classification and reporting. The first tier would include all "social" size trades, which must be reported immediately to market participants. The second tier would include trades that are a certain multiple of the "social" size, dependent on the maturity, underlying credit, and frequency of recent transactions in the specific instrument. Each of these transactions would be reported to a security-based swap data repository ("SDR") within 15 minutes of trade execution. This, the WMBAA believes, would be acceptable to the market participants in as much as it would be less disruptive to their ability to place, hedge or exit positions. Finally, the WMBAA would suggest a third tier for trades greater than twice the amount of the block trade threshold, reported with an indication that an extremely large block trade was executed.

Such a reporting regime would ensure market participants retain a level of transparency acceptable to successful trading. It is important to distinguish between public reporting to market participants and regulatory reporting through the SDR, which would be privy to complete trade information. By identifying an appropriate social size, the Commission would encourage additional market participants to post prices and provide liquidity on electronic platforms. This, in turn, would support the Commission's objective of increasing the number of market makers and bringing greater transparency into the swaps markets.

Block Trade Calculation and Publication

Proposed Regulation SBSR contemplates that a registered SDR would be responsible for establishing and maintaining written policies and procedures for calculating and publicizing block trade thresholds for all security-based swap instruments reported to the registered SDR in accordance with the criteria and formula for determining block size as specified by the Commission.[6] Under this framework, the Commission would specify the criteria and formula for determining block size based on the limited information provided to it consisting of SBS transaction data reported to an SDR for completed SBSs. Such information only provides a partial picture of the liquidity challenges of a particular SBS marketplace. There is other information, such as the size and quantity of bids and offers that do not result in completed transactions, that is available to security-based swap execution facilities ("SB SEFs") as neutral intermediaries in the market.

The WMBAA believes that it is necessary to consider this more complete scope of information in calculating block trade thresholds that are truly appropriate for security-based swap markets. The WMBAA therefore proposes the formation of a block trade standards setting board (the "Security-Based Swaps Standards Board") made up of recognized experts and representatives of registered SDRs and SB SEFs to make recommendations to the Commission for appropriate block trade thresholds for SBSs.

The Security-Based Swaps Standards Board would work with the Commission to establish and maintain written policies and procedures for calculating and publicizing block trade thresholds for all SBSs reported to the registered SDR in accordance with the criteria and formula for determining block size as specified by the Commission. The Security-Based Swaps Standards Board would also undertake market studies and research at its expense as is necessary to establish such standards. This arrangement would permit SB SEFs, as the entities most closely related to block trade execution, to provide essential input into the Commission's block

---

[4] Pub. L. No. 111–203, H.R. 4173.

[5] Statement of Senator Blanche Lincoln ("The committee expects the regulators to distinguish between different types of swaps based on the commodity involved, size of the market, term of the contract and liquidity in that contract and related contracts, *i.e.*,, for instance the size/dollar amount of what constitutes a block trade in 10 year interest rate swap, 2 year dollar/euro swap, 5 year CDS, 3 year gold swap, or a 1 year unleaded gasoline swap are all going to be different."). Senate *Congressional Record* S. 5921, July 15, 2010.

[6] *See* 75 *Fed. Reg.* at 75287.

trade determinations and work with registered SDRs to distribute the resulting threshold levels to SB SEFs. Further, the proposed regulatory structure would reduce the burden on SDRs, remove the possibility of miscommunication between SDRs and SB SEFs, and ensure that SB SEFs do not rely upon dated or incorrect block trade thresholds in their trade execution activities.

Further, if there is more than one registered SDR for an asset class, it may prove difficult for the Commission to ensure that all registered SDRs calculate the same block trade thresholds for the same SBS instruments. In comparison, one common regulatory organization responsible for facilitating SB SEF compliance with core principles will be uniquely situated to prevent the problem posed by multiple SDRs, which becomes further exacerbated if there are multiple registered SDRs in the same asset class each with individual market data feeds that need to be aggregated to calculate block trade thresholds.

The determination whether an SBS transaction is a block trade should reflect a risk-weighted basis, calculated on an instrument-by-instrument basis. This threshold should be updated at an appropriate time interval, taking into account the unique liquidity characteristics and challenges of the market in which the instrument trades. Any formulaic approach to computing the thresholds from trade size or other population parameters should reflect the number of participants in the market, the frequency of trading activity (daily, weekly and monthly) and the average trade sizes and terms of the transactions.

The established block trade threshold could be subject to gaming, particularly if the market perceives the threshold to be arbitrarily determined. However, if the block threshold accurately captures the risk and liquidity parameters related to trading activity, then gaming would be ineffective, and less likely to occur.

With respect to inter-affiliate transactions or trades resulting from portfolio compression, the WMBAA believes that if the block thresholds are appropriately calculated, market participation will increase, resulting in additional transparency and markets that better serve the public interest. If the block trade levels allow market makers time to appropriately hedge the risk that they've committed capital to, then they will be better able to continue to provide liquidity.

Reporting of Block Trades

The Commission remarks in the preamble to proposed Regulation SBSR that because the registered SDR, and not the reporting party, would have the responsibility to determine whether a transaction qualifies as a block trade, the reporting party would be required to report an SBS to a registered SDR or the Commission pursuant to the time frames set forth in Rules 901(c) and (d), regardless of whether the reporting party believes the transaction qualifies for block trade treatment. Proposed Regulation SBSR does not include a delay in reporting block trades to a registered SDR.[7]

As noted in a previous letter, the WMBAA is supportive of trade reporting for all trades as soon as technologically practicable. The Association believes that all trade reporting, regardless of size, should be reported to the SDR. The WMBAA members each possess the technological capabilities to provide regulators with real-time electronic trade information for transactions executed in multiple financial markets.[8]

While the WMBAA believes that posting the full details of SB SEF-executed transactions to market participants should be at the core of the SB SEF obligations, the reporting obligations of the SB SEF should reflect the information that the SB SEF possessed at the time of the transaction. The SB SEF should not have the primary reporting obligations. The SB SEF would likely not be privy to all of the terms required to be reported in accordance with proposed Regulation SBSR, such as, but not limited to: (i) contingencies of the payment streams of each counterparty to the other; (ii) the title of any master agreement or other agreement governing the transaction; (iii) data elements necessary to calculate the market value of the transaction; and (iv) other details not typically provided to the SB SEF by the customer, such as the actual desk on whose behalf the transaction is entered. Moreover, and quite critical, an SB SEF would not be in a position or necessarily have the capabilities to report life cycle event information. Indeed, even if an SB SEF were required to report the transaction details as the proposed regulation requires, something we do

[7] *See id.* at 75233.

[8] *See, e.g.,* Comments from Shawn Bernardo, Tullett Prebon Americas Corp., representing Wholesale Markets Brokers Association, ("All of the brokers have the capability to report trades to the regulators in a timely fashion . . . as far as TRACE is concerned, we have a track record of reporting those trades efficiently, and we have the systems in place to do that, along with the various means . . . we can do that voice, we can do it electronically, we can do it as hybrid as far as the execution, but we send those trades electronically to them in a timely fashion.") Roundtable Transcript at 227–228.

not think advisable, it would likely take at least 30 minutes to gather and confirm the accuracy of that information.

Additionally, the post trade reporting requirements may have an adverse effect on liquidity, particularly with respect to larger transactions since the reporting of larger transactions will likely have the effect of causing participants to refrain from entering the market which those participants might not otherwise have done, adversely impacting the ability of the parties to the large transaction to mitigate the risks of that transaction by entering into separate, offsetting transactions. This could effect a party's ability to hedge its risks and mitigate the exposure of that legitimate hedge will be diminished, resulting in fewer transactions of that nature and potentially widening spreads, which in turn will increase end-user costs.

Nevertheless, the WMBAA believes that trading counterparties with reporting obligations should be able to contract with a SB SEF to handle the reporting process without transferring their reporting obligations. This will put smaller counterparties with limited trading reporting technology in a less disadvantaged trading position to larger trading counterparties.

Dissemination of Block Trade Information

Under proposed Regulation SBSR, a registered SDR must publicly disseminate a transaction report of an SBS that constitutes a block trade immediately upon receipt of information about the block trade from the reporting party. Under proposed Regulation SBSR, the market participants will learn the price, but not the size, of an SBS block trade in real-time. The transaction report must contain all of the information required under the real-time reporting rules, including the transaction ID and an indicator that the report represents a block trade. The SDR is required to publicly disseminate a complete transaction report for a block trade (including the transaction ID and the full notional size) as follows:

- If the SBS was executed on or after 05:00 Coordinated Universal Time ("UTC") and before 23:00 UTC of the same day (which corresponds to 12:00 midnight and 6:00 p.m. EST), the transaction report (including the transaction ID and the full notional size) will be disseminated at 07:00 UTC of the following day (which corresponds to 2:00 a.m. EST of the following day).
- If the SBS was executed on or after 23:00 UTC and up to 05:00 UTC of the following day (which corresponds to 6:00 p.m. until midnight EST), the transaction report (including the transaction ID and the full notional size) will be disseminated at 13:00 UTC of that following day (which corresponds to 8:00 a.m. EST of the following day).

All block trades will have at least an 8 hour delay before the full notional size will be disseminated. The established cut-off time will be 23:00 UTC, which corresponds to 6:00 p.m. EST. Block trades executed on or after 05:00 UTC (which corresponds to midnight EST) and up to 23:00 UTC (6:00 p.m. EST) will have to have their full notional size disseminated by 07:00 UTC, which corresponds to 2:00 a.m. EST. Under the proposed approach, block trades executed during a period that runs roughly from the close of the U.S. business day to midnight EST will have their full sizes disseminated by a registered SDR at a time that corresponds to the opening of business on the next U.S. day. If a registered SDR is in normal closing hours or special closing hours at a time when it will be required to disseminate information about a block trade pursuant to this section, the registered SDR must disseminate that information immediately upon re-opening.

The WMBAA would suggest that disseminating the specific notional amount of a block could jeopardize the anonymity of the counterparties to such trades, making counterparties less willing to engage in transactions of size. Further, the effect of having no delay, or only a short dissemination delay, for a block trade report that includes the full notional size will discourage market makers from committing capital and providing liquidity to the broader market. From a market perspective, there is little gain from disseminating full notional size information. Consistent with the experiences from the implementation of the Financial Industry Regulatory Authority's Transaction Reporting and Compliance Engine ("TRACE"), which provides regulators with full trade information and publicly disseminates trades within a size range, the WMBAA believes the Commission should implement a public reporting methodology. This benefits market participants without exposing a trade's

notional size, which protects counterparty anonymity, and preserves liquidity and price competition in the market.[9]

Additionally, market participants will be wary of committing to larger sized transactions knowing the rapidity in which other participants will gain knowledge of these trades, leading to less liquidity for the dealer market, and ultimately for end-user participants. The WMBAA also believes that the public dissemination of block trades, as proposed, will allow some market participants to infer the identity of the parties to the transaction and materially reduce market liquidity.

If a liquidity provider perceives greater danger in supplying liquidity, it will step away from providing tight spreads and leave those reliant on market maker liquidity with poorer hedging opportunities. From a market structure standpoint, liquidity "takers" benefit from liquidity providers acting in a competitive environment. The liquidity providers compete with each other, often deriving very small profits per trade from a large volume of transactions. By relying on their ability to warehouse trades and post capital to make markets and using their distribution and professional know-how to offer competitive prices to their customer base, market makers provide liquidity essential to fulfill the need of hedgers. For these reasons, having either no delay or a short dissemination delay will actually erode price discovery and the level of price efficiency in the market.

Publication of Market Data

Proposed Regulation SBSR contemplates that no person other than a registered SDR can make available to one or more persons (other than a counterparty) transaction information relating to an SBS before the earlier of 15 minutes after the time of execution of the security-based swap, or the time that a registered SDR publicly disseminates a report of that security-based swap.[10] The preamble indicates that other private sources of market data reflecting subsets of the security-based swaps market could arise. The Commission remarks in the preamble to proposed Regulation SBSR that SB SEFs would have information about SBSs executed on its systems and could find that commercial opportunities exist to sell such information.[11] In a related release, the Commission's proposed regulation concerning Security-Based Swap Data Repository Registration, Duties, and Core Principles does not specifically address commercial use of SBS data.[12] However, under proposed 17 CFR § 240.13n–4(c)(3)(iii) the third core principle—rules and procedures for minimizing and resolving conflicts of interest—requires an SDR to establish, maintain and enforce policies and procedures regarding the SDR's non-commercial and/or commercial use of SBS data.[13] In connection with the preamble discussion of this requirement, the SEC makes several requests for comment on an SDR's commercial use of data.[14]

The WMBAA member firms will report the required SBS transaction information to a registered SDR in the mandated time frame as set forth in Commission regulations. However, the provisions of such information to SDRs should be for the specific and limited purpose of the SDR fulfilling specific regulatory requirements (reporting data to regulators for regulatory oversight and enforcement, public reporting of trade information as specifically prescribed by the Commission). Reporting such data to an SDR by a reporting entity (*e.g.,* an SB SEF or any other party reporting the transaction information) should not relinquish ownership of such data by the SB SEF or other reporting entity and would also not inhibit its right to use the data for other purposes. Consistent with reporting practices in other markets, the reporting of SBS transaction information to a registered SDR should not bestow the SDR with the authority to use the SBS transaction data for any purpose other than those explicitly enumerated in the Commission's regulations.

The WMBAA is concerned that proposed rules inhibit an SB SEF's ability to continue to have ownership and control over its data and the ability to sell that data to the marketplace. The WMBAA would suggest that Section 242.902(d) of proposed Regulation SBSR be revised in such a way that an SDR would accept and maintain SBS transaction data for use by regulators, but the SBS counterparties and SB

---

[9] *See* 75 *Fed. Reg.* at 75232, fn. 108. ("If the par value of the trade exceeds $5 million (in the case of investment grade bonds) or $1 million (in the case of non-investment-grade bonds) the quantity disseminated by TRACE will be either "5 million+" or "1 million+". At no time will TRACE subsequently disseminate the full size of the trade. See TRACE User Guide, version 2.4 (last update March 31, 2010), at 50.")

[10] *See* 75 *Fed. Reg.* at 75286.

[11] *See id.* at 75242, fn. 153.

[12] *See* Security-Based Swap Data Repository Registration, Duties, and Core Principles, 75 *Fed. Reg.* 77306 (December 10, 2010).

[13] *See id.* at 77369.

[14] *See id.* at 77325–26.

SEFs continue to have the ability to market and commercialize their own proprietary data. This could be achieved, in part, by requiring SDRs to include such a provision in its required policies and procedures regarding the SDR's non-commercial and/or commercial use of SBS data required to be established, maintained and enforced by the Commission's proposed SDR rules. Ultimately, the WMBAA urges the Commission to take caution in implementing a regulation that could be inconsistent with existing models in equity and futures markets and might prevent entities with the necessary technological capabilities from capturing, publishing, and monetizing data for purposes outside of regulatory oversight.

Conclusion

The WMBAA thanks the Commission for the opportunity to comment on the proposed Regulation SBSR. Please feel free to contact the undersigned with any questions you may have on our comments.

Sincerely,

JULIAN HARDING,
Chairman.

February 7, 2011

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

Re: *Real-Time Public Reporting of Swap Transaction Data (RIN 3038–AD08)*

Dear Mr. Stawick:

The Wholesale Market Brokers' Association, Americas ("WMBAA" or "Association")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC" or "Commission") on the proposed rules related to the real-time public reporting of swap transaction data ("Proposed Rules")[2] under the Commodity Exchange Act ("CEA").

Summary of Response

As the Commission contemplates an appropriate regulatory regime for reporting and dissemination of swap information, the WMBAA believes it is incumbent upon the Commission to follow the direction given in Section 2(a)(13)(E) of the CEA, which requires that the Commission's rule providing for the public availability of swap transaction and pricing data contain provisions that take into account whether public disclosure will materially reduce market liquidity. The WMBAA, as an association representing the largest inter-dealer brokers in OTC markets, believes that the impact of these rules on market liquidity is highly dependent on how the policy governing large block trading is finalized. If the policy governing block trades does not properly define such a trade, the WMBAA remains very concerned that possible rules related to the calculation of a block trade threshold and trade reporting could negatively impact market liquidity, disturbing businesses' ability to hedge commercial risk, to appropriately plan for the future and, ultimately, unnecessarily inhibit economic growth and competitiveness.

The WMBAA is pleased to offer its comments related to: (i) the importance of a harmonized regulatory regime for execution facilities; (ii) methods to calculate block trade thresholds; (iii) appropriate entities to calculate and publish block trade thresholds; and (iv) time delays for post-trade dissemination of block trade information.

---

[1] The WMBAA is an independent industry body representing the largest inter-dealer brokers ("IDBs") operating in the North American wholesale markets across a broad range of financial products. The WMBAA and its member firms have developed a set of *Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets.* Using these *Principles* as a guide, the WMBAA seeks to work with Congress, regulators, and key public policymakers on future regulation and oversight of over-the-counter ("OTC") markets and their participants. By working with regulators to make OTC markets more efficient, robust and transparent, the WMBAA sees a major opportunity to assist in the monitoring and consequent reduction of systemic risk in the country's capital markets.

[2] *See* Real-Time Public Reporting of Swap Transaction Data, 75 *Fed. Reg.* 76140 (December 7, 2010).

Importance of Harmonized Regulatory Regime

Several differences exist between the SEC's Proposed Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information,[3] and the CFTC's Proposed Rule. While the WMBAA does not strongly support one Commission's proposed approach in its entirety over the other, as entities likely to register as swap execution facilities ("SEFs") with the CFTC and security-based SEFs with the SEC, respectively, it is important that the framework for block trade calculation, reporting, and dissemination are consistent between the two agencies and do not unreasonably burden market participants with duplicative compliance requirements. The WMBAA does, however, believe that the framework ultimately adopted should provide sufficient discretion for market participants. In this regard, the WMBAA believes the CFTC's Proposed Rules are more prescriptive when compared with the SEC's proposed rules.

The WMBAA encourages the use of block trade calculation provisions that provide deference to the SEF in determining what constitutes a block trade, which is most explicitly suggested in the SEC's proposed rules for security-based SEFs.[4] The SEC's proposed rules define the term block trade in a way that gives each security-based SEF the authority to set the criteria and formula for determining what constitutes a block trade, as long as such criteria and formula comply with the core principles relating to security-based SEFs (until the SEC sets the requisite criteria).[5] This approach allows the necessary time and flexibility for the markets to establish the appropriate criteria and formula based on actual trading on security-based SEFs in each security-based swap category and should be considered by the Commission for its corresponding rules.

Discussion of Proposed Rules

As interdealer brokers involved in the formulation and execution of large derivatives transactions between swap dealers and major swap participants, the distinction between block and non-block trades is vital to ensure OTC derivatives markets can continue to provide liquidity to and be a source for risk mitigation for end-users.

It is important that the Commission recognize that OTC derivatives markets are different than financial markets that have significant retail participation.[6] While the relationship between exchange-traded and OTC markets generally has been complimentary, as each market typically provides unique services to different trading constituencies for products with distinctive characteristics and liquidity needs, the nature of trading liquidity in the exchange-traded and OTC markets is often materially different. Liquidity is the degree to which a financial instrument is easy to buy or sell quickly with minimal price disturbance. The liquidity of a market for a particular financial product or instrument depends on several factors, including the parameters of the particular instrument, including tenor and duration, the number of market participants and facilitators of liquidity, the degree of standardization of instrument terms, and the volume of trading activity.

Highly liquid markets exist for both commoditized, exchange-traded products, and the more standardized OTC instruments, such as the market for U.S. Treasury securities, equities, and certain commodity derivatives. Exchange-traded markets provide a trading venue for fairly simple and commoditized instruments that are based on standard characteristics and single key measures or parameters. Exchange-traded markets rely on relatively active order submission by buyers and sellers and generally high transaction flow. These markets allow a broad base of trading customers meeting relatively modest margin requirements to transact standardized contracts in a relatively liquid market. As a result of the high number of market participants

---

[3] *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 *Fed. Reg.* 75208 (December 2, 2010).

[4] *See* Registration and Regulation of Security-Based Swap Execution Facilities, Release No. 34–63825, File No. S7–06–11. Available at *http://www.sec.gov/rules/proposed/2011/34-63825.pdf.*

[5] *See id.* at 390. ("The term *block trade* has the same meaning as § 242.900 (published at 75 FR 75208, Dec. 2, 2010), provided however that until the Commission sets the criteria and formula for determining what constitutes a block trade under § 242.907(b), a security-based swap execution facility may set its own criteria and formula for determining what constitutes a block trade as long as such criteria and formula comply with the Core Principles relating to security-based swap execution facilities in section 3D of the Act (15 U.S.C. 78c–4) and the rules and regulations thereunder.").

[4] *See, e.g.,* Comments from Yuhno Song, Merrill Lynch, ("I think one of the distinctions we have is a market that may be more smaller in retail based *versus* a market that is with far small number of participant and that's institutional based.") Public Roundtable to Discuss Swap Data, Swap Data Repositories, and Real Time Reporting, September 14, 2010 ("Roundtable Transcript") at 332–333. *Available* at: *http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/derivative18sub091410.pdf.*

and the relatively small number of standardized instruments traded, liquidity in exchange-traded markets is relatively continuous in character.

In comparison, many swaps markets feature a broader array of less-commoditized products and larger-sized orders that are traded by fewer counterparties, almost all of which are institutional and not retail. Trading in these markets is characterized by variable or non-continuous liquidity. Such liquidity can be episodic, with liquidity peaks and troughs that can be seasonal (*e.g.,* certain energy products) or more volatile and tied to external market and economic conditions (*e.g.,* many credit, energy, and interest rate products).

As a result of the episodic nature of liquidity in certain swaps markets combined with the presence of fewer participants, the WMBAA believes that the CFTC and SEC need to carefully structure a clearing and reporting regime for block trades that is not a "one size fits all" approach, but rather takes into account the unique challenges of fostering liquidity in the broad range of swaps markets. Such a regime would provide an approach that permits the execution of larger transactions without unnecessary regulatory burdens, and does not materially reduce market liquidity.

Formulation of Block Trade Threshold

Section 43.5(g) of the Proposed Rules describes the procedure and calculations that a registered swap data repository ("SDR") must follow in determining the appropriate minimum block size. Specifically, the Proposed Rules would require a registered SDR to set the appropriate minimum block size at the greater resulting number of each of the "distribution test" and "multiple test."[7]

Distribution Test

The distribution test would apply the "minimum threshold" to the "distribution of the notional or principal transaction amounts" and would require a registered SDR to create a distribution curve to see where the most and least liquidity exists, based on the notional or principal transaction amounts for all swaps within a category of swap instrument. Under this proposed approach, a registered SDR must first determine the distribution of the rounded notional or principal transaction amounts of swaps and then apply the minimum threshold to such distribution. The Proposed Rules describe the "minimum threshold" as a notional or principal amount that is greater than 95% of transaction sizes in a swap instrument or category during the period of time represented by the distribution of the notional or principal transaction amounts.

Multiple Test

The multiple test would require a registered SDR to multiply the "block multiple" by the "social size" to determine the appropriate block threshold for each swap instrument. The Commission recognizes that the social size for a swap varies by asset class, tenor, and delivery points. Once the appropriate social size is determined, the registered SDR must then apply the block multiplier, currently proposed to be five. The resulting product would be the number that the registered SDR compares to the resulting number from the distribution test, the greater of which would be the appropriate minimum block size for such swap instrument.[8]

While the WMBAA believes that each asset class and each swaps instrument has a threshold amount that could be calculated and used to distinguish between typical and block trades, its primary concern is that the block trade exceptions be individually set for the unique liquidity requirements of the broad range of swaps instruments. Appropriate threshold levels will ensure that the process of completing a block trade is appropriately defined and trading may continue without adversely impacting market participants' ability to place, exit, or hedge their trades. As other industry participants have noted, academic studies on the impact of transparency rules in major markets have found evidence of an adverse impact of transparency in a range of markets.[9] The WMBAA urges the Commission to implement a flexible, appropriate regime that will provide increased transparency without impairing the liquidity currently found in OTC derivatives markets.

With respect to block trade thresholds, while the appropriate threshold amount will differ by asset class and instrument, the notion of a block trade involves more than merely the size of a transaction. WMBAA member firms have witnessed an evolution in interdealer markets with the development of a process referred to as

---

[7] *See* 75 *Fed. Reg.* at 76161.

[8] *See id.* at 76162.

[9] See International Swaps & Derivatives Association and the Securities Industry and Financial Markets Association, "Block Trade Reporting for Over-the-Counter Derivatives Markets," January 18, 2011 (Citing Canadian stock markets, London Stock Exchange, and future exchanges). *Available* at: *http://www.isda.org/speeches/pdf/Block-Trade-Reporting.pdf.*

"work-up." In this model, once a price is agreed for trading, the resultant trade is reported to market participants and they are offered the opportunity for a brief, preset period of time to "join the trade" by placing a firm bid or offer that is characterized by only two variables (the quantify and whether the order is a "buy" or "sell" order). This results in an increase in liquidity at the most recently established market price. Work-up enables traders to assess the markets in real-time and make real-time decisions on trading activity, without the fear of moving the market one way or another. It is vital that any block trade calculation recognize the role work-up plays in forming liquidity. This is done to allow the market to find the appropriate pricing levels to optimally complete the transaction without prematurely causing the market impact of a large block trade. During the "work up" or "join the trade" period, all market participants have knowledge that a trade is taking place and are welcome to participate in this transparent process. However, as the initiating trade and other trades that take place are not fully complete until the end of the work-up period, and may result in both block and non-block trades, the reporting of the amounts executed during this process should not be done until the short work-up period expires.

The WMBAA believes it is appropriate to provide regulators with necessary market information for oversight purposes, but the public dissemination of incremental activity that would otherwise constitute a block trade could jeopardize identification of counterparties and materially reduce market liquidity, which does not comport with the reporting goals [10] enumerated in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[11]

Congress recognized the importance of tailored block trade thresholds specific to an asset class and instrument.[12] The WMBAA advocates, as an example, a tiered solution for swap classification and reporting. The first tier would include all "social" size trades, which must be reported immediately to market participants. The second tier would include trades that are a certain multiple of the "social" size, dependent on the maturity, underlying credit, and frequency of recent transactions in the specific instrument. Each of these transactions would be reported to a registered SDR within an appropriate time after trade execution. This, the WMBAA believes, would be acceptable to market participants because it would be less disruptive to their ability to place, hedge or exit positions. Finally, the WMBAA would suggest a third tier for trades greater than twice the amount of the block trade threshold, reported with an indication that an extremely large block trade was executed.

Such a reporting regime would ensure market participants retain a level of transparency acceptable to successful trading. It is important to distinguish between public reporting to market participants and regulatory reporting through the SDR, which would be privy to complete trade information. By identifying an appropriate social size, the Commission would encourage additional market participants to post prices and provide liquidity on electronic platforms. This, in turn, would support the Commission's objective of increasing the number of market makers and bringing greater transparency into the swaps markets.

Block Trade Calculation and Publication

Section 43.5(g) of the Proposed Rules would require registered SDRs to calculate the appropriate minimum block size for swaps for which such registered SDR receives data in accordance with Section 2(a)(13)(G) of the CEA. The appropriate minimum block sizes for each swap instrument must be the greater of the resulting number derived from the "distribution test" and the "multiple test." If there is only one registered SDR for a particular asset class, that registered SDR will have to calculate the appropriate minimum block size. In the event that there are multiple registered SDRs for an asset class, and therefore multiple registered SDRs will accept swaps for a particular category of swap instrument, the Commission will prescribe how the appropriate minimum block size should be calculated in a way that accounts for all of the relevant data.[13]

---

[10] CEA Section 2(a)(13)(E) ("With respect to the rule providing for the public availability of transaction and pricing data for swaps . . . , the rule promulgated by the Commission shall contain provisions . . . (iv) that take into account whether the public disclosure will materially reduce market liquidity.").

[11] Pub. L. No. 111–203, H.R. 4173.

[12] Statement of Senator Blanche Lincoln ("The committee expects the regulators to distinguish between different types of swaps based on the commodity involved, size of the market, term of the contract and liquidity in that contract and related contracts, *i.e.,* for instance the size/dollar amount of what constitutes a block trade in 10 year interest rate swap, 2 year dollar/euro swap, 5 year CDS, 3 year gold swap, or a 1 year unleaded gasoline swap are all going to be different."). Senate *Congressional Record* S. 5921, July 15, 2010.

[13] *See* 75 *Fed. Reg.* at 76160.

Proposed Section 43.5(h) provides that after an "appropriate minimum block size" is established by either a registered SDR or by a Commission-prescribed method, a swap market must set the "minimum block trade size" for those swaps that it lists and wishes to allow block trading, by referring to the appropriate minimum block size (equal to or greater than the SDR threshold) that is posted on a registered SDR's Internet website (along with the precise methodology and complete data set used by the SDR for calculating each swap) for the swap instrument category for such swap.

Swaps Standards Advisory Committee

The WMBAA believes that it is necessary to consider this more complete scope of information in calculating block trade thresholds that are truly appropriate for swap markets. The WMBAA therefore proposes the formation of a block trade standards setting advisory committee (the "Swaps Standards Advisory Committee") made up of recognized experts and representatives of registered SDRs and SEFs to make recommendations to the Commission for appropriate block trade thresholds for swaps.

The WMBAA recommends that the Commission consider the role of existing advisory committees, such as the Agricultural Advisory Committee, Global Markets Advisory Committee, Energy and Environmental Markets Advisory Committee, and the Technology Advisory Committee, as a model for receiving market participant input and recommendations related to regulatory and market issues concerning block trades on swaps. Recent Commission rulemakings in agricultural commodities [14] and co-location [15] have benefitted greatly from industry input on these advisory committees. While the Commission is authorized under the Dodd-Frank Act to establish block trade standards on its own, and possesses the requisite knowledge and experience in futures markets, the WMBAA believes that a Swaps Standards Advisory Committee, similar to the above-referenced advisory committees, could provide the Commission with meaningful statistics and metrics from a broad range of contract markets, SDRs and SEFs to be considered in any ongoing rulemakings in this area.

The Swaps Standards Advisory Committee would work with the Commission to establish and maintain written policies and procedures for calculating and publicizing block trade thresholds for all swaps reported to the registered SDR in accordance with the criteria and formula for determining block size as specified by the Commission. The Swaps Standards Advisory Committee would also undertake market studies and research at its expense as is necessary to establish such standards. This arrangement would permit SEFs, as the entities most closely related to block trade execution, to provide essential input into the Commission's block trade determinations and work with registered SDRs to distribute the resulting threshold levels to SEFs. Further, the proposed regulatory structure would reduce the burden on SDRs, remove the possibility of miscommunication between SDRs and SEFs, and ensure that SEFs do not rely upon dated or incorrect block trade thresholds in their trade execution activities.

The WMBAA supports the notion that the Commission should require registered SDRs to self-certify determinations of the appropriate minimum block size for swap instruments. SDRs should be subject to certification by the Commission (or the Swaps Standards Advisory Committee) and be required to display on their website the precise calculation of every block size (including the complete data set used for the calculation).

The WMBAA also believes it is important for the Commission to recognize the potential for abuse of the block trade calculation by an SDR that operates an affiliated SEF or designated contract market. The WMBAA believes that the Commission must authorize a Swaps Standards Advisory Committee to insure that the block facility serves the public interest and is not abused to serve one or more narrow commercial interests.

Further, as the Commission recognizes, if there is more than one registered SDR for an asset class, it may prove difficult for the Commission to ensure that all registered SDRs calculate the same block trade thresholds for the same swap instruments. In comparison, one common regulatory organization responsible for facilitating SEF compliance with core principles will be uniquely situated to prevent the problem posed by multiple SDRs, which becomes further exacerbated if there are multiple registered SDRs in the same asset class, each with individual market data feeds that need to be aggregated to calculate block trade thresholds.

---

[14] *See* Agriculture Commodity Definition, 75 *Fed. Reg.* 65586 (October 26, 2010).

[15] *See* Co-Location/Proximity Hosting Services, 75 *Fed. Reg.* 33198 (June 11, 2010).

The determination of whether a swap transaction is a block trade should reflect a risk-weighted analysis, calculated on an instrument-by-instrument basis. This threshold should be updated at an appropriate time interval, taking into account the unique liquidity characteristics and challenges of the market in which the instrument trades. Any formulaic approach to computing the thresholds from trade size or other population parameters should reflect the number of participants in the market, the frequency of trading activity (daily, weekly, and monthly), and the average trade sizes and terms of the transactions.

The established block trade threshold could be subject to gaming, particularly if the market perceives the threshold to be arbitrarily determined. However, if the block threshold accurately captures the risk and liquidity parameters related to trading activity, then gaming would be ineffective and less likely to occur.

With respect to inter-affiliate transactions or trades resulting from portfolio compression, the WMBAA believes that if the block thresholds are appropriately calculated, market participation will increase, resulting in additional transparency and markets that better serve the public interest. The allocation or compression of trades that have already occurred are not open market transactions, and it would be misleading if they were reported as open market transactions, giving the illusion of more liquidity than exists. These transactions should be reported as compression trades or allocations, so as not to be taken into account in any type of market liquidity or block trading equations.

Reporting of Block Trades

The Proposed Rules provide that a reporting party for any block trade must report the block trade transaction and pricing data pursuant to the rules of the swap market that makes that swap available for trading. Such reporting must occur as soon as technologically practicable after execution of the block trade and pursuant to the rules of the swap market. The Proposed Rules define the term "as soon as technologically practicable" to mean as soon as possible, taking into consideration the prevalence of technology, implementation, and use of technology by comparable market participants. The Commission recognizes that what is "technologically practicable" for one party to a swap may not be the same as what is "technologically practicable" for another party to a swap. The swap market that accepts the block trade must immediately send the block trade transaction and pricing data to a real-time disseminator, which must not publicly disseminate the swap transaction and pricing data before the expiration of the time delay described in Proposed Section 43.5(k).

As noted in previous letters, the WMBAA is supportive of trade reporting for all trades as soon as technologically practicable. The Association believes that all trade reporting, regardless of size, should be reported to the SDR. The WMBAA members each possess the technological capabilities to provide regulators with real-time electronic trade information for transactions executed in multiple financial markets.[16]

While the WMBAA believes that posting the full details of SEF-executed transactions to market participants should be at the core of the SEF obligations, the reporting obligations of the SEF should reflect the information that the SEF possessed at the time of the transaction. The SEF should not have the primary reporting obligations. The SEF may not necessarily be privy to all of the terms required to be reported in accordance with the Proposed Rules, such as, but not limited to: (i) contingencies of the payment streams of each counterparty to the other; (ii) the title of any master agreement or other agreement governing the transaction; (iii) data elements necessary to calculate the market value of the transaction; and (iv) other details not typically provided to the SEF by the customer, such as the actual desk on whose behalf the transaction is entered. Moreover, and quite critical, a SEF would not be in a position or necessarily have the capabilities to report lifecycle event information. Indeed, even if a SEF were required to report the transaction details as the Proposed Rules require, something the Association does not think is advisable, it would likely take at least 30 minutes to gather and confirm the accuracy of that information.

Additionally, requiring the post trade reporting requirements to be "as soon as technologically practicable" may have a negative effect on liquidity, particularly with respect to larger transactions.

---

[16] *See, e.g.,* Comments from Shawn Bernardo, Tullett Prebon Americas Corp., representing Wholesale Markets Brokers Association, ("All of the brokers have the capability to report trades to the regulators in a timely fashion . . . as far as TRACE is concerned, we have a track record of reporting those trades efficiently, and we have the systems in place to do that, along with the various means . . . we can do that voice, we can do it electronically, we can do it as hybrid as far as the execution, but we send those trades electronically to them in a timely fashion.") Roundtable Transcript at 227–228.

The reporting of larger transactions will likely cause participants to refrain from entering the market in situations where they might otherwise have entered, which will adversely impact the ability of the parties to the large transaction to mitigate the risks of that transaction by entering into separate, offsetting transactions. This could affect a party's ability to hedge its risks, and the exposure of that legitimate hedge will be diminished, resulting in fewer transactions and potentially widening spreads, which in turn will increase end-user costs.

Nevertheless, the WMBAA believes that trading counterparties with reporting obligations should be able to contract with a SEF to handle the reporting process without transferring their reporting obligations. This will put smaller counterparties with limited trade reporting technology in a less disadvantaged trading position to larger trading counterparties.

Real-Time Public Reporting of Block Trade Information

Time Delay

Section 43.5(k) of the Proposed Rules provides that the time delay for block trades must be no later than 15 minutes after the time of execution (the time that that a swap market receives the swap transaction and pricing data from a reporting party). After the 15 minute time delay has expired, the registered SDR or the swap market (through a third-party service provider) must immediately disseminate the swap transaction and pricing data to the public. By comparison, the SEC's proposed Regulation SBSR requires the immediate dissemination of most of the block trade data, with delayed dissemination for the trade's notional size and the transaction ID at a designated delayed time.

Based on the experiences related to the implementation of the Financial Industry Regulatory Authority's Transaction Reporting and Compliance Engine ("TRACE"), the WMBAA advocates a gradual implementation of the 15 minute delayed reporting requirement. When the TRACE reporting system was first introduced in 2002, there was a 75 minute delay for block trades. This time delay was reduced to 45 minutes the next year, and then reduced to current standard of 15 minutes in 2005. For the same reasons that the TRACE system required a delayed implementation period, the WMBAA would recommend the CFTC consider a similar phased-in approach to this requirement.

Further, the WMBAA would suggest that the CFTC consider fashioning a more flexible time delay regime that takes into account the block trade's asset class, the type of swap instruments, and the actual trade size. The time delay should not be an arbitrary period of time, but rather should reflect the period of time reasonably needed to hedge the block trade position without distorting the market. Each asset class will have varying regular trade frequency and block size thresholds. Accordingly, if implemented, the Commission may find that 15 minutes is too long of a time delay for markets which trade actively, and too short of a time delay for markets with see infrequent trading. To this end, an approach that factors in the relative size of a transaction compared to average trading volume and transaction activity for that specific asset class might be more appropriate to achieve the stated goals for the time delayed reporting provisions.

Information Publicly Reported

Section 43.5(l) of the Proposed Rules provides that all information in the data fields described in Section 43.4 and *Appendix A* to the Proposed Rules must be disseminated to the public for block trades and large notional swaps. The Proposed Rules list 23 data fields, which include date stamp, time stamp, whether the trade is cleared or uncleared, an indication of a block trade, the execution venue, the asset class, contract type, underlying asset, price notation, the unique product identifier, and the notional currency.

The WMBAA suggests that disseminating the specific notional amount of a block trade could jeopardize the anonymity of the counterparties to such trades, making counterparties less willing to engage in transactions of size. Further, the effect of having no delay, or only a short dissemination delay, for a block trade report that includes the full notional size will discourage market makers from committing capital and providing liquidity to the broader market. From a market perspective, there is little gained from disseminating full notional size information. Consistent with the experiences from the implementation of TRACE, which provides regulators with full trade information and publicly disseminates trades within a size range, the WMBAA believes the Commission should implement a similar public reporting methodology. This benefits market participants without exposing a trade's notional size, which protects counterparty anonymity, and preserves liquidity and price com-

petition in the market.[17] The Swaps Standards Advisory Committee would formulate and recommend to the Commission methodology for determining appropriate transaction information to be reported to the public. For example, the Swaps Standards Advisory Committee could recommend that amounts under block size were reported as soon as practicable while blocks were reported only as "block size+" after the appropriate delay for that particular instrument. As with block size itself, the amount reported to the public would be based on the observed number of bids and offers in a given instrument, the number of market participants, the amount of retail participation (if any), and the volume of trades executed.

Additionally, market participants will be wary of committing to larger sized transactions after knowing the rapidity in which other participants will gain knowledge of these trades, leading to less liquidity for the dealer market, and ultimately for end-user participants. The WMBAA also believes that the public dissemination of block trades, as proposed, will allow some market participants to infer the identity of the parties to the transaction and materially reduce market liquidity.

If a liquidity provider perceives greater danger in supplying liquidity, it will step away from providing tight spreads and leave those reliant on market maker liquidity with poorer hedging opportunities. From a market structure standpoint, liquidity "takers" benefit from liquidity providers acting in a competitive environment. The liquidity providers compete with each other, often deriving very small profits per trade from a large volume of transactions. By relying on their ability to warehouse trades and post capital to make markets and using their distribution and professional know-how to offer competitive prices to their customer base, market makers provide liquidity essential to fulfill the need of hedgers. For these reasons, having either no delay or a short dissemination delay will actually erode price discovery and the level of price efficiency in the market.

Conclusion

The WMBAA thanks the Commission for the opportunity to comment on the Proposed Rule. Please feel free to contact the undersigned with any questions you may have on our comments.

Sincerely,

STEPHEN MERKEL,
Chairman.

The CHAIRMAN. Thank you, Mr. Bernardo.

I appreciate that.

We now go to Bill Bullard, Chief Executive Officer of R–CALF, Billings, Montana.

Mr. Bullard.

STATEMENT OF WILLIAM T. BULLARD, JR., CHIEF EXECUTIVE OFFICER, R–CALF USA, BILLINGS, MT

Mr. BULLARD. Thank you, Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee, for this opportunity to testify on the Dodd-Frank Wall Street Reform and Consumer Protect Act that I will refer to as the Wall Street Reform Act.

R–CALF USA, of which I am the CEO, my name is Bill Bullard, is a national nonprofit cattle association representing the interest of farmers and ranchers who raise and sell live cattle. Unlike our counterpart, the National Cattlemen's Beef Association, that has meat packers seated on their governing board and tries to represent the entire beef supply chain, R–CALF USA does not rep-

[17] *See* 75 *Fed. Reg.* at 76161. ("The Commission also considered the standards used by TRACE in setting its minimum threshold for block trades. In that regard, for trades with a par value exceeding $5 million for investment grade bonds or $1 million for non-investment grade bonds (*e.g.,* high-yield and unrated debt), TRACE publicly disseminates the quantity as "5MM+" and "1MM+", respectively.")

resent packers. We exclusively represent the interests of the actual farmers and ranchers that are raising and selling cattle.

R–CALF is the largest organization in the United States representing cattle producers, again exclusively regarding the economic interests of the actual cattle farmers and ranchers of this country.

It is critically important for this Subcommittee to understand that there is a clear demarcation point between the live cattle industry and the beef production industry, the beef packing industry. And that demarcation point is so profound that often there is an inverse relationship between the economic prosperity in the cattle industry and the economic price prosperity in the beef processing industry.

That competition between the live cattle industry and the beef industry over the price of cattle is fierce, or so it should be in a free market system. But today it isn't, and that is because a handful of concentrated packers have all but captured the marketplace for live cattle. And that is why we are here today, to discuss the necessity of implementing the significant regulatory reforms under the Wall Street Reform Act to restore robust, if not fierce, competition in the cattle market that is today largely controlled by the four dominant packers.

As a result of the meet packers' control, we have seen that our cattle industry is in a severe state of crisis. And for the benefit of this Subcommittee, we looked at the 16 states that are represented by the 24 Members of this Subcommittee and realized that over the past 10 years, where data are available, the 16 states have lost 49,850 cattle producers. During that 10 year period, the size of the beef cow herd in those 16 states has been reduced by 1.3 million head, and the production of cattle and calves in those states has been reduced by 935 million pounds.

Nationally, this same fate is being suffered by cattle producers all across the country.

This unprecedented long-term contraction of our industry is occurring even while domestic consumption of beef has actually increased and reached a 40 year high in 2007 and 2008. A shrinking industry that is unable to keep pace with growth and domestic consumption is an industry with a severe problem, a problem that can be addressed with the Wall Street Reform Act.

Today I want to provide evidence showing that the dominant beef packers are engaging in practices that are destroying the price discovery and the risk-management function of the cattle futures markets, practices that the Wall Street Reform Act can address.

In February of 2006, four of the largest meat packers engaged in a coordinated action of withdrawing from the cash market for an unprecedented 2 week period. Industry analysts at the time said the packers did this to gain control over cattle prices, which they did. Cash prices fell $3 a hundredweight during their boycott, and live cattle futures markets fell to multi-month lows during the period.

The effect of this coordinated action was to destroy completely the price discovery function and the risk-management function of the cattle futures market. And this caused direct financial harm to cattle producers that were selling cattle all across the country. In

2008, we testified before Congress and said if this type of attack isn't—attack on our marketplace is not addressed immediately by Congress, we would witness this—experience this type of a problem again in the near future. And we didn't have to wait long before our prediction materialized.

On the last trading day in October 2009, the cattle futures market fell to $81.65 a hundredweight. There were no underlying market forces that would warrant this break in the market. Suggesting that a dominant market participant had shorted the market, the cash price at the time was $87.50, and we viewed this as the worst convergence in a long time in the cattle futures market.

On February 7, the CFTC ordered a trader Newedge to pay a penalty of over $220,000 for activities, unlawful activities that occurred in October 2009. The CFTC found that in October, Newedge exceeded the contract speculative limit for trading cattle over 4,000 contracts, which contracts it had purchased from JBS, the world's largest packer, and then Newedge then sold JBS an over-the-counter swap in live cattle. The CFTC took this action in part under the—pursuant to the Wall Street Reform Act.

Ladies and gentlemen, we believe firmly that we must immediately implement the Wall Street Reform Act, support the CFTC's rulemaking process, fund it completely in order to ensure that we restore for independent cattle producers across this country an open robust marketplace that is functional in terms of discovery price and the marketplace that provides them with a risk-management tool.

Thank you.

[The prepared statement of Mr. Bullard follows:]

PREPARED STATEMENT OF WILLIAM T. BULLARD, JR., CHIEF EXECUTIVE OFFICER, R–CALF USA, BILLINGS, MT

Good afternoon, Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee. I am Bill Bullard and I thank you for the opportunity to provide testimony regarding the Subcommittee's review of the implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Wall Street Reform Act").

I am here today representing the cattle-producing members of R–CALF USA, the Ranchers-Cattlemen Action Legal Fund, United Stockgrowers of America. R–CALF USA is a membership-based, national, nonprofit trade association that represents United States farmers and ranchers who raise and sell live cattle. We have thousands of members located in 46 states and our membership consists of seed stock producers (breeders), cow/calf producers, backgrounders, stockers and feeders. The demographics of our membership are reflective of the demographics of the entire U.S. cattle industry, with membership ranging from the largest of cow/calf producers and large feeders to the smallest of cow/calf producers and smaller, farmer-feeders. Our organization's mission is to ensure the continued profitability and viability for all independent U.S. cattle producers.

R–CALF USA does *not* represent the entire U.S. beef supply chain. Rather, R–CALF USA exclusively represents the live cattle segment of the beef supply chain, meaning it represents the farmers and ranchers located across the U.S. who breed, birth, and raise live cattle for breeding purposes and beef production. These live cattle are subsequently marketed to beef packers that transform live cattle into the commodity beef, which beef is then further processed and/or marketed to other entities within the beef commodity industry (*e.g.,* beef processors, beef wholesalers and distributors, and beef retailers).

It is critically important that the Subcommittee recognize that the live cattle industry is a distinct industry segment within the U.S. beef supply chain and that a clear demarcation point exists between the live cattle industry and the beef commodity industry—a demarcation point so profound that often there is an inverse re-

lationship between economic prosperity in the live cattle industry and economic prosperity in the beef commodity industry.[1]

I. Introduction

The United States cattle industry is in prolonged state of severe crisis. For the benefit of the Subcommittee, in just the most recent 10 year periods where data are available, the 16 states represented by this Subcommittee's 24 members collectively lost 49,850 beef cattle businesses from their respective rural economies (1988–2007),[2] representing a rate-of-loss of nearly 5,000 beef cattle business operations per year. In addition, the combined size of the U.S. beef cow herd in those 16 states declined during the most recent 10 year period (2002–2011) by over 1.3 million cows.[3] And, the volume of production of cattle and calves in those 16 states declined during this period (2000–2009) by over 935 million pounds.[4]

Data clearly show that the geographic segment of the U.S. cattle industry represented by the 16 states represent by the Members of this Subcommittee is declining rapidly in terms of the number of beef cattle operations, the size of the beef cow herd, and the volume of cattle and calf production. Nationally, the number of U.S. cattle operations has declined 40 percent since 1980,[5] the size of the U.S. cattle herd is now the smallest since 1958,[6] and the production of U.S. beef has declined since 2000.[7]

These factors indicate an industry in severe crisis, particularly when one considers that this ongoing, rapid contraction was rapidly occurring even while domestic consumption of beef, as measured by its disappearance from the market, was increasing significantly and reached 40 year highs in both 2007 and 2008,[8] before beginning a decline due to the United States' recent economic downturn. Even though per capita beef consumption decreased over the past few decades, the considerable growth in U.S. population fostered a long-term increase in total domestic beef consumption that the U.S. cattle industry has been unable to satisfy.

A shrinking industry unable to keep pace with domestic consumption is, undeniably, an industry in serious trouble—the kind of serious trouble that warrants sweeping remedial reforms such as those Congress passed in the Wall Street Reform Act.

A principal factor driving the rapid contraction of the U.S. cattle industry is a dysfunctional cattle market that lacks robust competition and adequate transparency, which results in a marketplace that is subject to manipulation and distortion.

---

[1] *See, e.g.,* Sparks Companies Inc., "Potential Impacts of the Proposed Ban on Packer Ownership and Feeding of Livestock," A Special Study, (March 18, 2002) at 24 ("Vertical integration [of the live cattle industry and the beef commodity industry] often attracts investors because of the negative correlation between profit margins at the packing stage [beef commodity stage] and the feeding stage [live cattle stage].").

[2] *See Cattle and Calves: Number of Operations by State and United States, 1997–1998, Cattle,* U.S. Department of Agriculture, Agricultural Statistics Board, National Agricultural Statistics Service, January 1999, at 12; *see also Farms, Land in Farms, and Livestock Operations 2008 Summary,* U.S. Department of Agriculture, Agricultural Statistics Board, National Agricultural Statistics Service, February 2009, at 18.

[3] *See Cattle and Calves: Number by Class, State, and the United States, January 1, 2002–2003, Cattle,* U.S. Department of Agriculture, Agricultural Statistics Board, National Agricultural Statistics Service, January 2003, at 5; see also *Cattle Inventory by Class—States and United States: January 1, 2010 and 2011, Cattle,* U.S. Department of Agriculture, Agricultural Statistics Board, National Agricultural Statistics Service, January 2003, at 6.

[4] *See Cattle and Calves: Production and Income by State and the United States, Revised 2000, Meat Animals Production, Disposition, and Income 2001 Summary,* U.S. Department of Agriculture, Agricultural Statistics Board, National Agricultural Statistics Service, April 2002, at 4: see also *Cattle and Calves: Production and Income by State and the United States, 2009, Meat Animals Production, Disposition, and Income 2009 Summary,* U.S. Department of Agriculture, Agricultural Statistics Board, National Agricultural Statistics Service, April 2010, at 7.

[5] The size of the U.S. cattle industry, as measured by the number of cattle operations in the U.S., declined from 1.6 million in 1980 to 983,000 in 2005 and further declined to 967,400 in 2007. *See Fed. Reg.* Vol. 72, No. 152, Wednesday, August 8, 2007, at 44681, col. 2.

[6] *See Cattle,* U.S. Department of Agriculture, National Agricultural Statistics Service, January 28, 2011.

[7] *See* Beef: Supply and disappearance (carcass weight, million pounds) and per capita disappearance (pounds), *Livestock, Dairy, and Poultry Outlook: Tables,* U.S. Department of Agriculture, Economic Research Service (Total production declined from 26.89 billion pounds in 2000 to 26.07 billion pounds in 2009), available at *http://www.ers.usda.gov/publications/ldp/LDPTables.htm.*

[8] *See id.* (Total disappearance (*i.e.,* consumption) of beef increased to a over 28 billion pounds in both 2007 and 2008, which are record-setting highs since USDA began reporting disappearances in 1970).

II. The Cash and Futures Markets in the Cattle Industry Are Prone To Manipulation and Distortion

A. The Live Cattle Production Chain and Its Relation To Markets

The U.S. cattle industry is unique in that it raises an animal with the longest biological cycle of any farmed animal. This is the characteristic that created the historical phenomenon known as the cattle cycle. According to the U.S. Department of Agriculture ("USDA"), the cattle cycle "arises because biological constraints prevent producers from instantly responding to price."[9] It takes approximately 15 to 18 months to rear cattle to slaughter weight and cattle consume considerable volumes of forage (*i.e.,* from grazing) for much of this time. After cattle reach approximately 1 year of age on forage, and weigh approximately 800 pounds, they then become adaptable to a more concentrated production regime (*i.e.,* they can be finished in concentrated feedlots).

Because of the long biological cycle and the diminishing forage requirements as cattle intended for slaughter grow to maturity, the cattle production chain is segmented. Typically, the farmer or rancher that maintains a beef-cow herd births new calves each year and those calves are raised at their mothers' side on milk and forage for their first several months of life. At approximately 6 months of age the calves are typically weaned from their mothers and placed in a backgrounding lot where they are fed a growing ration of forage and grain, or they may be weaned and turned back out on forage such as pasture. At approximately 1 year of age and weighing approximately 800 pounds, the calves will have matured sufficiently to be placed in feedlots and fed a fattening grain ration for approximately 4 to 5 additional months before they become slaughter-ready.

The approximately 1 year-old cattle that weigh approximately 800 pounds and are ready to be placed in a feedlot correspond to the "Feeder Cattle" category of the commodity futures market. The feeder cattle that are subsequently fed in a feedlot for 4 to 5 months and are ready to be sold to the beef packer to be slaughtered correspond to the "Live Cattle" category of the commodity futures market and are referred to as fed cattle.

Due to the segmented production chain in the cattle industry, calves are often first sold by those who raised them—the cow/calf producer—then sold to those that background them or turn them back to pasture—the backgrounder or stocker—who in turn sells them to those that feed them to slaughter weight—the feedlot. From the moment a newborn calf hits the ground, its value is based on the expected future value of that calf when it is mature and ready for slaughter. Thus, the value of a calf weaned today at approximately 6 months of age is the expected value of that calf when it is sold for slaughter approximately 1 year into the future. This explains why it is so vitally important to the entire cattle industry to ensure that the market for slaughter-ready cattle—the price discovery market—is robustly competitive and transparent. Any manipulation or distortion of the price for cattle that are ready for slaughter permeates throughout the entire cattle industry and can translate into lower prices for everyone within the cattle industry (which includes 753,000 cattle farmers and ranchers throughout the United States),[10] regardless of what segment of the production chain they specialize in.

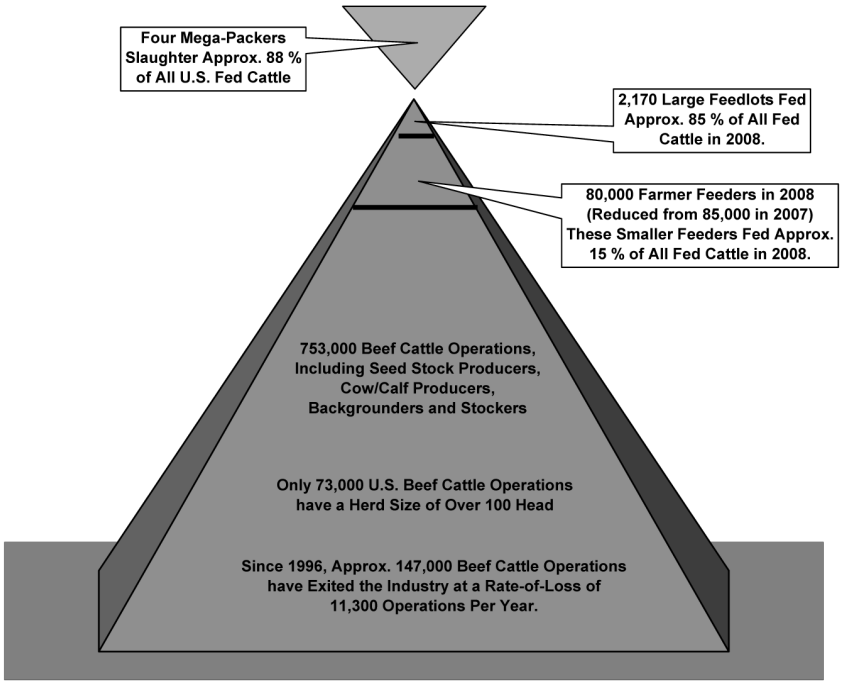
The entire cattle industry can thus be visualized as a pyramid as depicted below in which the nation's feedlots comprise the top sections of the pyramid and the nation's hundreds of thousands of cattle producers occupy its base. Importantly, it is the price negotiated at the pyramid's apex between the feedlots and the highly concentrated beef packers that determines whether the cattle industry as a whole remains profitable. Economists have long expressed grave concerns regarding the unprecedented concentration in the beef packing industry. For example, as early as 2001, Oklahoma State University Economist Clement E. Ward described the concentration level in the U.S. meatpacking industry as among the highest of any industry in the United States, "and well above levels generally considered to elicit non-competitive behavior and result in adverse economic performance."[11]

---

[9] Cattle: Background, Briefing Room, USDA, ERS, updated June 7, 2007, available at *http://www.ers.usda.gov/Briefing/Cattle/Background.htm.*

[10] *See Farms, Land in Farms, and Livestock Operations 2009 Summary,* USDA, National Agricultural Statistics Service (hereafter "NASS"), Feb. 2010, at 14, available at *http://usda.mannlib.cornell.edu/usda/current/FarmLandIn/FarmLandIn-02-12-2010.pdf.*

[11] *A Review of Causes for and Consequences of Economic Concentration in the U.S. Meatpacking Industry,* Clement E. Ward, CURRENT AGRICULTURE FOOD AND RESOURCE ISSUES, 2001, at 1.



Another important factor that makes cattle marketing unique is the perishable nature of fed cattle. Unlike many agricultural commodities that are storable, fed cattle that have reached their optimal slaughter weight must be marketed within a narrow window of time (generally within about a 2 week period); otherwise, the animals would degrade in quality and value.[12] This characteristic severely reduces the pricing power of fed cattle sellers who often are relegated to take whatever price is offered by the beef packer, regardless of whether it is a legitimate price or a distorted price.

The cash market for slaughter-ready or fed cattle is the price discovery market for the entire cattle industry. The cattle futures market was intended to compliment the price-discovery function of the cash market by projecting it out into future months, thus serving as a risk-management tool for cattle producers that raise and sell cattle intended for slaughter and for beef packers that purchase and slaughter the fed cattle for human consumption. Unfortunately, the cash market for fed cattle, to which the futures market is intrinsically tied, has become too thin to function as an accurate indicator of the fair market value of fed cattle.

The USDA reports that the national-average volume of fed cattle sold in the cash market has shrunk from 52 percent in 2005 to 37 percent in 2010.[13] The volume of cash cattle in the Texas, Oklahoma, and New Mexico marketing region is now down to less than 22 percent[14] and the Colorado region is now down below 20 percent.[15] With such a small volume of cattle actually sold in the cash market today, the cash market can no longer function as an accurate price discovery market. With an overwhelming number of cattle committed to the beef packers outside the cash market at undisclosed prices and terms on any given day (which cattle are referred to as the beef packers' captive supply), the actual fair market price for fed cattle is difficult, if not impossible, to determine. This is why, in addition to supporting

[12] *See GIPSA Livestock and Meat Marketing Study,* January 2007, Volume 3, at 5–4, available at *http://archive.gipsa.usda.gov/psp/issues/livemarketstudy/LMMS_Vol_3.pdf.*

[13] *See National Breakdown by Purchase Type, 2005–2010 Fed Cattle Summary of Purchase Types,* USDA MARKET NEWS.

[14] *See Texas-Oklahoma-New Mexico Breakdown of Volume by Purchase Type, 2005–2010 Fed Cattle Summary of Purchase Types,* USDA MARKET NEWS.

[15] *See Colorado Breakdown of Volume by Purchase Type, 2005–2010 Fed Cattle Summary of Purchase Types,* USDA MARKET NEWS.

the ongoing rulemaking by the Commodity Futures Trading Commission ("CFTC") that will increase transparency in the futures market, R–CALF USA also supports the USDA Grain Inspection, Packers and Stockyards Administration ("GIPSA") rulemaking that will increase transparency in the fed cattle market.

In addition to the reduced volume of cattle sold in the cash market, the trades that do occur in the cash market are too infrequent to function as a viable price discovery tool. Anecdotal evidence from numerous cattle feeders indicate that beef packers' exposure to the cash market is now so limited that the current bidding practice often involves an offer by the beef packer once per week, and oftentimes within only about a fifteen minute timeframe. If the beef packers are short bought (*i.e.,* they have insufficient cattle numbers even with their captive supplies), this fifteen minute window may occur on a Thursday, or perhaps even on a Wednesday. However, if the beef packer is long-bought (*i.e.,* has more than enough captive supply cattle), the fifteen minute marketing opportunity may not occur until late Friday afternoon, after the close of the futures markets. This extremely narrow window of opportunity to market cattle places cattle feeders at a distinct disadvantage as there is insufficient time to make calls to other beef packers after an offer is made—it is essentially a take-it or leave-it offer that, if refused, means the cattle feeder must continue feeding for another week, even if the cattle have already reached their optimal weight, in hopes of a more realistic offer the next week. This limited and infrequent bid window affords the beef packers with tremendous market power that gives them the ability to leverage down the price discovery market.

B. Empirical Evidence of Behaviors That Manipulate and Distort the Cash and Futures Market

Empirical evidence shows that the U.S. cattle market is already susceptible to coordinated and/or simultaneous entries and exits from the cash market that negatively affect the futures market. In February 2006, all four major beef packers—Tyson, Cargill, Swift, and National—withdrew from the cash cattle market in the Southern Plains for an unprecedented period of 2 weeks. On February 13, 2006, market analysts reported that no cattle had sold in Kansas or Texas in the previous week.[16] No cash trade occurred on the southern plains through Thursday of the next week, marking, as one trade publication noted, "one of the few times in recent memory when the region sold no cattle in a non-holiday week."[17] Market analysts noted that "[n]o sales for the second week in a row would be unprecedented in the modern history of the market."[18] During the week of February 13 through 17, there were no significant trades in Kansas, western Oklahoma, and Texas for the second week in a row.[19] Market reports indicated that Friday, February 17, 2006, marked 2 full weeks in which there had been very light to non-existent trading in the cash market, with many feedlots in Kansas, Oklahoma, and Texas reporting no bids at all for the past week.[20] The beef packers made minimal to no purchases on the cash market, relying on captive supplies of cattle to keep their plants running for 2 weeks and cutting production rather than participating in the cash market. The beef packers reduced slaughter rates rather than enter the cash market. Cattle slaughter for the week of February 13–17 was just 526,000 head, down from 585,000 the previous week and 571,000 at the same time a year earlier.[21] According to one analyst, the decision to cut slaughter volume indicated "the determination by beef packers to regain control of their portion of the beef price pipeline."[22] Another trade publication noted that the dramatic drop in slaughter was undertaken in part to "try and get cattle bought cheaper."[23] At the end of the second week of the buyers' abandonment of the cash market, one market news service reported, "The big question was whether one major [packer] would break ranks and offer higher money. That has often occurred in the past, said analysts."[24]

As a result of the beef packers shunning the cash market, cash prices fell for fed cattle, replacement cattle, and in futures markets. Sales took place after feedlots in Kansas and the Texas Panhandle lowered their prices to $89 per hundredweight, down $3 from the $92 per hundredweight price reported in the beginning of February.[25] The same day, February 17, live and feeder cattle futures fell to multi-

---

[16] "Packers Finally Seriously Cut Kills," *Cattle Buyers Weekly* (Feb. 13, 2006).
[17] "Classic Standoff Continues Through Thursday," *Cattle Buyers Weekly* (Feb. 20, 2006).
[18] "Classic Standoff Continues Through Thursday," *Cattle Buyers Weekly* (Feb. 20, 2006).
[19] Curt Thacker, "Cash Cattle Quiet 2–20," *Dow Jones Newswires* (Feb. 20, 2006).
[20] Lester Aldrich, "Cash Cattle Standoff 2–17," *Dow Jones Newswires* (Feb. 17, 2006).
[21] Curt Thacker, "Cash Cattle Quiet 2–20," *Dow Jones Newswires* (Feb. 20, 2006).
[22] Jim Cote, "Today's Beef Outlook 2–17," *Dow Jones Newswires* (Feb. 17, 2006).
[23] "Classic Standoff Continues Through Thursday," *Cattle Buyers Weekly* (Feb. 20, 2006).
[24] "Classic Standoff Continues Through Thursday," *Cattle Buyers Weekly* (Feb. 20, 2006).
[25] Curt Thacker, "Cash Cattle Quiet 2–20," *Dow Jones Newswires* (Feb. 20, 2006).

month lows.[26] Replacement cattle prices also dropped in response to buyer reluctance.[27] In Oklahoma City, prices for feeder cattle dropped as much as $4 per hundredweight.[28]

Whether the beef packers' simultaneous boycott of the cash market was deliberately coordinated or not, it was a highly unusual event that required simultaneous action in order to effectively drive down prices, which it did. As market analysts observed, the major question in markets during the second week of the buyers' strike was whether or not any one of the major beef manufacturers would "break ranks" to purchase at higher prices than the other beef manufacturers. No buyer did so until prices began to fall. In fact, beef packers were willing to cut production rather than break ranks and purchase on the cash market.

Abandonment of the cash market in the Southern Plains by all major beef manufacturers for 2 weeks in a row resulted in lower prices and had an adverse effect on competition. Cattle producers in the Southern Plains cash markets during those two weeks were unable to sell their product until prices fell to a level that the buyers would finally accept. The simultaneous refusal to engage in the market did not just have an adverse effect on competition—it effectively precluded competition altogether by closing down an important market for sellers. The simultaneous boycott of cash markets in the Southern Plains was, however, a business decision on the part of the beef packers that did not conform to normal business practices and that resulted in a marked decline in cattle prices. At the time, market analysts interpreted the refusal to participate in the cash market as a strategy to drive down prices, and purchases only resumed once prices began to fall.

The coordinated/simultaneous action in February 2006 was not isolated and was soon followed by a second, coordinated/simultaneous action. During the week that ended October 13, 2006, three of the nation's four largest beef packers—Tyson, Swift, and National—announced simultaneously that they would all reduce cattle slaughter, with some citing, *inter alia,* high cattle prices and tight cattle supplies as the reason for their cutback.[29] During that week, the packers reportedly slaughtered an estimated 10,000 fewer cattle than the previous week, but 16,000 more cattle than they did the year before.[30] Fed cattle prices still fell $2 per hundredweight to $3 per hundredweight and feeder prices fell $3 per hundredweight to $10 per hundredweight.[31]

By Friday of the next week, October 20, 2006, the beef packers reportedly slaughtered 14,000 more cattle than they did the week before and 18,000 more cattle than the year before—indicating they did not cut back slaughter like they said they would.[32] Nevertheless, live cattle prices kept falling, with fed cattle prices down another $1 per hundredweight to $2 per hundredweight and feeder cattle prices were down another $4 per hundredweight to $8 per hundredweight.[33]

The anti-competitive behavior exhibited by the beef packers' coordinated/simultaneous market actions caused severe reductions to U.S. live cattle prices on at least two occasions in 2006. This demonstrates that the exercise of abusive market power is manifest in the U.S. cattle industry.

In testimony to the U.S. Senate Judiciary Subcommittee on Antitrust, Competition Policy, and Consumer Rights, R–CALF USA informed Congress on May 7, 2008, that the potential for a recurrence of this type of anti-competitive behavior that caused the manipulation and distortion of both the cash market and the futures market was considerable and constitutes an empirically demonstrated risk that would likely become more frequent, more intense, as well as extended in duration unless Congress took decisive, remedial action.

R–CALF USA did not have to wait very long before evidence surfaced that indicated the beef packers were once again involved in manipulating and distorting the

---

[26] Jim Cote, "Live Cattle ReCap—2/17/2006," *Dow Jones Newswires* (Feb. 17, 2006).

[27] "The Markets," *AgCenter Cattle Report* (Feb. 18, 2006), available on-line at *http://www.agcenter.com/cattlereport.asp.*

[28] "The Markets," *AgCenter Cattle Report* (Feb. 18, 2006), available on-line at *http://www.agcenter.com/cattlereport.asp.*

[29] *See* "National Beef Cuts Hours at Two Kansas Plants (Dodge City, Liberal)," Kansas City Business Journal (October 10, 2006) attached as Exhibit 17; "Update 1—Tyson Foods to Reduce Beef Production," Reuters (October 10, 2006), attached as Exhibit 18; "Swift to Stay with Reduced Production at U.S. Facilities," *Meatpoultry.com* (October 10, 2006), attached as Exhibit 19.

[30] *See* "Livestock Market Briefs, Brownfield Ag Network," (October 13, 2006), attached as Exhibit 20.

[31] *See id.*

[32] *See* "Livestock Market Briefs, Brownfield Ag Network," (October 20, 2006), attached as Exhibit 21.

[33] *See id.*

cash/futures market relationship. As discussed more fully below, R–CALF USA immediately recognized the symptoms of the unlawful market manipulation that occurred in the cattle futures market in October 2009 and formally notified Federal regulatory officials of the disastrous consequences to U.S. livestock producers resulting from that manipulation. At that time, R–CALF USA witnessed a severe break in the cattle futures market, likely indicating that a dominant market participant had shorted the market, causing the futures market to fall the limit. However, R–CALF USA had no knowledge at that time regarding which dominant market participant was involved. Below are actions R–CALF USA initiated in its attempts to address this incidence of obvious market manipulation:

Soon after the close of the October 2009 live cattle futures contract month, on Dec. 9, 2009, R–CALF USA Marketing Committee Chairman Dennis Thornsberry submitted a formal complaint/affidavit to GIPSA in which he stated:

> I have used the Chicago Mercantile Exchange to hedge cattle for the purpose of managing the risk associated with marketing my cattle. However, the problems in the cash cattle market are mirrored in the futures market as it too is subject to undue influence by the dominant corporate packers and feedlots. For example, on the last trading day before the October futures contract expired, some outside force broke the October board, causing it to fall by the full $3.00 limit to $81.65 per cwt. However, the live cattle trade was at $87.50. This was among the worst convergences that I have seen in the futures market for a long time. It is unlikely that the futures market can attract sufficient long positions to add the needed liquidity to the futures market for determining the value of cattle when the market remains vulnerable to those who would exercise speculative short selling to effectively drive down the futures price. Given that this type of volatility cannot be attributed to market fundamentals (but, according to market analysts can be triggered by a $50 million infusion, which is not beyond the means of hedge funds and perhaps the dominant beef packers), small to mid-sized producers would not have the financial wherewithal to cover the margin calls associated with such a volatile market. This, I believe, plays directly into the hands of the large corporations that use the markets daily to gain an advantage over the small to mid-sized producer. And, the volatility in the futures market caused by manipulative practices has rendered it incapable of serving as a risk management tool for the small to mid-sized producer and is contributing to the exodus of these producers from the industry.

Later, in its formal comments submitted December 31, 2009, to both the U.S. Department of Justice ("Justice Department") and USDA regarding the two agencies' joint investigation on Agriculture and Antitrust Enforcement Issues in Our 21st Century Economy, R–CALF USA provided the same evidence that indicated that the beef packers' manipulation of the cash market is mirrored in the futures market where they also exercise abusive market power. R–CALF USA stated:

> R–CALF USA is concerned that beef packers are able to significantly influence the commodities futures market, rendering it unsuitable for managing the risks of independent cattle producers. Practices such as shorting the market to drive down both cash and futures prices, particularly on the last trading day of the month before futures contracts expire are a form of market manipulation. The October 2009 futures board, *e.g.,* broke the limit down on the last trading day in October, causing an unprecedented number of live cattle deliveries to occur. Based on information and belief, the manipulative practices by the beef packers in the commodities futures market has created a disinterest among speculators who would otherwise participate in long speculative positions in the market. The lack of speculative long positions in the market may well be depressing the cash and futures market by several dollars per hundredweight and reducing the utility of the commodity futures market as a risk management tool for cattle producers. R–CALF USA urges the Department of Justice and USDA to investigate the beef packers' activities in the commodities futures market.

Later, on April 26, 2010, R–CALF USA submitted formal comments to the CFTC concerning its proposed Federal speculative position limits under the Wall Street Reform Act and informed the agency of R–CALF USA's concern that dominant beef packers were manipulating the cattle futures market to lower the price of live cattle. R–CALF USA provided the CFTC with the information that originated in Mr. Thornsberry's complaint/affidavit to GIPSA to substantiate R–CALF USA's concern that dominant market participants were manipulating the cattle futures market:

> Evidence, albeit anecdotal, that the cattle futures market is subject to undue influence by dominant market participants includes market events that oc-

curred in October 2009. On the last trading day before the October 2009 futures contract expired, some outside force broke the October board, causing it to fall by the full $3.00 limit to $81.65 per cwt. However, the live cattle trade was at $87.50, resulting in an unexplained convergence that is suggestive of direct manipulation.

Just last Monday, on Feb. 7, 2011, the CFTC issued an announcement stating it had ordered Chicago-based futures commission merchant Newedge USA, LLC ("Newedge") to pay more than $220,000 for violating speculative position limits in live cattle futures trading.[34] In its announcement, the CFTC stated that one of the nation's largest beef packers, JBS USA, LLC ("JBS"), was involved in the transaction that led to the CFTC's remedial sanction.

According to the CFTC order issued in this matter, Newedge purchased 4,495 October 2009 live cattle futures contracts on the CME from their client JBS, and then Newedge sold JBS an over-the-counter swap (OTC) in live cattle on Oct. 9, 2009—a transaction that caused Newedge to exceed the 450 contract speculative limit for trading live cattle by 4,045 contracts.[35] The CFTC order further states of the transaction: "On Friday, October 9, 2009, Newedge and JBS, a live cattle end-user, agreed that JBS would sell Newedge 4,495 contract long October 2009 live cattle futures position. Newedge would hedge the purchase with a short position in an underlying swap in live cattle and sell JBS a live cattle swap."[36] The CFTC order also stated that Newedge earned $80,910 in total profit and commissions on related transactions with JBS.[37]

We applaud the CFTC for taking this enforcement action, which, according to the CFTC's order in this matter, was taken pursuant to the Commodity Exchange Act, the Food, Conservation, and Energy Act of 2008, the new Wall Street Reform Act, and CFTC regulations. The CFTC has taken decisive steps to ensure that dominant market participants are not exercising abusive market power to manipulate and distort the cattle futures market. Though three Federal agencies were informed about this incident, to our knowledge only the CFTC took the initiative to investigate and enforce this unlawful action. R–CALF USA believes the October 2009 live cattle futures market transaction that involved both Newedge and JBS, and in which Newedge was known to have engaged in unlawful activity, was a significant, contributing cause for the manipulation of the cattle futures price and resulting harm to U.S. cattle producers. Further, and based on the available information, we believe JBS' involvement in this transaction constitutes a direct violation of the Packers and Stockyards Act of 1921 ("PSA") that prohibits beef packers from engaging in any course of business or do any act for the purpose or with the effect of manipulating or controlling prices.[38] For those reasons, R–CALF USA has formally requested GIPSA and the Justice Department to immediately initiate a PSA enforcement action against JBS for its role in the debilitating cattle futures market transaction that occurred in October 2009.

III. The Dire Need for Sweeping Futures Market Reform

R–CALF USA is a member of the Commodity Markets Oversight Coalition ("CMOC"), which is an independent, non-partisan and nonprofit alliance of groups that represent commodity-dependent industries, businesses and end-users, including American consumers, that rely on functional, transparent and competitive commodity derivatives markets as a hedging and price discovery tool. The CMOC strongly supported Congressional reforms to the commodity futures market and is actively involved in the CFTC's rulemaking process to fully and expeditiously implement the Wall Street Reform Act.

R–CALF USA is particularly concerned with the practice whereby large beef packers, which are legitimate hedgers for a certain volume of cattle, enter the commodity futures markets also as speculators with the intent and effect of manipulating the futures (and hence the cash price) of cattle. These beef packers should not be entitled to the end-user exception for speculative trades beyond their physical needs for slaughter cattle.

---

[34] *See CFTC Orders Chicago-Based Futures Commission Merchant Newedge USA, LLC to Pay More than $220,000 for Violating Speculative Position Limits in Live Cattle Futures Trading,* U.S. Commodity Futures Trading Commission, Release PR5981–11, Feb. 7, 2011, available at *http://www.cftc.gov/PressRoom/PressReleases/pr5981-11.html.*

[35] *See* CFTC Docket No: 11–07, Order Instituting Proceedings Pursuant to Section 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, U.S. Commodity Futures Trading Commission, Feb. 7, 2011, available at *http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfnewedgeorder020711.pdf.*

[36] *Ibid.*

[37] *Ibid.*

[38] *See* 7 U.S.C. § 192(e).

R–CALF USA has urged the CFTC to use its rulemaking authority to fully restore the cattle futures market to its original purpose of affording U.S. cattle producers a useful risk-management marketing tool void of distortion and manipulation by certain speculators and other dominant market participants (*i.e.,* beef packers). As previously mentioned, United States cattle producers sell their cattle into one of the most highly concentrated marketing structures in the U.S. economy. Inherent to this high level of market concentration is substantial disparity between the economic power of the hundreds of thousands of disaggregated U.S. cattle producers (*i.e.,* cattle sellers) and the economic power wielded by very few beef packers (*i.e.,* cattle buyers).

A. The Futures Market for Live Cattle Is Fundamentally Broken

R–CALF USA believes the commodities futures market is fundamentally broken and no longer functionally capable of serving as an effective, economic risk management tool for U.S. cattle producers. Rather than to provide true price discovery, the live cattle futures market has become a device that enhances the ability of dominant market participants to manage and manipulate both live cattle futures prices and cash cattle prices.

Evidence that the live cattle futures market is no longer functionally capable of serving as an effective risk management tool for U.S. cattle producers includes data that show the physical hedgers share of the long open interest in the feeder cattle futures market and the live cattle futures market declined from 52.4 percent and 67.6 percent, respectively, in 1998 to only 17 percent and 11.7 percent, respectively, in 2008.[39] Such a drastic decline in the physical hedgers open interests in just a 10 year period in these commodities show either or both that commercial (*i.e., bona fide* hedgers) interests are now avoiding the futures market (which they would not do if the market served an economically beneficial function) and/or speculator interests have now besieged the markets once dominated by actual sellers and buyers of the commodities.

The consolidation and concentration that already has occurred in the beef packing industry is now occurring at a rapid rate in the feedlot sector of the U.S. cattle industry, thereby exacerbating the ongoing thinning of the numbers of *bona fide* hedgers participating in the cattle futures market. For example, the numbers of U.S. feedlots that purchase feeder cattle and sell fed cattle have declined drastically in recent years. Today just 58 of the 2,170 feedlots with capacities of more than 1,000 head feed approximately seven million of the approximately 26 million cattle fed and marketed, representing over ¼ of all the fed cattle in 2008.[40] As shown below, the number of smaller U.S. feedlots, those with capacities of less than 1,000 head, has declined sharply over the past 13 years, with nearly 30,000 feedlots having exited the industry since 1996.[41]

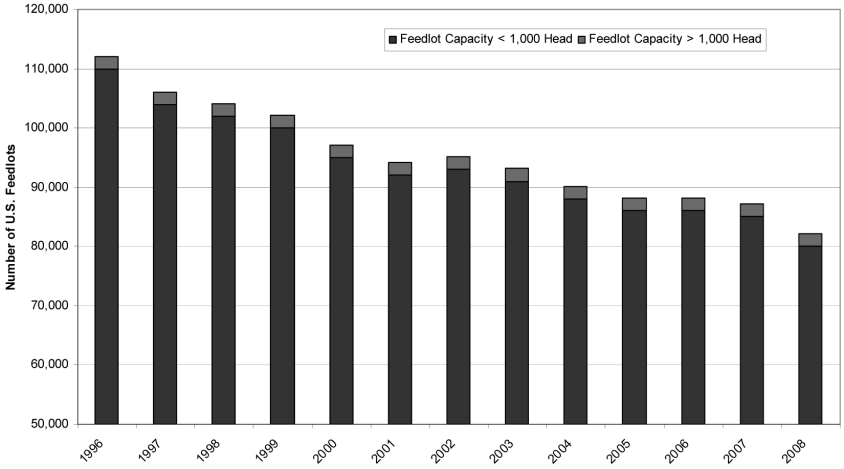
---

[39] *See The Accidental Hunt Brothers: How Institutional Investors Are Driving Up Food and Energy Prices,* Michael W. Masters and Adam K. White, CFA, Table 10: Commodities Futures Markets—Long Open Interests Composition, July 31, 2008, at 34, available at *http://accidentalhuntbrothers.com/wp-content/uploads/2008/09/accidental-hunt-brothers-080731.pdf.*

[40] *See Cattle on Feed,* USDA, NASS, Feb. 20, 2009, at 14.

[41] *See Cattle, Final Estimates,* various reports, 1996–2008, USDA, National Agricultural Statistics Service (hereafter "NASS"); *see also Cattle on Feed,* USDA, NASS, Feb. 20, 2009.

Decline in Numbers of U.S. Feedlots
1996–2008



Source: USDA–NASS, *Various Cattle on Feed Reports.*

As a result of the worsening economic disparity caused by the ongoing consolidation and concentration of the U.S. cattle market, the remaining cattle producers, some of whom continue to rely on futures markets to offset price risk, are vulnerable to any market distortions caused by beef packers that may not only participate in the futures market as physical hedgers, but as significant speculators as well. The cattle futures market is susceptible to downward price movements—in contradiction of supply/demand fundamentals, when, *e.g.,* beef packers, who may hold a physical hedging position in the market, also engage in substantial speculative short selling of the market. The effect of the beef packers' speculative short selling is to lower not only the futures market price, but also the cash spot market price, which is intrinsically tied to the futures market.

Another troubling development in the U.S. cattle market is that the same concentrated beef packers, who are the dominant purchasers of fed cattle, are fast becoming dominant purchasers of feeder cattle through their expanded feedlot holdings. Of the nations four largest feedlot companies, JBS Five Rivers Ranch Cattle Feeding; Cactus Feeders, Inc.; Cargill Cattle Feeders, LLC; and, Friona Industries, LP,[42] two, including the largest, are owned by two of the largest beef packers, JBS and Cargill. Thus, the beef packers' ongoing infiltration into the cattle feeding industry means that dominant participants in both the feeder cattle futures market and the live cattle futures market now have an economic interest in lowering both feeder cattle prices and fed cattle prices.

It is R–CALF USA's belief that futures market prices directly and significantly influence prices for all classes of cattle, including fed cattle, feeder cattle, stocker calves, and breeding stock, regardless of whether or not these cattle are included under any futures contract. For this reason, it is imperative that the futures market be protected from unfair, manipulative, and speculative practices that effectively distort the U.S. cattle market.

B. The Cattle Futures Market Must Be Protected From Manipulation by Speculators With a Vested Interest in the Prices for Cattle

R–CALF USA believes the ongoing distortions to and manipulation of the cattle futures markets, particularly those that we believe are perpetrated through speculative short selling by one or more dominant beef packers and/or other concentrated/dominant traders, can be rectified within the CFTC's rulemaking by prohibiting traders holding positions pursuant to a *bona fide* hedge exemption from also trading speculatively.[43] To be effective, this provision would need to apply to any subsidiary,

[42] *See Recent Acquisitions of U.S. Meat Companies,* Congressional Research Service, 7–5700, RS22980, March 10, 2009, at 2.
[43] *See* 75 *Fed. Reg.* 4159.

affiliate, or other related entity of the *bona fide* hedger, particularly with respect to a dominant beef packer.

C. The Cattle Futures Market Must Be Protected From Distortions Caused by Excessive Speculation

Like other commodity futures markets, the futures market for live cattle is highly susceptible to market distortion should excessive liquidity be introduced in the form of excessive speculation. The remaining participants in the U.S. live cattle industry, whose numbers have already been reduced by an alarming 40 percent since 1980,[44] operate on slim margins and are highly vulnerable to even small changes in cattle prices.[45] As a result, cattle producers are particularly susceptible to financial failure caused by both market volatility and market distortions created by excessive speculation that can swing prices low, even for short periods, as they are operating in an industry already suffering from a long-run lack of profitability. In addition, small to mid-sized cattle producers do not have sufficiently deep pockets to cover margin calls associated with market volatility caused by excessive speculation, which, we believe, has rendered the cattle futures markets incapable of serving as an effective risk management tool for the small to mid-sized producer and is contributing to the ongoing exodus of these producers from the U.S. cattle industry.

R–CALF USA believes the ongoing distortions to the cattle futures market, particularly those we believe are created by excessive speculation, can be rectified within the CFTC's rulemaking with a provision that would limit speculative positions by index funds and other trading entities that have no specific interest in the underlying commodity and bear no risk relative to the commodity's production or consumption. To achieve the goal of effectively preventing excessive speculation, which is known to facilitate abrupt price movements and price distortions in other futures markets,[46] we are inclined to agree with the recommendation made by Michael W. Masters:

> As a general rule of thumb, speculators should never represent more than 50% of open interest, because at that level, they will dominate the price discovery function, due to the aggressiveness and frequency of their trading. The level I recommend is 25%; this will provide sufficient liquidity, while ensuring that physical producers and consumers dominate the price discovery function.[47]

D. The Cattle Industry Must Be Protected From Distortions in Feed Grain Prices Caused Also by Excessive Speculation

Because feed grains are a major component of production costs for fed cattle, the price of feed grains is a major consideration by *bona fide* hedgers when formulating expectations for future cattle prices. If feed grain prices are expected to rise—thus increasing the cost of cattle production—without a corresponding expectation that beef prices also will rise, cattle feeders will attempt to offset the expectation of higher feed grain prices by purchasing feeder cattle at lower prices. The relationship between feed grain prices and cattle-feeder profitability has long influenced pricing decisions by *bona fide* hedgers. If, however, feed grain prices are themselves subject to non-market forces such as excessive speculation, as they were during the 2008 commodity bubble, the profitability of cattle feeders can be immediately affected. And, this lack of profitability, or reduced profitability, immediately translates into a perception that feeder cattle must be purchased at lower prices to offset the resulting increase in production costs. Thus, distortions in futures feed grain prices result in distortions to cattle futures prices and must be eliminated. R–CALF USA believes that effective speculative position limits imposed on all feed grain commodities markets would alleviate the transference of market distortions from the feed grains futures market to the cattle futures market.

---

[44] The size of the U.S. cattle industry, as measured by the number of cattle operations in the U.S., declined from 1.6 million in 1980 to 983,000 in 2005 and further declined to 967,400 in 2007. *See Fed. Reg.* Vol. 72, No. 152, Wednesday, August 8, 2007, at 44681, col. 2.

[45] *See A Review of Causes for and Consequences of Economic Concentration in the U.S. Meatpacking Industry,* Clement E. Ward, Current Agriculture Food and Resource Issues, 2001, at 2 ("[E]ven seemingly small impacts on a $/cwt. basis may make substantial difference to livestock producers and rival meatpacking firms operating at the margin of remaining viable or being forced to exit an industry.").

[46] *See, e.g.,* 75 *Fed. Reg.* 4148, col. 3.

[47] Testimony of Michael W. Masters, Managing Member/Portfolio Manager, Masters Capital Management, LLC, before the Commodities Futures Trading Commission, March 25, 2010.

E. The CFTC Should Consider Additional Reforms To Protect the Integrity of the Cattle Futures Market

R–CALF USA has urged the CFTC to ensure that the cattle futures market is always dominated by *bona fide* hedgers. In addition, it has urged the CFTC to strictly curtail the practice of allowing passive speculation in the commodities futures market by entities that hold large market positions without any interest in the underlying commodity and without any risk relative to the commodity's production or consumption. R–CALF USA further believes it important that the CFTC recognize the two types of excessive speculation that has invaded the cattle futures market: (1) the excessive speculation by one or more dominant market participants with market shares sufficient to engage in market manipulation (this can include dominant beef packers acting speculatively as discussed above or any other concentrated/dominant speculator), and (2) the excessive speculation by those without any vested interest in the underlying commodity and without any risk relative to the commodity's production or consumption (including both active and passive speculators). Both of these types of excessive speculation contribute to market distortions that are harmful to *bona fide* market participants, as well as to consumers who ultimately consume products derived from these commodities.

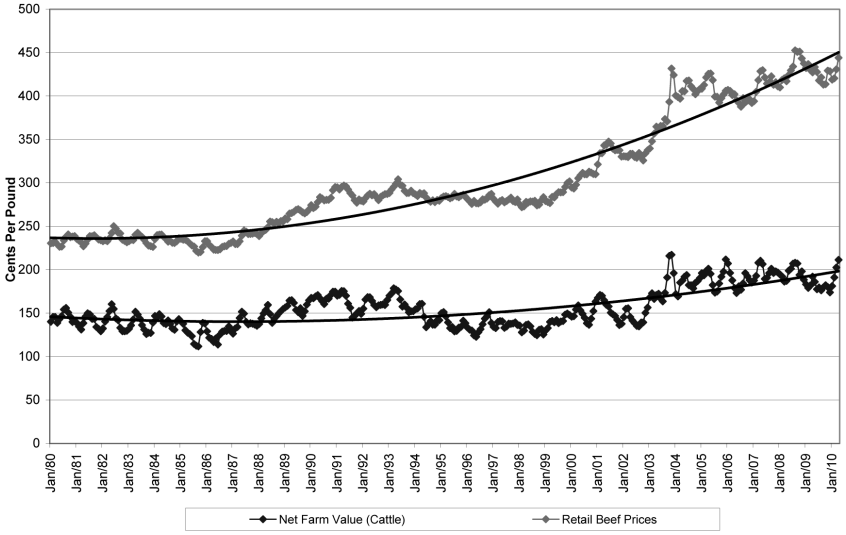
To achieve an optimal level of liquidity provided by speculators, it would be important that the actual speculative position limits for one or more concentrated/dominant speculators and the overall actual limit of speculation in the cattle futures market be established by *bona fide* hedgers in the futures market and adjusted by them from time-to-time as conditions may warrant. Further, the CFTC should restore daily market price limits to levels that minimize market volatility. The previous daily market limit in the cattle futures market of $1.50, which could still be adjusted upward following extended periods of limit movement, resulted in far less volatility than the current $3.00 daily market limit. Finally, R–CALF USA seeks reform to the practice of allowing cash settlements on futures contracts in lieu of actual delivery of the commodity, a practice that effectively lowers the cattle futures price on the day of contract expiration.

IV. Like Cattle Producers, Consumers Are Being Harmed by the Dysfunctional Cash and Futures Markets in the U.S. Cattle Industry

The USDA Economic Research Service ("ERS") states that the price spread data it reports can be used to "measure the efficiency and equity of the food marketing system,"[48] and "increasing price spreads can both inflate retail prices and deflate farm price."[49] According to ERS, "[h]igher price spreads translate into lower prices for livestock,"[50] innovative technologies can reduce price spreads and economic efficiency increases when price spreads drop,[51] and "[b]oth consumers and farmers can gain if the food marketing system becomes more efficient and price spreads drop."[52] Thus, if U.S. cattle markets were functioning properly and the ongoing concentration and consolidation of U.S. cattle markets were creating efficient economies of scale, then the spread between cattle prices and consumer beef prices would be expected to narrow over time. However, this is the opposite of what has occurred within the present marketing system. As shown below, the price spreads between ranch gate prices (*i.e.,* cattle prices) and retail prices (*i.e.,* prices paid by consumers) have been steadily increasing over time.

[48] *Beef and Pork Values and Price Spreads Explained,* U.S. Department of Agriculture, Economic Research Service, at 3.
[49] *Id.* at 2.
[50] *Id.* at 8.
[51] *Id.* at 3.
[52] *Ibid.*

Consumers' Retail Beef Prices Compared To Cattle Prices
Jan. 1980–May 2010



Source: USDA–ERS.

It is clear that both consumers and producers are being harmed by the current marketing structure that is creating increased price spreads, which means the marketplace is becoming less innovative and less inefficient. USDA found in 2004 that "the total price spreads show a weak upward trend when corrected for inflation,"[53] and this upward trend has only worsened since 2004. The ever-increasing price spread between ranch gate prices for cattle and retail prices for beef is further evidence of the broken cash and futures markets in the U.S. cattle industry where price discovery occurs. R–CALF USA believes this market anomaly is caused by the unrestrained exercise of market power by dominant industry participants and results in the exploitation of both consumers and producers.

V. Conclusion

R–CALF USA encourages Congress to continue its efforts to implement sweeping changes that will improve market transparency and eliminate manipulation and other anti-competitive practices that have caused artificial price distortions in the commodities futures market and relegated the cattle futures market to an ineffective tool for price discovery and risk management for U.S. cattle producers. We urge Congress to support CFTC's rulemaking as well as to ensure that the agency has sufficient funding to effectively carry out the new responsibilities Congress mandated in the Wall Street Reform Act.

The integrity of the cattle futures market will depend on Congress' and CFTC's ability to impart the greatest transparency possible into the cattle futures market and on a sincere effort by both Congress and the CFTC to address the causes of volatility in the cattle futures market that are unrelated to underlying commodity fundamentals. We firmly believe that Congress and the CFTC are on the right track for restoring the cattle futures market to its original purpose of providing buyers and sellers with both a risk management tool that also can serve an important price discovery function by reflecting the legitimate market signals of supply and demand.

Respectfully,

BILL BULLARD,

[53] *See Beef and Pork Values and Price Spreads Explained,* U.S. Department of Agriculture, Economic Research Service, at 10.

CEO,
R–CALF USA.

The CHAIRMAN. We will now go to Stuart Kaswell, General Counsel, Managed Funds Association, Washington, D.C.

Mr. Kaswell, 5 minutes.

STATEMENT OF STUART J. KASWELL, EXECUTIVE VICE PRESIDENT, MANAGING DIRECTOR, AND GENERAL COUNSEL, MANAGED FUNDS ASSOCIATION, WASHINGTON, D.C.

Mr. KASWELL. Thank you very much, Chairman Conaway, Ranking Member Boswell, Members of the Subcommittee.

I am Stuart Kaswell. I am the General Counsel of the Managed Funds Association, and we appreciate the opportunity to provide our views on the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. MFA commends the Subcommittee for its diligent oversight of the new OTC derivatives framework.

MFA is the voice of the global alternative investment industry and is the primary advocate for professionals in hedge funds, fund to funds, and managed futures funds as well as industry service providers. Our members primarily help pensions, university endowments and other institutions diversify their investments, manage risk, and generate reliable returns to meet their obligations to their beneficiaries.

MFA's members are active participants in the OTC derivatives markets. As such, we have a strong interest in promoting the integrity and proper functioning of these markets through increased transparency and systemic risk mitigation. In seeking to accomplish these goals, it is important to ensure that the implementation of Title VII proceeds in a thoughtful, logical fashion that strengthens the derivatives markets and does not impair market participants' ability to mitigate risks through swaps.

We support the implementation of a thoughtful regulatory framework that will protect the public while fostering legitimate economic activity. Therefore, we believe regulators should gather data and complete more empirical analysis before adopting new rules. We think regulators can accomplish this in a quick and efficient manner that properly balances the desire to move forward toward central clearing—sorry—to move promptly towards central clearing with a need to develop rules through a deliberative process.

We also ask that regulators continue to coordinate to ensure consistent implementation and harmonization. MFA supports policymakers' efforts to reduce systemic risk by requiring central clearing and data gathering about swaps. We believe that central clearing will play an essential role in reducing systemic, operational and counterparty risk, and will enhance market transparency, competition and regulatory efficiencies.

Since the beginning of this important debate, MFA has supported central clearing, and we urge regulators to move with alacrity to implement it.

The success of central clearing and data gathering will depend on the structured governance and financial soundness of derivatives clearing organizations, data repositories, swap execution facilities,

and designated contract markets. We strongly believe that there is a need for those entities to have transparent, irrevocable risk models that enable fair and open access, incentivize competition and reduce barriers to entry.

We also believe that it is important to have customer representation on the governance and risk committees of derivatives clearing organizations and for no one group to constitute a controlling majority.

In addition, MFA believes several other Title VII provisions can further protect against the risk of future systemic events. Among those measures is segregation of customer collateral for swaps. We believe that the right to elect individual segregation of customer initial margin on commercially reasonable terms is essential for effective OTC derivatives regulation.

For non-cleared swaps, we support the CFTC's efforts to require segregation of customer collateral using tri-party arrangements. While some customers have individually been able to negotiate these types of agreements, we believe all customers should have the right to this protection, which can help avoid the type of systemic event we witnessed with the collapse of Lehman Brothers.

For cleared swaps, MFA supports complete segregation of customers' initial margin at both the futures commission merchant and the central counterparty levels. We think this level of segregation provides the greatest protection of customer assets and provides for portability in the event of a default.

We are concerned that the CFTC appears to be moving away from complete segregation for customer collateral posted on cleared swaps. We encourage policymakers to recommend that the CFTC conduct or sponsor an independent comparative cost study that thoroughly examines the direct and external costs of segregation before adopting any rule.

Last, the CFTC and SEC recently issued a joint proposed rule intended to further clarify which entities meet this major swap participant definition, a new category created by the legislation. 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, we would appreciate additional details to support the SEC and CFTC's proposal in order to ensure that market participants are clear on whether they need to register as an MSP.

MFA appreciates the opportunity to testify before the Subcommittee, and I am happy to answer any questions.

[The prepared statement of Mr. Kaswell follows:]

PREPARED STATEMENT OF STUART J. KASWELL, EXECUTIVE VICE PRESIDENT, MANAGING DIRECTOR, AND GENERAL COUNSEL, MANAGED FUNDS ASSOCIATION, WASHINGTON, D.C.

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Agriculture Subcommittee on General Farm Commodities and Risk Management's hearing, "[t]o review implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act [(the 'Dodd-Frank Act')], Part II" held on February 15, 2011. 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 sub-

stantial portion of the approximately $1.9 trillion invested in absolute return strategies around the world.

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 a currency 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 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 counterparty and systemic risk, and protect customers' collateral by requiring a clearing organization to hold, and a swap dealer to offer to hold, customer funds in individually segregated accounts, which are protected in the event of bankruptcy. 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 smart regulation will improve efficiency and competitiveness in the OTC derivatives markets, reduce counterparty and systemic risk, and help regulators identify cases of market manipulation or other abuses.

MFA appreciates the Committee's review of the implementation of Title VII of the Dodd-Frank Act. We provide a number of comments, which we believe 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 Subcommittee, the CFTC and any other interested parties in addressing these issues and are committed in working towards regulations that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy.

Protecting the Integrity of the Regulatory Process

MFA recognizes that the Dodd-Frank Act mandates regulators to promulgate a record number of new regulations within 360 days of its enactment, and commends regulators for their diligence and dedication to implementing a new OTC derivatives regulatory framework. Nevertheless, we offer a few recommendations to further encourage the Committee, in its oversight role, to ensure and protect the integrity of the regulatory process.

The OTC derivatives markets play an important role in our economy because OTC derivatives have become an important tool for market participants to mitigate risk. MFA supports a formal OTC derivatives regulatory framework as we believe smart regulation will reduce systemic and counterparty risk, and enhance market efficiency, competition and investor protection. We are concerned however, that at times the current regulatory process has been overly focused on quantity over quality of regulations.

In order to establish a regulatory framework that achieves the goals of policymakers, it is important to ensure that the implementation of Title VII proceeds in

a thoughtful, logical fashion that strengthens the derivatives markets and does not impair market participants' ability to mitigate risk through swaps. In this respect, we note, as an example, that it has been a challenge responding to proposals on the regulatory requirements of certain entities prior to understanding how the specific entities are proposed to be, or will be, defined.

MFA also respectfully urges the Committee to encourage regulators to enhance coordination and consistency of their regulations, where applicable, and reduce duplicative regulation. The reality of more and more market participants diversifying their trading strategies and business ventures is that more entities will find that they need to register with both the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC"). Inconsistent regulations will be costly, burdensome and, in some cases, impossible for market participants to comply with both regimes. We believe regulators should also work together to reduce duplicative regulation. This would be a more efficient use of government resources, as well as reduce the regulatory costs and burdens on market participants and their customers.

Central Clearing and Access To Clearing Significant Entities

MFA supports policymakers' efforts to reduce systemic risk through proliferating central clearing and enhancing transparency. We believe that central clearing will play an essential role in reducing systemic, operational and counterparty risk. While we expect a bilateral market to remain for market participants to customize their business and risk management needs, 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. Therefore, it is important to move with alacrity towards central clearing.

As customers, 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, swap execution facilities ("SEFs") and designated contract markets ("DCMs"). Accordingly, we emphasize the need for DCOs, wherever applicable, to have transparent and replicable risk models and to 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 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.

Segregation of Customer Collateral

MFA supports measures aimed at increasing protections for customer assets posted as collateral for swaps. Therefore, with respect to uncleared swaps, we support the legislation's requirement that swap dealers ("SDs") offer their customers the option to segregate initial margin in a custodial account, separate from the assets and other property of the SD. Similarly, we support indications from the CFTC that they intend to require segregation of customer collateral for uncleared swaps be pursuant to custodial agreements where the SD or MSP, custodian and customer are all parties (*i.e.,* tri-party agreements). It is essential that counterparties have the right to elect individual segregation of initial margin for uncleared swaps on commercially reasonable terms because it not only protects customer property in the event of an

SD or MSP default, but also ensures the stability and integrity of the OTC derivatives markets.

While the CFTC's proposed rule for uncleared swaps seems to imply that an SD or MSP is required to offer segregation of initial margin to its counterparty in the form of a tri-party agreement, policymakers should recommend that the CFTC explicitly clarify that use of a tri-party agreement is required. Many of our largest members have already negotiated tri-party agreements with respect to their initial margin for uncleared swaps, but we believe all counterparties should have the right to these protections, which will help to prevent harm to counterparties and the markets.

However, we recognize that tri-party agreements are only one of several arrangements through which counterparties might protect their collateral delivered as margin for uncleared swaps. As a result, we appreciate that the CFTC has retained the flexibility for counterparties to accept a less secure form of segregation. We agree that market participants' should have the freedom to use any form of negotiated collateral arrangement they so choose.

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. Because we support the protection of customers, we are concerned that the CFTC appears to be moving away from requiring the use of individual customer segregated accounts for cleared swaps.

The comment period recently closed on a CFTC advanced notice of proposed rulemaking, where the CFTC solicited comment on four potential segregation models for collateral posted on cleared swaps. Out of the CFTC's four proposed models, we believe that only the full segregation model offers strong protections for customer collateral in the event of an FCM default and allows for efficient transfer of customer positions and collateral in the event of an FCM default.

MFA recognizes that other market participants have provided the CFTC with conflicting views on the expense of the proposed segregation models. We believe current cost estimates associated with the use of the full physical segregation model may be overstated. To determine which proposed model best accomplishes the goals of the legislation and the CFTC, we strongly urge policymakers to recommend that the CFTC conduct or sponsor an independent, comparative cost study of each segregation option before adopting any particular model, and require the CFTC to provide market participants sufficient time to evaluate the study results and respond. If the study concludes that adopting full physical segregation for cleared swaps would not impose inordinate costs on customers, we strongly urge adoption of this model in order to best protect customer assets and allow for the transfer of customer accounts and related assets.

Definition of Major Swap Participant

The legislation provides a definition for a new category of market participant called "major swap participants" ("MSPs"). 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 this important term is defined will significantly affect the evolving markets for swaps and the conduct of participants in these markets. MFA believes that the MSP designation should capture systemically important, 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". Recently, the CFTC and SEC 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 such a survey can be conducted without incurring significant costs or delaying the progression of the regulations. In addi-

tion, we would appreciate more clarity around the tests, such as the effects of over-collateralization or cleared swap positions on the calculations, 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.

Capital and Margin Requirements

For market participants that must register as MSPs, the legislation requires that the CFTC impose capital and margin requirements on entities that are subject to regulation as non-bank SDs or MSPs. We are concerned, however, about what capital requirements the CFTC may impose.

Unlike banks, our members do not hold capital, but instead manage assets on behalf of their investors, who have the right to redeem them subject to the terms of their contractual agreements. Accordingly, instead of holding capital, our members post margin to secure their obligations to their counterparties and our members are generally comfortable with margin requirements consistent with current market levels. Moreover, our members posting of margin serves a risk mitigation purpose functionally equivalent to the role that capital serves for banks (*i.e.,* protecting our counterparties and the financial system against our default).

As a result, requiring our members to hold capital would be inconsistent with their business structures and would materially increase the cost for them to enter into OTC derivatives contracts. Furthermore, imposing capital requirements over and above the margin that our members post could have significant, unintended consequences, including potentially precluding them from participating in the market altogether. Accordingly, given our members' business model, we believe that in setting capital requirements for non-bank MSPs, the CFTC should count margin posted by such non-bank MSPs towards any capital requirements to which they may be subject.

Position Limits

MFA recognizes that the Dodd-Frank Act expanded the CFTC's authority to set position limits, as appropriate, to deter and prevent excessive speculation, market manipulation, squeezes and corners. Academic and governmental studies and real world examples show that policies restricting investor access to derivatives markets impair commercial participants' ability to hedge and restrict the use of risk management tools. We do not believe position limits have proven to be effective at reducing volatility or market manipulation.

As a general matter, MFA believes that position limits should only be imposed for physically-delivered commodities and only where the deliverable supply of the commodity is limited and, thus, subject to control and manipulation. Even then, regulators need to consider the right size for such limits to accommodate a market's unique depth and liquidity needs. On the other hand, where there is a nearly inexhaustible supply of the underlying commodity, concerns related to control and manipulation are largely irrelevant, making position limits an unnecessary and costly interference in markets.

Nevertheless, if the CFTC is determined to impose position limits, we believe it is critical for the CFTC to conduct a study on commodities markets for purposes of assessing the appropriateness of setting position limits, and, if appropriate, the level at which limits should be set. Regulation should be based on appropriate findings, and the CFTC should have data on the size of the markets before considering imposing position limits. We also believe it is critical for any position limits regulation to provide market participants with a *bona fide* hedging exemption, consistent with CFTC Regulation 1.3(z), and independent account controller exemptions. 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 Subcommittee encourage the CFTC to conduct a study of the commodities markets, including the size and number of market participants in related or equivalent OTC derivatives markets, prior to imposing position limits.

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 defini-

tion 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).

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 the broadest range of swap trading platforms (subject to the requirements under the legislation) would benefit investors, promote market-based competition among providers, and enable 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.

MFA is still reviewing and analyzing the CFTC's proposal and we would appreciate the opportunity to provide our written comment letter to the Committee as an addendum to our testimony once it is complete.

Conclusion

MFA appreciates the Subcommittee's review of the implementation of Title VII of the Dodd-Frank Act. 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 the Subcommittee encourage the CFTC in implementing the Dodd-Frank Act to work with market participants to consider and adopt meaningful and cost-effective regulations in a logical, thoughtful and timely manner. To the extent practicable, regulation of OTC derivatives by the CFTC and SEC should be streamlined, consistent, and take into consideration the economic fundamentals of the product, as well as the likelihood that an entity will need to register with both agencies. 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 Subcommittee 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.

The CHAIRMAN. Thank you.

Now the President of the Futures Industry Association in Washington, D.C., John Damgard.

Five minutes, sir

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. DAMGARD. Thank you very much, Chairman Conaway, Ranking Member Boswell, ladies and gentlemen of the Committee.

I am John Damgard, President of the Futures Industry Association and am pleased to be here today. Many Members of the Subcommittee are new, and I would like to take a minute to explain who we are.

FIA is the principal spokesman for the commodity futures and options industry, and our regular membership is comprised of approximately 30 of the largest futures commission merchants in the United States. And among FIA's associate members are representatives from virtually all other segments of the industry, both national and international, and we estimate that among our members, probably 80 to 85 percent of the public customer transactions executed on futures exchanges are done by our member firms.

As the principal clearing members of the U.S. derivatives clearing organizations, our members' firms play a critical role in the re-

duction of systemic risk in the our financial system. Our member firms commit a substantial amount of our own capital to guarantee the futures and options transactions that our customers submit for clearing. We take justifiable pride that the U.S. futures markets operated extremely well throughout the financial crisis. No FCM failed, and no customer lost money as a result of the failure of the futures regulatory system.

And I should say this Committee deserves a lot of credit for that. You created the CFTC in this very room some 45 years ago, and you have created an agency that has done a tremendous job of protecting the public and at the same time nurturing an industry that has grown by something like 6,000 or 7,000 percent, as measured by the volume of trades.

Today I would like to highlight four major concerns about the Dodd-Frank rulemaking process.

First, some of the proposed rules have gone well beyond the intent of Congress. Given the intense pressure that we all face in bringing down the level of government spending, it would make more sense to focus on the regulatory requirements that are mandated by Congress and set aside other initiatives for a future date.

Second, the rules have been published for comment in an order and at a pace that makes meaningful analysis and comment very difficult, if not impossible. We encourage both Congress and the Commodity Futures Trading Commission to take the time necessary to fully analyze all of the costs and benefits of the proposed rules and allow sufficient time for the implementation.

Third, the cost of complying with Dodd-Frank will discourage participation in the markets and force certain firms out of business. You have already heard similar concerns from many groups that represent the end-users of derivatives. I would only add that the potential costs could lead to a loss of competition among clearing firms and also liquidity providers.

Fourth, I encourage Congress to consider the international dimensions of rulemaking process. In particular, FIA believes that the Commission should use its exemptive authority to avoid duplicative and perhaps conflicting regulatory requirements for activities that take place outside the United States.

Let me turn to the rulemaking process.

Our member firms believe that the CFTC should implement the reforms envisioned by Dodd-Frank in a deliberate and measured way. We recognize that the CFTC and its staff are working day and night to comply with the very tight time frames set out in the Act, and we also appreciate that the Commission has repeatedly invited affected parties to provide input into the rulemaking. And we have responded.

As of today, we filed comment letters on 17 proposed rulemakings with many more to come. We have participated in three CFTC roundtables, and we have met with CFTC staff on many occasions to discuss matters of particular concern. I regret to say, however, that providing meaningful analysis and comment is extraordinarily difficult due to the tremendous number of rules that have been proposed in such a short period of time.

To give you one example, the Commission has proposed a myriad of rules that taken together would completely overhaul the record

keeping and reporting requirements for clearing member firms. These proposals include the advanced notice of proposed rulemaking, core principles, and other requirements for designated contract markets, risk management requirements, information management requirements, position limits for derivatives, core principles, and many other requirements for swap execution facilities.

All of the pending rulemaking and reporting requirements must be evaluated collectively, not individually. Otherwise, it is impossible to determine whether the pending rules are complimentary or conflicting, nor is it possible to calculate the financial and operational burdens these proposals will impose on the industry and customers.

FIA also believes that some of the Commission's proposed rules go way beyond Congressional intent. And an example is the rulemaking on governance and ownership of clearing organizations, contract markets, and swap execution facilities. Although the House version of the financial reform legislation contained provisions that set specific limits, these provisions were removed when the legislation reached the conference committee. And the Dodd-Frank Act in its final form simply authorized the Commission to adopt a rule with respect to ownership and governance.

Furthermore, the Act states that any such rule should be adopted only after the Commission first determines that such rules are necessary or appropriate to improve the governance, mitigate systemic risk, promote competition, or mitigate conflicts of interests. Although the Commission has not made the required determination, the Commission nonetheless has proposed specific rules on governance and ownership that effectively would implement the very provisions that were removed.

It has been suggested that the Commission should move forward with rules adopting Dodd-Frank Act time frames but set selective dates that will afford participants sufficient time to come into compliance. Although this is certainly one alternative, we believe the better choice is to delay adopting final rules until all affected participants have a reasonable opportunity to fully analyze and understand the scope of the complex and far-reaching regulatory regime that the Commission has proposed.

Furthermore, it is our view that the Commission should be encouraged to use its exemptive authority to ensure the market participants and transactions taking place outside the United States are not subject to duplicative regulations.

We urge the Subcommittee to take whatever actions it deems necessary to encourage the Commission to shift regulatory obligations to the NFA, through the NFA and to other self-regulatory organizations. As discussed above, for example, the Commission could delegate to the NFA the responsibility to adopt rules for chief compliance officers.

Thanks again for the opportunity to appear before you today. I am happy to answer any questions.

[The prepared statement of Mr. Damgard follows:]

PREPARED STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Chairman Conaway, Ranking Member Boswell, Members of the Subcommittee, 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 the Subcommittee is aware, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) substantially rewrote the Commodity Exchange Act (CEA) to: (i) establish a comprehensive regime for swaps, including the mandatory clearing of swaps; (ii) grant important new authority to the Commodity Futures Trading Commission (Commission); and (iii) impose significant, new obligations on futures industry participants, in particular, the futures commission merchants (FCMs) that FIA represents.

Because Congress gave the regulatory agencies, including the Commission, broad discretion in adopting rules to implement provisions of the Dodd-Frank Act, it is essential that the Committee on Agriculture, as the Committee of jurisdiction with respect to matters relating to the CEA, monitor carefully the Commission's implementation of the Dodd-Frank Act and provide additional guidance when appropriate. We, therefore, welcome these hearings and are pleased that Chairman Lucas and Chairman Conaway have indicated that they intend to conduct regular oversight hearings with respect to the Dodd-Frank Act.

We have had an opportunity to review the testimony presented by the Chicago Mercantile Exchange and the International Swap Dealers Association at the full Committee hearing last Thursday and share some of the concerns they expressed.

Futures Industry Association: Who We Are

Since many of the Members of the Subcommittee are new, I would like to take a minute to explain who we are. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants in the United States. Among FIA's associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

As the principal clearing members of the U.S. derivatives clearing organizations (DCOs), our member firms play a critical role in the reduction of systemic risk in the financial markets. We commit a substantial amount of our own capital to guarantee our customers' transactions cleared through the DCO and, through contributions to the DCO's guarantee fund, guarantee the obligations of other clearing members to the DCO, in the unlikely event of a clearing member's default. As a result, 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.

The FIA Principal Traders Group. This past year, we welcomed the FIA Principal Traders Group (FIA PTG) as a new division of FIA. The FIA PTG is comprised of firms that trade their own capital in exchange-traded markets. Members of the FIA PTG engage in automated, manual and hybrid methods of trading and are active in a variety of asset classes, such as futures, equities, foreign exchange, and fixed income. They are a critical source of liquidity in the exchange-traded markets, allowing those who use these markets to manage their business risks, to enter and exit the markets efficiently.

Depending on the eventual market structure of the swaps market, some of the firms that are members of the FIA PTG may choose to provide liquidity to the developing cleared swaps markets. They currently are active participants in the over-the-counter markets operated by ICE and the New York Mercantile Exchange, both of which may be required to be registered as swap execution facilities, and would expect to continue trading these products under the Dodd-Frank regulatory regime. These firms' willingness and ability to do so, however, will depend on a number of factors, including the costs associated with complying with requirements applicable to cleared swaps, as well as the absence of other barriers to entry to the swaps market.

Implementation of the Dodd-Frank Act: The Rulemaking Process

The success of the futures model understandably led Congress to require a comparable model for the swaps markets. What may have seemed like a simple solution in concept to address systemic risk in the bilateral swaps market, however, has

proved to be tremendously complex in implementation. While swaps and futures may serve similar risk management purposes, the manner in which they trade and are priced and, consequently, the financial risks they pose to DCOs and clearing members when cleared, are substantially different.

As clearing member FCMs will be most directly affected by the failure of a customer or other clearing member to meet its financial obligations with respect to cleared swaps, our member firms believe it is essential that the reforms envisioned by the Dodd-Frank Act be implemented in a deliberate, measured way to assure that the risks associated with the clearing of swaps are properly identified and managed. A "Big Bang" approach threatens simply to shift systemic risk to DCOs and their clearing members, to the potential detriment of both futures market participants and swaps market participants.

We do not underestimate the challenges facing the Commission, and we recognize that the Commission and its staff are working hard to comply with the very tight timeframes set out in the Dodd-Frank Act. We also appreciate that the Commission has made an effort to solicit the views of affected parties.

In this regard, FIA member firms have committed significant time and resources to provide their views and assist the Commission in developing the rules to implement this regulatory regime. Our members have made available more than 200 professional staff with risk management and operational expertise to help FIA in this effort. Member firm representatives have participated in three roundtables conducted by Commission staff and have met with the staff on other occasions to discuss matters of particular concern. Moreover, to date, FIA has filed comment letters on 17 rule proposals.

Insufficient Time To Analyze and Comment Meaningfully

Although FIA has supported several of the Commission's proposals, as a general matter, rules have been published for comment in an order and at a pace that makes meaningful analysis and comment difficult, if not impossible.

The Commission has published for comment a myriad of proposed rulemakings that, collectively, contemplate a complete overhaul of the record-keeping and reporting requirements to which FCMs, U.S. exchanges and clearing organizations are subject. These proposals include: (i) the advance notice of proposed rulemaking regarding the protection of cleared swaps customers before and after commodity broker bankruptcies; (ii) core principles and other requirements for designated contract markets; (iii) risk management requirements for derivatives clearing organizations; (iv) information management requirements for derivatives clearing organizations; (v) position limits for derivatives; (vi) core principles and other requirements for swap execution facilities; and (vii) swap data record-keeping and reporting requirements.

These various rulemakings cannot be considered in isolation. All of the pending record-keeping and reporting requirements, and the estimated costs and benefits of each, must be analyzed and evaluated collectively, not individually. In the absence of such a coordinated analysis, it is impossible to determine whether the pending rules are complementary or conflicting. Neither is it possible to calculate the aggregate financial and operational burdens these various proposals will have on the industry.

The Ownership and Control Rules. Record-keeping and reporting requirements have real costs. The Commission's proposed rules requiring designated contract markets and other reporting entities to submit weekly ownership and control reports (OCR) to the Commission demonstrate this point. It is important to note that the OCR rules not required under the Dodd-Frank Act and are in addition to the list of rules above.

The pending OCR rules would require each reporting entity to provide the Commission detailed information, consisting of approximately 28 separate data points, with respect to each account reported in its trade register. The proposed data points include detailed information on beneficial owners and account controllers, account numbers and dates on which account numbers were assigned.

Because the OCR rules would require FCMs to collect and report a substantial amount of information that either is not collected in the manner the Commission may anticipate or is not collected at all, the proposed rules would require a complete redesign of the procedures, processes and systems pursuant to which FCMs create and maintain records with respect to their customers and customer transactions. To obtain and maintain the required information, an FCM would be required to: (i) renegotiate all active customer agreements to require customers to provide and routinely update the necessary data points; (ii) build systems to enter the data; (iii) manually enter the data for each active account; (iv) put in place resources and

processes to maintain the data; (v) provide it to the reporting entity on a weekly basis; and (vi) monitor changes daily in order to update the database.

To prepare our comment letter on the proposed OCR rules, FIA formed an OCR Working Group, comprised of individuals with significant experience in operations from (i) 16 FCMs, both large and small, with both retail and institutional customers, (ii) the several U.S. exchanges, (iii) the principal back office service providers, and (iv) other experts to analyze their potential impact.

FIA received cost estimates for building and maintaining an OCR database from 12 FIA member firms, both large and small. These firms carry more than 500,000 customer accounts and hold in excess of $83.8 billion of customer funds, or approximately 62 percent of customers' segregated funds (as of July 31, 2010, according to monthly financial reports filed with the Commission). We found that the median firm would face total costs of roughly $18.8 million per firm, including implementation costs of roughly $13.4 million, and ongoing costs of $2.6 million annually. These costs, combined with the unwarranted structural change in the conduct of business among U.S. futures markets participants the proposed rules would require, could force a number of FCMs to withdraw from the business and the barrier to entry for potential new registrants will be raised.

In its comment letter, FIA presented an alternative OCR proposal which we believe would achieve the essential regulatory purposes of the Commission's proposed rules. The cost of the alternative OCR was considerably less than the estimated cost of implementing the OCR rules, but they are substantial nonetheless. We must emphasize that this alternative was not developed within the 60 day comment period originally proposed by the Commission. It took several months of detailed analysis by industry representatives who otherwise perform critical operational and risk management responsibilities in their firms.

Rules Go Beyond Congressional Intent

The Commission has also proposed rules (or published an advance notice of proposed rulemaking) that we believe go well beyond Congressional intent in the Dodd-Frank Act. In doing so, the Commission has moved away from the principles-based regulation, which has facilitated growth and innovation in the exchange-traded markets over the past decade, and has proposed a far more prescriptive regulatory regime.

Conflicts of Interest. The rules regarding conflicts of interest for FCMs, swap dealers and major swap participants provide one example where we believe the Commission has gone beyond the requirements of the Dodd-Frank Act. Among other things, these provisions, found in 4s(j)(5) and 4d(c) of the CEA, require firms to establish informational barriers among the different business units within the firm to assure that the research and analysis unit and the unit responsible for clearing are not subject to pressure from the swap dealer unit that might bias their judgment or supervision.

The Commission's proposed rules go far beyond the principles established in these provisions of the CEA and require absolute bans on communications in many instances. They would prohibit any employee of a swap dealer or major swap participant business unit from participating in any way with the provision of clearing services and related activities by the FCM. The rules would restrict routine contacts between trading and clearing personnel, which we believe would work to the detriment of customers, and call into question other forms of completely benign and beneficial conduct. Moreover, these proposed rules could impair a firm's ability to follow established risk management best practices. We believe the Commission needs to revise or even reissue these rules for comment.

Governance and Ownership. Proposed rules on governance and ownership of clearing organizations, contract markets and swap execution facilities is another example of the Commission's decision to propose rules that go beyond the Dodd-Frank Act and, in this case, would impose restrictions that Congress specifically rejected. Although the House version of the financial reform legislation contained provisions that set specific ownership limits for these entities, they were rejected in the Dodd-Frank Act, which simply authorizes the Commission to adopt rules with respect to ownership and governance, but only after completing a review, and only if it first determines "that such rules are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest." Although the Commission conducted no review and did not make the required determination, the Commission nonetheless proposed rules that would effectively implement provisions that were removed by the Conference Committee.

Chief Compliance Officer. The proposed rules relating to chief compliance officers provide another. The Dodd-Frank Act sets out specific responsibilities that chief compliance officers of swap dealers and major swap participants must meet, but

simply requires chief compliance officers of FCMs to "perform such duties and responsibilities as shall be set forth in regulations to be adopted by the Commission or rules to be adopted by a futures association."

Notwithstanding these differences, the Commission elected to propose that FCMs be subject to the same rules as swap dealers and major swap participants. Although there may be advantages in creating uniform rules for entities under its jurisdiction, we are concerned that, in so doing, the Commission has ignored the model for compliance that FCMs have long followed.

In a detailed comment letter that FIA filed jointly with the Securities Industry and Financial Markets Association, we explained that the proposed rules would establish a compliance framework that is significantly different from that currently in place in the financial services industry under the regulations promulgated by other Federal regulators, including the Securities and Exchange Commission (SEC) and the several banking regulators, as well as the compliance model adopted by the Commission itself as recently as September 2010.

Among other things, the proposed rules would fundamentally change the role of chief compliance officers by requiring them to perform supervisory duties. Traditionally, the chief compliance officer acts as an independent advisor to the firm's business-line supervisors, who have the authority to supervise the firm's business activities and are ultimately responsible for the firm's compliance with applicable law. By eliminating the separation between supervision and compliance, the proposed rules would eliminate the independence necessary to perform the chief compliance officer function effectively and would undermine the long-standing regulatory principle that the supervisory responsibility in the firm rests with the business managers, not the chief compliance officer.

Particularly troublesome is the Commission's statement that chief compliance officers may be subject to criminal liability as a result of carrying out their duties, although there is no indication that Congress intended that chief compliance officers would be subject to criminal liability under the applicable sections of the Dodd-Frank Act. Criminal liability is not specifically a part of the existing financial services compliance model, and potential criminal liability will make it much more difficult, if not impossible, for firms to hire competent employees who will be willing to serve as chief compliance officers. Moreover, imposition of criminal liability on chief compliance officers would create a duplicative, inconsistent, burdensome and unpredictable regulatory environment in many registrants that are subject to and have implemented the existing financial services compliance model.

In lieu of these proposed rules, we believe the Commission should exercise the authority that Congress specifically provided in the Dodd-Frank Act and delegate to the National Futures Association (NFA) the responsibility to adopt rules for chief compliance officers. NFA has considerable experience in this area and such delegation would be consistent with the policy followed by the SEC, which has delegated this responsibility to FINRA.

The Potential Costs Are Not Well-Understood

The Commission has acknowledged that its proposed rules will increase the costs of effecting transactions in swaps, but believes that the benefits outweigh any additional costs that may be imposed on customers. We believe the Commission may well have underestimated certain costs. Again, however, we simply have not had the time, and in certain cases lack the information necessary, to make a meaningful analysis in the time provided.

Moreover, these additional costs will not be imposed solely on swap participants. They are certain to affect participants in the exchange-traded markets as well. In this regard, we are concerned by Chairman Gensler's announcement in his testimony last week that the Commission has established a rulemaking team to develop "conforming rules" to update the Commission's existing rules to take into account the provisions of the CEA. To the extent this rulemaking team recommends imposing the proposed rules for swaps on the exchange market, costs are certain to rise. As a result, as discussed earlier, a number of FCMs could be compelled to withdraw from registration and the barrier to entry for potential new registrants will be raised which will negatively affect competition. In any event, FCMs will have little choice but to pass these costs on to their customers.

Essential Decisions Have Been Deferred

As important, the Commission has not yet made decisions on 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 proposed. 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. Therefore, they may not have had an opportunity to, or reason to believe that they should, comment on the proposed rules.

The Commission has also offered no guidance on the extent to which it may seek to assert its jurisdiction over entities located, or transactions that take place, outside of the United States, but which touch the U.S. in some way. Because swaps have not previously been entered into on organized exchanges or other trading facilities, the swaps market is truly international in scope. For example, the U.K. branch of a U.S. bank and a French bank may enter into an interest rate swap, which is governed by New York law.

The Dodd-Frank Act provides that its provisions should not apply to activities that take place outside of the United States, unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States." Further, the Commission is authorized to exempt from regulation foreign derivatives clearing organizations and swap execution facilities that are subject to comparable, comprehensive supervision and regulation in their home country. As the Members of the Subcommittee may be aware, the European Union (EU) is developing a comprehensive regulatory regime for swaps, including clearing through EU clearing organizations. The Commission should be encouraged to use its exemptive authority to assure that transactions and participants that do not have a "direct and significant connection with activities in, or effect on, commerce of the United States" are not subject to duplicative, and perhaps conflicting, regulatory requirements.

The Commission has a successful model for the regulation of international transactions that could serve as an starting point for exempting participants and transactions from its jurisdiction. Under the Commission's Part 30 rules, governing the offer and sale of futures and options traded on foreign exchanges, 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. On the same basis, the Commission has also authorized certain foreign boards of trade to permit direct access from the U.S. In each case, the exemption is made subject to appropriate information sharing agreements and all affected participants must consent to the jurisdiction of the Commission and Department of Justice to be certain that the Commission and the Department of Justice are able to obtain information when necessary.

Delay in Adopting Final Rules

It has been suggested that the Commission should move forward with adopting final rules within the Dodd-Frank Act timeframes, but set effective dates that will afford participants sufficient time to come into compliance. Although this is certainly one alternative, we believe the better choice is to delay adopting final rules until all affected participants have a reasonable opportunity to analyze fully and understand the scope of the regulatory regime the Commission has proposed.

Responsibilities Should Be Delegated to the National Futures Association

In closing, I want to note that we were pleased that Chairman Gensler has indicated that he intends to rely more heavily on the National Futures Association. Self-regulation has worked extremely well in the futures markets, and we see no reason why the success of these programs cannot be transferred to the swaps markets.

When Congress amended the CEA in 1974 to establish the Commission, it included a provision for an industry-wide self-regulatory organization such as NFA. Since NFA began operations in 1982, Congress has demonstrated its confidence in NFA by amending the CEA three times to provide it with additional responsibilities.

As a self-regulatory organization, NFA is subject to the ongoing oversight of the Commission. Our experience is that NFA and the Commission have a very close and cooperative working relationship. The Subcommittee can be confident, therefore, that NFA will use its broad authority to achieve the regulatory goals that Congress sought in enacting the Dodd-Frank Act. Importantly, NFA is funded entirely by futures market participants, thereby relieving additional strain on the Federal budget.

We urge the Subcommittee to take whatever action it deems appropriate to encourage the Commission shift many of the regulatory obligations that it has assumed for itself under the proposed rules to NFA and, through NFA, to the other industry self-regulatory organizations. As discussed above, for example, the Commission could delegate to NFA the responsibility to adopt rules for chief compliance officers.

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

The CHAIRMAN. Thank you, Mr. Damgard.

Votes have been called. If we could go through Mr. McMahon's testimony, and then we will recess real quickly, go vote and come back.

Ms. Sanevich, we will come back to visit with you about your testimony.

Mr. McMahon.

STATEMENT OF RICHARD F. MCMAHON, JR., VICE PRESIDENT OF ENERGY SUPPLY AND FINANCE, EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.; ON BEHALF OF AMERICAN PUBLIC POWER ASSOCIATION; ELECTRIC POWER SUPPLY ASSOCIATION

Mr. MCMAHON. Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee. Thank you for the opportunity to discuss the role of over-the-counter derivatives markets in helping energy companies insulate our customers from the volatility of commodity price risk as well as some of the key implementation issues of the Dodd-Frank Act.

I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute. I am testifying today on behalf of EEI, APPA and EPSA. Together our members serve most of our nation's electric consumers. The goal of our members is to provide our customers with reliable electric service at affordable and stable rates. Therefore, it is essential to manage the significant price volatility inherent in wholesale commodity markets for natural gas and electricity.

The derivatives market is an extremely effective tool in insulating our customers from this price volatility. Utility and energy companies are financially stable and highly credit worthy. As a result, utilities and their customers get a significant cost-benefit from little or no collateral requirements for their OTC derivative swaps from exchanges, and clearinghouses, on the other hand, are generally blind to the financial help of our participants and demand cash margin requirements from us.

We support the goals of Dodd-Frank to bring greater transparency and oversight to the derivatives markets and to address the systemic risk to the economy. However, a margin requirement on all utility OTC swaps would have an average annual cash flow impact of between $250 million and $400 million per company.

If our members are forced to post margin on all of their OTC transactions, we will have three equally undesirable choices: One, redirect dollars from our core infrastructure capital spending programs to margin accounts at clearinghouses; or borrow the money to post in margin accounts and pass the costs of borrowing through to our customers in rates; or curtail our derivatives hedging programs and pass the commodity price volatility in natural gas and electric power through to our customers.

We were pleased to hear CFTC Chairman Gary Gensler testify last week that proposed rules on margins shall focus on transactions between financial entities rather than those transactions involving non-financial end-users. It is essential that this approach be fully implemented. It was the clear intent of Congress, as confirmed in the letter drafted by Senators Dodd and Lincoln as part

of the conference, to fully exempt end-users from margin and burdensome CFTC compliance obligations.

The Dodd-Frank Act left many important issues to be resolved by regulators and set impractical, tight deadlines on rulemakings. To further complicate matters, many of the complex issues raised by scores of rulemakings are interrelated. As a result, interested parties are unable to comment on the proposed rules in a meaningful way because they cannot know the full effect of the complete universe of the proposed rules.

For instance, the CFTC has not yet issued proposed rules on the definition of a swap. This definition is critical to many of the current rulemakings of Dodd-Frank and could significantly expand the reach and impact of these regulations.

In the end-user clearing exemption provision of Dodd-Frank, Congress gave our members the flexibility to elect, not to clear, swaps that they use to hedge commercial risk. The CFTC's proposed rulemaking implementing this provision would require an end-user to report roughly a dozen items of information to CFTC every time it elects to rely on the end-user clearing exemption for a swap. The CFTC does not need such representations from end-users about every one of their non-cleared swaps to prevent abuse of the end-user clearing exemption. End-users understand that knowingly providing the CFTC with inaccurate information is a very serious violation of the Commodity Exchange Act.

We request that the Subcommittee emphasize to CFTC that it can implement the end-user clearing exemption consistent with Congress' intent, by streamlining their proposed requirements in the following ways: By requiring end-users to represent once that they will only rely on the end-user exemption for swaps that hedge commercial risks; and by informing the Commission once how they generally meet their financial obligations associated with entering into non-cleared swaps, of course coupled with an obligation to provide notice of any material change; and in the case of publicly traded companies, by maintaining a record showing that an appropriate committee of the board of directors has reviewed and approved their overall decision not to clear.

We also have serious concerns about the CFTC's plans to define swap dealer. The CFTC's proposed rule includes very extensive language, expansive language about the types of activity that CFTC views as dealing. At the same time, the Commission has proposed to implement the "not as part of the regular business" and *de minimis* exceptions in a very restrictive manner. The result could be that commercial end-users are inappropriately miscast as swaps dealers.

We appreciate your role in helping to ensure that energy end-users can continue to use OTC derivatives to help to protect and insulate our nation's consumers from volatile wholesale gas and wholesale power commodity prices in a cost-effective way.

I am happy to answer any questions you may have.

[The prepared statement of Mr. McMahon follows:]

PREPARED STATEMENT OF RICHARD F. MCMAHON, JR., VICE PRESIDENT OF ENERGY SUPPLY AND FINANCE, EDISON ELECTRIC INSTITUTE, WASHINGTON, D.C.; ON BEHALF OF AMERICAN PUBLIC POWER ASSOCIATION; ELECTRIC POWER SUPPLY ASSOCIATION

Chairman Conaway and Members of the Subcommittee, thank you for this opportunity to discuss the role of over-the-counter (OTC) derivatives markets in helping utilities and energy companies insulate our customers from the volatility of commodity price risk, as well as some of the key issues we see in the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

I am Richard McMahon, Vice President of Energy Supply and Finance for the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric utilities, with international affiliates and industry associates worldwide. EEI's U.S. members serve 95 percent of the ultimate electricity customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the total U.S. electric power industry.

I also am testifying on behalf of the American Public Power Association (APPA) and the Electric Power Supply Association (EPSA). APPA represents the nation's more than 2,000 community-owned electric utilities. EPSA is the national trade association representing competitive power suppliers, including generators and power marketers.

Utilities and Energy Companies Hedge Risk

Wholesale natural gas and electric power are, and have been historically, two of the most volatile commodity groups. Our members use natural gas extensively as a fuel to generate electric power, as well as distribute natural gas to consumers in their homes. Additionally, utilities purchase wholesale electricity from generators and marketers to meet consumer demand.

The goal of our members is to provide their customers with reliable service at affordable and stable rates. Therefore, it is essential to manage the price volatility inherent in wholesale commodity markets for natural gas and electric power. Our members purchase fuel and sell power at thousands of delivery points throughout the U.S. They need the ability to use OTC swaps because existing futures contracts cover limited natural gas and electricity delivery points. The derivatives market has proven to be an extremely effective tool in insulating our customers from this risk and price volatility. Utilities and energy companies use both exchange traded and cleared and OTC swaps for natural gas and electric power to hedge commercial risk. About ½ of our gas swaps and about ⅓ of our power swaps are traded on-exchanges.

Why the Margin Issue is Critically Important

Utilities and energy companies are financially stable and highly creditworthy. On average EEI's members are rated BBB. As a result, utilities and their customers get a significant cost-benefit from low or no collateral requirements for their OTC derivatives transactions. In some cases, our members provide a letter for credit or a lien on assets as collateral to support their obligations on swaps. Exchanges and clearinghouses are generally blind to the financial health of their participants and demand cash margin deposits, both initial and variation margin.

Our industry is in the midst of a major capital spending program to enhance the electric grid, make our generation fleet cleaner and bring new technologies to our customers. Last year, shareholder-owned electric utilities' capital expenditures (CAPEX) were $83 billion, and we expect this pace of capital investment to continue throughout the decade. The capital investments of all of our members are contributing to our nation's economic recovery and job growth.

A margin requirement on all utility OTC swaps would have an average annual cash flow impact of between $250 million–$400 million per company. This "dead capital" tied up in margin accounts at clearinghouses would need to be funded by our customers.

If our members are forced to post margin on all of our OTC transactions, we have three equally undesirable choices:

- Re-direct dollars from our core infrastructure capital spending programs to margin accounts at clearinghouses;
- Borrow the money to post in margin accounts and pass that cost through to our customers in rates; or
- Curtail our derivatives hedging programs and pass the commodity price volatility in gas and electric power through to our customers.

Because of these undesirable consequences, the National Association of Regulatory Utility Commissioners (NARUC) passed a resolution in support of the industry's goal of maintaining our ability to use OTC derivatives without cash margining requirements (see attached).

We were very pleased to hear Commodity Futures Trading Commission (CFTC) Chairman Gensler's testimony last week before the full House Agriculture Committee in which he stated, "Proposed rules on margin shall focus on transactions between financial entities rather than those transactions that involve non-financial end-users." It is essential that this now unambiguous direction from the CFTC Chairman be carried through fully in implementation of the Dodd-Frank Act. We believe this was the clear intent of the Congress, and it was confirmed in the Dodd-Lincoln letter, which was drafted as part of the conference committee to fully clarify the intent of the Congress to fully exempt end-users from margining and burdensome CFTC compliance obligations. (see attached)

Need for a Proper Sequencing and Implementation Timetable

We support the overarching goals of the Dodd-Frank Act to bring greater transparency and oversight to derivatives markets and to address systemic risk to the economy. Additionally, we compliment the CFTC Chairman, Commissioners and staff for their hard work and openness in seeking input from different market participants during the implementation process.

However, the Dodd-Frank Act left many important issues to be resolved by regulators and set impractical, tight deadlines on rulemakings by the agencies charged with implementation. To further complicate matters, many of the complex issues raised by scores of rulemakings are interrelated. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect of the complete universe of proposed rules. For example, it is difficult to comment on the proposed swap dealer definition, position limits, and record-keeping and reporting rules for swaps before the proposed definition of a swap has been issued.

Concerns Regarding Implementation Burdens on End-Users

In a provision of the Dodd-Frank Act known as the "end-user clearing exception," Congress gave our members and other end-users of swaps the flexibility to elect not to clear swaps that they use to hedge commercial risk.

The CFTC's proposed rule implementing this provision would require an end-user to report roughly a dozen items of information to the CFTC every time it elects to rely on the end-user clearing exception for a swap. The required information for each swap includes representations that:

- it is a non-financial entity,
- the swap is hedging commercial risk,
- it has certain credit arrangements in place, and
- in the case of publicly-traded companies like most of our members, that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved its decision not to clear.

The CFTC does not need such representations from our members and other end-users about every one of their non-cleared swaps to prevent abuse of the end-user clearing exception. Our members and other end-users understand that knowingly providing the CFTC with inaccurate information is a very serious violation of the Commodity Exchange Act (CEA). That is more than sufficient incentive for end-users to rely on the end-user clearing exception only when they are authorized to do so.

We request that the Subcommittee emphasize to the CFTC that it can implement the end-user clearing exception, consistent with Congress's intent, by requiring end-users to:

- represent once that they will only rely on the end-user clearing exception for swaps that hedge commercial risk;
- inform the Commission once how they *generally* meet their financial obligations associated with entering into non-cleared swaps (coupled with an obligation to provide notice of material changes); and
- in the case of publicly-traded companies, maintain a record that shows that an appropriate committee of the board of directors (or equivalent body) has reviewed and approved their decision not to clear.

In addition to our concerns about the CFTC's proposed implementation of the end-user clearing exception, we have serious concerns about how the CFTC plans to de-

fine "swap dealer." The CFTC's proposed rule includes very expansive language about the types of activity—including "accommodating" the demand of third parties for swaps—that the CFTC views as dealing activity. At the same time, the Commission has proposed to implement the "not as part of a regular business" and "*de minimis*" exceptions to the definition of "swap dealer" in a very restrictive manner. The result could be that commercial end-users are inappropriately miscast as swap dealers. If our members, which primarily engage in hedging activities, are caught within the definition of "swap dealer," not only will they face the costs of margin requirements, but they also will be subject to additional capital and collateral requirements (not yet defined by the CFTC), cost of IT systems for additional reporting, and other costly requirements not appropriate for end-users.

The CEA, prior to the passage of the Dodd-Frank Act, excluded physical forward transactions from the CFTC's jurisdiction over futures contracts. The definition of swap in the Dodd-Frank Act includes options on physical commodities, but excludes "any sale of a non-financial commodity . . . so long as the transaction is intended to be settled." The CFTC has issued proposed rules on swap position reporting and on agricultural swaps which indicate that the CFTC intends to regulate options on physical commodities as swaps or "swaptions." The end-user community is concerned about the CFTC's proposal because many contracts for the delivery of power in the electric industry, such as capacity and requirements contracts, include price, volume or other optionality. Including these end-user to end-user contracts in the definition of swap would greatly expand the scope of the CFTC's regulation over the electric utility industry and potentially would subject end-users to a number of burdensome regulatory requirements. We urge Congress to restrain CFTC's regulatory authority in this critical area of our business.

Conclusion

Thank you for your leadership and interest in implementation of the Dodd-Frank Act. We appreciate your role in helping to ensure that utilities and energy companies can continue to be able to use OTC derivatives to cost-effectively help protect our nation's consumers from volatile wholesale natural gas and power commodity prices.

ATTACHMENTS

National Association of Regulatory Utility Commissioners

Resolution on Financial Reform Legislation Affecting Over-the-Counter Risk Management Products and Its Impacts on Consumers

Whereas, There is a diverse group of end-users, consisting of electric and natural gas utilities, suppliers, customers, and other commercial entities who rely on over-the-counter ("OTC") derivative products and markets to manage electricity and natural gas price risks for legitimate business purposes, thereby helping to keep rates stable and affordable for retail consumers; *and*

Whereas, The United States Congress is considering financial reform legislation with the goal of ensuring that gaps in regulation, oversight of markets and systemic risk do not lead to economic instability; *and*

Whereas, Previous NARUC resolutions support Federal legislative and regulatory actions that fully accommodate legitimate hedging activities by electric and natural gas utilities; *and*

Whereas, The proposed legislation would, among other things, provide the Commodity Futures Trading Commission (CFTC) with oversight of OTC risk management products, including mandatory centralized clearing and exchange trading of all OTC products; *and*

Whereas, Mandatory centralized clearing of all OTC contracts will increase expenses associated with hedging activity, and ultimately end-user prices, due to increased margin requirements; *and*

Whereas, A report by the Joint Association of Energy End-Users stated that the effect of margin requirements resulting from mandatory clearing for electric utilities would have the unintended effect of reducing or eliminating legitimate hedging practices and could jeopardize or reduce investments in Smart Grid technology; and for natural gas utilities and production companies could reduce capital devoted to infrastructure and natural gas exploration; *and*

Whereas, The laudable goals of reform that ensure market transparency and adequate regulatory oversight can be accomplished by means other than mandatory clearing of OTC risk management contracts and the anticipated extra expense. For example, a requirement that natural gas and electric market participants engaging

in legitimate hedging report all OTC derivative transactions to a centralized data repository, like the CFTC, provides sufficient market transparency without the costs associated with mandatory clearing; *and*

Whereas, Proposed reforms would cause regulatory uncertainty with regard to the oversight of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs), where such uncertainty and/or overlapping jurisdiction can lead to negative impacts on liquidity, market confidence and reliability; *and*

Whereas, The Federal Energy Regulatory Commission (FERC), and the Public Utility Commission of Texas (PUCT) for Texas/ERCOT, as the regulators with the necessary expertise and statutory mandates to oversee electricity and natural gas markets to protect the public interest and consumers, should not be preempted by the financial reform legislation from being able to continue exercising their authority to ensure reliable, just and reasonable service and protect consumers; *and*

Whereas, Energy markets currently regulated by FERC or the PUCT (for Texas/ERCOT) under accepted tariffs or rate schedules should continue to be subject to FERC's and the PUCT's (for Texas/ERCOT) exclusive Federal jurisdiction, including jurisdiction over physical and financial transmission rights, and market oversight; and should themselves not be subject to CFTC jurisdiction as a clearinghouse due to the financial and other settlement services they provide those transacting in regional electricity markets; *now, therefore be it*

Resolved, That the Board of Directors of the National Association of Regulatory Utility Commissioners, convened at its 2010 Winter Committee Meetings in Washington, D.C., supports passage of financial reform legislation ensuring that electric and natural gas market participants continue to have access to OTC risk management products as tools in their legitimate hedging practices to provide more predictable and less volatile energy costs to consumers; *and be it further*

Resolved, That new financial legislation being considered by Congress should weigh the costs of potential end-user utility rate increases *versus* the benefits of new standards for the clearing of OTC risk management contracts used by natural gas and electric utilities for legitimate hedging purposes; *and be it further*

Resolved, That any Federal legislation addressing OTC risk management products should provide for an exemption from mandatory clearing requirements for legitimate hedging activity in natural gas and electricity markets; *and be it further*

Resolved, That any exemption to the mandatory clearing requirement for OTC derivatives be narrowly tailored as to not allow excessive speculation in natural gas and electricity markets; *and be it further*

Resolved, That the FERC, and the PUCT for Texas/ERCOT, charged with the statutory obligation to protect the public interest and consumers, should continue to be the exclusive Federal regulators with authority to oversee any agreement, contract, transaction, product, market mechanism or service offered or provided pursuant to a tariff or rate schedule filed and accepted by the FERC, or the PUCT for Texas/ERCOT; *and be it further*

Resolved, That NARUC authorizes and directs the staff and General Counsel to promote with the Congress, the Commodity Futures Trading Commission and other policymakers at the Federal level, policies consistent with this statement.

Sponsored by the Committee on Gas, Consumer Affairs, and Electricity Adopted by the NARUC Board of Directors February 17, 2010.

June 30, 2010

Hon. BARNEY FRANK,
Chairman,
House Committee on Financial Services,
Washington, D.C.

Hon. COLLIN C. PETERSON,
Chairman,
House Committee on Agriculture,
Washington, D.C.

Dear Chairmen Frank and Peterson:

Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the

Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end-users to manage their risk. This letter seeks to provide some additional background on legislative intent on some, but not all, of the various sections of Title VII of H.R. 4173, the Dodd-Frank Act.

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. If regulators raise the costs of end-user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end-users or impair economic growth.

Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end-users, nor can the regulators require clearing for end-user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but rules may not be set in a way that requires the imposition of margin requirements on the end-user side of a lawful transaction. In cases where a Swap Dealer enters into an uncleared swap with an end-user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end-users from burdensome costs.

In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy and to streamline the regulatory framework. However, a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end-users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end-users. In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy." Capital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk.

Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of non-cash collateral for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.

Congress determined that clearing is at the heart of reform—bringing transactions and counterparties into a robust, conservative and transparent risk management framework. Congress also acknowledged that clearing may not be suitable for every transaction or every counterparty. End-users who hedge their risks may find it challenging to use a standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction. Congress recognized that imposing the clearing and exchange trading requirement on commercial end-users could raise transaction costs where there is a substantial public interest in keeping such costs low (*i.e.,* to provide consumers with stable, low prices, promote investment, and create jobs.)

Congress recognized this concern and created a robust end-user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, financials that are hedging in support of manufacturing or other commercial companies. The end-user exemption also may apply to our smaller financial entities—credit unions, community banks, and Farm Credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.

This is also why we narrowed the scope of the Swap Dealer and Major Swap Participant definitions. We should not inadvertently pull in entities that are appropriately managing their risk. In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies

simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a *de minimis* exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.

Just as Congress has heard the end-user community, regulators must carefully take into consideration the impact of regulation and capital and margin on these entities.

It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards for Swap Dealers and Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end-user counterparties—especially if those requirements will discourage the use of swaps by end-users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Congress determined that end-users must be empowered in their counterparty relationships, especially relationships with swap dealers. This is why Congress explicitly gave to end-users the option to clear swaps contracts, the option to choose their clearinghouse or clearing agency, and the option to segregate margin with an independent third party custodian.

In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.

Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended, or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act, including requirements on Swap Dealers and Major Swap Participants. It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system.

Regulators must carefully follow Congressional intent in implementing this bill. While Congress may not have the expertise to set specific standards, we have laid out our criteria and guidelines for implementing reform. It is imperative that these standards are not punitive to the end-users, that we encourage the management of commercial risk, and that we build a strong but responsive framework for regulating the derivatives market.

Sincerely,

Hon. CHRISTOPHER DODD,
Chairman,
Senate Committee on Banking, Housing, and Urban Affairs;

Hon. BLANCHE L. LINCOLN,
Chairman,
Senate Committee on Agriculture, Nutrition, and Forestry.

The CHAIRMAN. Thank you.

We will stand in recess. In the good old days, we could count on 30 minutes for that first vote, but we have a new sheriff in town. So we will be right back.

So thank you.

[Recess.]

The CHAIRMAN. The Committee will come back into session, and we will now hear from Ms. Sanevich, 5 minutes please.

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

Ms. SANEVICH. Good afternoon and thank you and welcome back.

My name is Bella Sanevich, and I am the General Counsel of NISA Investment Advisors. NISA is an investment advisor with over $60 billion under management for over 100 clients, the majority of which are private and public retirement plans.

I am testifying today on behalf of the American Benefits Council and the Committee on Investment of Employee Benefit Assets, which are two of the leading employee benefit trade associations in the country. Together, their members provide benefits directly or indirectly to over 100 million participants. We very much appreciate the opportunity to address the swap-related issues raised by Dodd-Frank for private retirement plans governed by ERISA, and we applaud the Subcommittee for holding a hearing on this critical set of issues.

We believe that the CFTC and the SEC have been working hard to provide guidance in this area. Nevertheless, there is one issue that is dwarfing all others—timing. The agencies are attempting to perform a complete restructuring of a nearly $600 trillion market with rules developed over only a few months. It is simply not possible to do that in a way that takes into account all relevant factors. It is inevitable that the rules will have unintended and unforeseen consequences that could adversely impact the retirement security of millions of Americans, and cost our country billions of dollars and countless jobs.

ERISA pension plans use swaps to manage the risk resulting from the volatility inherent in the present value of a pension plan's liability, as well as to manage regulatory plan funding obligations. If swaps were to become materially less available by reason of rules developed too quickly, funding volatility and cost would increase substantially, putting Americans' retirement assets at greater risk and forcing companies to reserve billions of additional dollars to satisfy possible funding obligations. Those greater reserves would have an enormous effect on the working capital that would be available to companies to create new jobs and for other business activities that promote economic growth. The greater funding volatility could also undermine the security of participant benefits.

Accordingly, we strongly urge you to adopt legislation that would provide that each provision of Title VII shall become effective as of the later of January 1, 2013, or 12 months after the publication of final regulations implementing such provision.

I also want to describe three critical problems in the proposed regulations as they relate to pension plans.

The first issue involves the business conduct standards. Although several aspects of the business conduct standards are problematic, one of the biggest problems is that the proposed CFTC rules, when combined with those recently proposed by the DOL relating to fiduciaries, will either cause an illegality to occur, which is a prohibited transaction in ERISA language, or will prevent an ERISA plan from entering into a swap transaction altogether. The two sets of results are irreconcilable in their current form.

The next issue involves required clearing of swaps by pension plans. Business end-users, such as operating companies, have the right to decide whether to clear a swap, this is the end-user exemption, but not the plan sponsored by those companies. To our knowledge, there is no substantive reason for this distinction. In fact, like operating companies, pension plans have an inherent risk to hedge which is interest rate risk. Plans need the flexibility to structure their swaps in a manner to protect and best serve their beneficiaries. Requiring clearing may hamper that flexibility.

The last issue relates to real-time reporting. Although the purpose of real-time reporting is to enhance price transparency with the ultimate goal of reducing prices, we believe the current proposed rules would likely have exactly the opposite effect. In fact, we believe that if the CFTC rules were finalized in their current form, swap transaction costs would increase dramatically.

In conclusion, the CFTC, the SEC, and the swaps community have an enormous challenge in working together to implement a complete restructuring of a nearly $600 trillion market. If we are forced to do this too quickly, it is inevitable that there will be negative unintended consequences, costing billions of dollars in the aggregate.

We urge Congress to modify the effective date of Dodd-Frank to let the process proceed in an orderly and careful manner, extend the end-user exemption to plans, and address any problems under the regulations, such as the proposed business conduct rules which would effectively ban all swaps with plans.

Thank you for the opportunity to present our views, and I would be happy to take any questions you may have.

[The prepared statement of Ms. Sanevich follows:]

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

My name is Bella Sanevich and I am the General Counsel of NISA Investment Advisors, L.L.C. NISA is an investment advisor with over $60 billion under management for over 100 clients, including private and public retirement plans. I am testifying today on behalf of the American Benefits Council, with respect to which NISA is a member, and the Committee on Investment of Employee Benefit Assets.

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

CIEBA represents more than 100 of the country's largest corporate sponsored pension funds. Its members manage more than $1 trillion of defined benefit and defined contribution plan assets, on behalf of 15 million plan participants and beneficiaries.

CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

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

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

Timing

Implementing Dodd-Frank is an enormous undertaking. With respect to the derivatives title of Dodd-Frank, there is one issue, however, that is dwarfing all others: timing. The agencies are attempting to perform a complete restructuring of a nearly $600 trillion market with rules developed over a few months. It simply is not possible to do that in a way that takes into account all relevant factors. It is inevitable that the rules will have unintended and unforeseen consequences that could adversely impact the retirement security of millions of Americans, and cost our country billions of dollars and countless jobs.

In the pension area alone, almost no one can keep up with the breathtaking speed at which regulations are being proposed and will soon be finalized. The pension community barely digests one significant proposed regulation when another significant proposed regulation is issued. More importantly, subsequent proposed regulations can affect the application of prior proposed regulations, making the comment process very challenging at best and ineffective at worst. Also, the pension community finds itself having to comment on everything, even regulations that it hopes will not apply to ERISA plans, because of the uncertainty regarding whether the regulations may apply.

As noted, the regulators are rushing to meet statutory deadlines. Those statutory deadlines were aggressive at the time they were adopted. In retrospect, given the enormity of the market, such deadlines now appear dangerous for pension plans because, in an attempt to meet those deadlines, regulators have proposed regulations which could ultimately threaten pension plan participants' retirement security.

As noted the CFTC and the SEC have opened their doors to ERISA pension plans and we have seen our comments very helpfully taken into account by these agencies in a number of proposed rules. But these agencies are under extreme time constraints. And pension trade groups are very concerned that such time constraints could result in regulations being adopted that inadvertently harm pension plans.

Effects of staying on the current course. To stay on the current course is to invite, if not ensure, a train wreck. In the pension area, inadvertent adverse developments with respect to the use of swaps would have devastating effects.

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

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

Assume that a plan has $15 billion of assets and $15 billion of liabilities so that the plan is 100% funded and there is thus no shortfall to fund. Assume that interest

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

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

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

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

What is needed. We believe:

- The agencies need more time to develop proposed rules. They also need to sequence the rule proposals in a logical progression.
- The retirement plan community needs more time to review those proposed rules and to provide comments to the agencies. Given the volume of rules being proposed in such a compressed time period, we propose that the Commission give much more than 60 days to comment.
- The agencies need more time to consider the comments and provide final rules.
- The retirement plan community needs more time to prepare to comply with an entirely new system.

Accordingly, we strongly urge you to adopt legislation that would provide that each provision of Title VII shall become effective as of the later of (a) January 1, 2013 or (b) 12 months after the publication of final regulations implementing such provision.

Issues

It is important for two reasons to share with you some specific issues arising under Title VII for plans. First, those issues will strikingly illustrate the need for more time and the potential adverse consequences of forcing the process to move too quickly. Second, if additional time is not provided or if the agencies do not modify their rules, it may be important for Congress to step in to prevent potentially devastating results.

Business conduct standards. Under the business conduct rules, a swap dealer entering into a swap with a plan is required to provide counsel and assistance to the plan. The underlying rationale of these rules was that swap dealers are more knowledgeable than plans and are likely to take advantage of plans unless compelled to help them. By definition, this rationale has no application to ERISA plans. By law, ERISA plans are prohibited from entering into swaps unless they have an advisor with an expertise in swaps. Accordingly, ERISA plans do not have any need for any assistance or counsel from dealers. And ERISA plans have no interest in counsel from their opposing party. So at best, the rules have no effect. Unfortunately, the rules as proposed by the CFTC would actually have devastating effects.

Here are just two examples, although there are other issues with respect to these proposed rules.

- **Requiring actions that would make swaps impossible.** The counsel that a swap dealer is required to provide to a plan under the CFTC's proposed rules would make the swap dealer a plan fiduciary under regulations recently proposed by the Department of Labor (the "DOL"). Pursuant to the DOL's prohibited transaction rules, a fiduciary to a plan cannot enter into a transaction with the plan. So, if the swap dealer is a plan fiduciary, then either no swap transaction can be entered into or the swap is an illegal prohibited transaction under the rules applicable to plans. Thus, the business conduct rules would require a swap dealer to perform an illegal action or refrain from entering into a swap with a plan. The only way to avoid violating the law is for all swaps with plans to cease, with the adverse results described above.

  The above characterization is not just our view. To our knowledge, it is the universal business community perspective, and informal conversations with agencies indicate that they also recognize this problem.

  Congress clearly never intended to indirectly prohibit plans from utilizing swaps. The CFTC must not propose conduct standards that require a swap dealer to do the impossible—act in the best interests of both itself and its counterparty. Even more importantly, the CFTC and the DOL must jointly announce that the business conduct rules will not be interpreted in a manner that will require the swap dealer to perform an illegal act under ERISA when trading with an ERISA plan in order to comply with a CFTC rule under the Commodity Exchange Act. If the agencies do not do this—and because of the time constraints and the difficulties of inter-agency coordination it is very possible that they will not—Congress needs to step in.
- **Dealers' right to veto plan advisors.** Under the proposed CFTC rules, swap dealers are required to carefully review the qualifications of a plan's advisor and would have the ability to veto any advisor advising a plan with respect to a swap. We are not suggesting that a dealer would use this power, but the fear of that result would have an enormous effect on advisors' willingness to zealously represent plans' interests against a dealer. Moreover, the specter of liability for not vetoing an advisor that subsequently makes an error may have an adverse impact on the dealers' willingness to enter into swaps with plans; this may result in the dealers demanding additional concessions from the plans or their advisors, or may cause the dealers to cease entering into swaps with plans. In all of the above cases, the effect on plans' negotiations with dealers would be extremely adverse. This, too, was never intended by Congress.

  As stated above, placing the responsibility on the dealers to veto advisors is not a service that would benefit plans. ERISA has a long history of requiring plan fiduciaries to be held to the highest fiduciary standard—that of a prudent expert. Therefore, not only are investment advisors held to this standard, but the plan sponsors choosing the advisors are held to the same strict standard. It is hard to see how a counterparty whose interests are adverse to a plan's interests can do a better job of choosing advisors. Consistent with the statute, a dealer should be deemed to meet the business conduct standards relating to dealers acting as counterparties if a plan represents that it is being advised by an ERISA fiduciary.

Required clearing. Business end-users, such as operating companies, have the right to decide whether to clear a swap (*i.e.,* the "end-user exemption"). Oddly, the plans sponsored by such companies do not have that right. Although plans have an "end-user exemption" with respect to major swap participant status, they are not eligible for the end-user exemption from the clearing requirement. To our knowledge, there is no substantive reason for this distinction; in fact, like operating companies, plans have an inherent risk to hedge—interest rate risk. Moreover, plans are required by law to be diversified, prudent, and focused exclusively on participants' interests. Fiduciaries, acting pursuant to the highest standard of conduct under the law, should have the right to decide whether to clear a swap. In this regard, here are two examples of very troubling aspects of applying the clearing requirement to plans:

- **Anti-avoidance and potential loss of customized terms.** Each plan has different risks, based on the unique demographics of its plan participants and its unique investment strategy. Accordingly, plans have a great need to customize the terms of their swaps to seek to most effectively hedge their unique risks; because of the customized terms, plans' swaps may not be generally clearable.

An issue arises because Dodd-Frank contains a section directing the CFTC to prescribe rules precluding evasion of the clearing requirement. The problem is that there is no clarity as to how this requirement will be interpreted and applied, and this may cause plans and their advisors to forego customized swaps that they think are in the best interests of the plan and its participants, in order to avoid inadvertently violating Dodd-Frank. It is critical that plans not be forced to give up those customized terms. Plans should be free to retain their customized terms and to use the over-the-counter market if the customized terms render a swap unclearable, without fear of violating the law.

- **Fellow customer risk.** Unless the CFTC allows segregation of collateral, the collateral posted by a pension plan would be aggregated with the collateral posted by other users of the clearing platform and thus could be subject to risks posed by other far less secure swap market participants. For example, in a clearing context, collateral posted by a plan could be used to address defaults by a very risky hedge fund that uses the same clearing platform. Prior to Dodd-Frank, plans were not exposed to the risk of other far riskier entities. It would be strange and ironic if Dodd-Frank were to force plans to assume far greater risk.

  We ask Congress to step in and extend the end-user exemption from clearing to plans.

Real-time reporting. The CFTC has issued rules regarding the real-time public reporting of swaps. The purpose of such reporting is to enhance price transparency, with the ultimate goal of reducing prices. But the CFTC issued rules that we believe would likely have exactly the opposite effect. In fact, we believe that if the CFTC rules were finalized in their current form, swap transaction costs would increase dramatically, perhaps by as much as 100% in some cases.

The problem is that if the terms of a swap are immediately known to the market, the dealer assuming the risk with respect to the swap will have far more difficulty in offsetting that risk in a subsequent transaction. Knowing that the dealer has to offset a specific risk, the rest of the market has a large negotiating and informational advantage over the dealer and can charge the dealer much more to offset its risk. The dealer thus has to charge much more for the original swap.

This is a problem that can be easily solved with data regarding how much time dealers need to offset risk with respect to different types of swaps. Any effort to act before sufficient data are collected and analyzed is likely to result in exactly the wrong result—cost increases.

Plan swap terms should not be altered without plan consent. It is essential that the CFTC and SEC adopt clear rules under which no party involved in the reporting or clearing process has the power to modify the terms of any swap. For example, today, it is not uncommon for a swap data repository or an electronic confirmation service provider to require, as a condition of using their service, the unilateral right to modify swap terms by "deeming" a user to have agreed to such terms if they use the system after notice. Today, plans can simply elect not to use those services. But after Dodd-Frank becomes effective, plans will be required by law to report swaps. If the swap data repository receiving such reports or an entity providing services with respect to such repository has the right to modify plan terms, the repository or entity would effectively have government-type power to control swap terms. This would be shocking and certainly not what Congress had intended.

* * * * *

In conclusion, the CFTC, the SEC, and the swaps community have an enormous challenge in working together to implement a complete restructuring of a nearly $600 trillion market. This cannot, and should not, be done in a few months. If we are forced to do this too quickly, it is inevitable that there will be negative unintended consequences, costing billions of dollars in the aggregate. With respect to the plan area alone, retirement benefits would be subject to greater risk and huge numbers of jobs and billions of dollars of participants' benefits could be adversely affected. We urge Congress to (1) modify the effective date of Dodd-Frank to let the process proceed in an orderly and careful manner, (2) extend the end-user exemption from clearing to plans, and (3) address any problems under the regulations, such as the fact that the proposed business conduct rules would effectively ban all swaps with plans.

Thank you for the opportunity to present our views. I would be happy to take any questions that you may have.

The CHAIRMAN. All right. Thank you, Ms. Sanevich.

I thank all the witnesses for being here today.

I was in a meeting with a fellow who runs the NSA named Keith Alexander who said, nothing is impossible for those who don't have to do it. And it seems like we have asked Gary Gensler and his team to do the impossible. Because, quite frankly, Congress didn't have to do it. And whether the 360 days to get all of this done made sense—it certainly made sense to those who supported this work last year. But in the current mix of things that are going on and all of the things that you talked about, the 360 does not make as much sense as it does to now.

We will go on the 5 minute clock.

I would like all of the witnesses to address these questions. If we don't have a chance to get to everybody, we will do a second round after we have gone through everybody. So I will just take my 5 minutes along with everyone else.

In terms of—help us understand the body of rules that are out there. Mr. Gensler said last week that he would have most of it done soon, and it would be in a quieter pause while they assimilated everything they have done.

If you were Mr. Gensler, in what order would you roll out the next round of either final rules or proposed rules or whatever in terms of a pecking order that he would—that you would roll those out in, and give me something a little clearer.

Ms. Sanevich, you mentioned compliance costs would go way up, *dramatic* was your word. If you could quantify those a little better.

Mr. McMahon, you talked about hundreds of millions of dollars in terms of margin and those kind of things, but help us understand from a qualitative standpoint how much we are actually talking about in terms of compliance costs.

So I will throw it open to anyone who wants to start off, and we will come back after we have had the other speakers.

Mr. DAMGARD. I am happy to start off.

He has really got it backwards. We would like to know what a definition of a *swap* is going to look like. We would like to know who qualifies as a significant swap participant. We would like to know what a SEF is. Until we have definitions of those kinds of organizations or those definitions, there are bodies of people out there that have no idea whether they are going to be affected. And if they find out after the fact it is going to be too late for them to comment.

Now I know that they are working real hard at the CFTC. I will say my organization is totally exhausted. We face four or five rulemakings a year historically from the CFTC, and there are 30 pending right now. We simply are unable to do an adequate job of making sure that what we are able to send to the CFTC, which has historically been very helpful, is even being properly considered.

I mean, I remember when the CFTC was created in this room. It was created as an oversight regulator. And the exchanges have very, very deep rule books; and they have an awful lot of self-interest in making sure that their exchanges are seen as good organizations. They don't want manipulation in their markets, because people wouldn't use them.

We have a very good self-regulator called the National Futures Association, which was also created by you guys; and they have done an excellent job and a very efficient job.

My view is Mr. Gensler wants to change all that from being an oversight regulator and go back to this prescriptive rules and regulation where everybody is going to have to come to the CFTC and ask his permission once he finalizes all these rules. He certainly has enough economists over there to write these rules and finalize them. Where he is going to ask for more money is implementation and enforcement.

And my concern—and he has essentially made this threat recently—he said, well, once I have all these regulations in place, then if I don't have the revenues and I don't have the resources in which to decide whether I am going to allow you to register as a SEF, then get in line. It could take a long, long time. So you people ought to be out there helping us get the additional resources.

Well, whether I would like to do that or not is irrelevant. It isn't going to happen. And I would like to see Congress maybe go back to what we did initially; and that was, when we created the CFTC, there were an awful lot of people that were already in the business and that they didn't instantly have all the resources at the CFTC to make all these approvals.

Truthfully, the year 2000 and that reauthorization was extremely helpful to the industry; and we have seen the industry grow dramatically because of that.

Now, it is true that—and I represent the listed markets. I represent exchange-traded futures. And other people can make excuses for the swaps market, but, truthfully, energy swaps, interest rate swaps, currency swaps, all those work perfectly. It is only when we get into the debt instruments and the CDSs, I mean, it just seems like our whole industry is paying an awful price for AIG.

And I see my time is almost up.

The CHAIRMAN. Ms. Sanevich.

Ms. SANEVICH. I agree that the definition of who is covered by what and who—so what is a swap, who falls under an MSP, who is an end-user, what is required under those things have to be sequentially addressed so that then people can process and think through how the various other rules that are being promulgated for all these entities will apply to that particular entity.

And very importantly from the pension plans perspective is that we have very similar sequencing issues and concerns. But, on top of that, we have the Department of Labor coming out and working with rules that will effectively shut down the use of pension plan swaps completely. And so at a very high level for pension plans, unless these things are coordinated and resolved adequately, the rest of it might be moot from a pension plan's perspective because they won't be able to use these instruments.

The CHAIRMAN. Thank you. We will come back on the other witnesses after everybody has had a chance.

Mr. Boswell, 5 minutes.

Mr. BOSWELL. Thank you, Mr. Chairman.

I know that some of the Members have meetings, so I am going to yield to them to go down your list. Because I am going to stay until it is over, and I will have another opportunity.

The CHAIRMAN. The gentleman from North Carolina, Mr. Kissell.

Mr. KISSELL. Thank you, Mr. Chairman. I thank everybody for being with us here today and your patience with us during voting and your testimony before us.

This whole idea of the derivatives was the first hearing I came into—this is my second term in Congress—my first year I came in here was on derivatives. And it was a back-and-forth testimony at the time between those who felt we needed to do something and those who said, well, no one lost any money and everything is fine.

Mr. Damgard, you mentioned a second ago the industry is paying a high price for AIG, and I felt that more than just the industry paid for AIG, is gas prices went up to $4 a gallon, and all the things that we associated with, while people may not have lost money, *per se,* that were in the swaps, I felt that we as a nation paid a pretty high price for some of the pricing and so forth and so on. And, as Mr. Boswell said earlier, shining a little bit of light in here, it doesn't seem like that is an issue.

So I am curious about when you said the industry paid a price for AIG, how would you separate the industry from AIG? And if you could elaborate on that briefly for me, please.

Mr. DAMGARD. AIG is now one of my member organizations, but I would say it is awful easy to shoot the messenger. Markets have worked extremely well. And when gas prices go up, truthfully, it is not the fault of the market. There are people in the market that are buying and selling, and, yes, there are passive longs, but the energy market, frankly, is hardly a free market when you have OPEC controlling a large percentage of the volume.

So when I say AIG is causing us a lot of agony, because we weren't directly involved in any of the difficulties in the market, and I am very proud of the fact that futures markets all over the world worked very, very smoothly through all of that stress. And the CFTC is now given this huge new mandate to regulate the OTC world or the swaps world, and an awful lot of that is, unfortunately, carrying over into the futures market. We would like to say futures markets have worked extremely well.

There is nothing in Dodd-Frank that says you have to go out and totally rewrite the rule book on an industry that worked perfectly well, and this is basically what is happening. And some of it is inevitable. If you are going to do something in the swaps area, it is almost impossible to necessarily differentiate those kinds of things from the futures market.

Just in collecting data, and I won't bore you with it, but in my——

Mr. KISSELL. If I could interrupt you, and I apologize, but I have a couple other questions I want to get to.

Mr. McMahon, you had talked about the concerns for the end-user; and if I heard you correctly, you said, yes, they are saying they are going to exempt the end-user. Are you satisfied that they are and that is what they say they are going to do? Or do you still have concerns there?

Mr. MCMAHON. Well, our concerns I think are two-fold.

One, as I mentioned in my statement, we want to make sure that we are fully exempt from the margining requirements, that commercial end-users are exempt, and also because of the $250 to $400 million per company impact of that on our companies. I will say

our companies use exchange-traded products as well as over-the-counter products. So it is not that we don't use them. It is just that when they are appropriate we do.

The other aspect of it, again, is the fact that the compliance cost associated with it, it looks to us as if the CFTC is taking more of a transactional approach to the end-user exemption so that instead of making a declaration that we use these products to hedge commercial risk and that being the end of it, in addition to the reporting that would come along with it, it appears that it looks as if we are going to have to make a transaction by transaction disclosure so that the compliance burden would be, we feel, pretty heavy in that sort of approach. And we haven't computed the cost of that, but we believe it would be pretty burdensome to do that. So I think that is a real concern.

And, again, we are not quite sure, because the definition of a swap hasn't been promulgated, how many of our transactions would be affected, because utilities are subject to weather and things like that, and that causes us to build in a lot of optionality into our agreements for fuel and things like that. So we are concerned that things that we would normally consider to be derivatives or swaps, if the definition is very broad, could be encompassed in this; and, of course, that would change potentially the end-user status if they are using a lot of these products that we normally wouldn't consider to be swaps.

Mr. KISSELL. Thank you, sir.

Thank you, Mr. Chairman.

The CHAIRMAN. Sure. I thank the gentleman.

And the gentlelady from Alabama, Terri Sewell, quite the comedienne from the other night. I was in the audience. I heard that activity. You are recognized for 5 minutes.

Ms. SEWELL. Thank you, Mr. Chairman.

To our panelists, thank you so much for coming in and enlightening us on this topic.

My question, everyone on the panel seemed to say that the lawmaking should not go into effect in July, that it is too onerous, that there is just not enough time. So my question really is—and this is to anyone who wants to answer it—are you saying that the market should go unregulated, that somehow we shouldn't put regulations on swaps and on these derivatives?

And if you are not saying that, then when is the timeline? Give me a timeline that would be acceptable to the marketplace.

Mr. BULLARD. Congresswoman, we believe that these regulations should be implemented as swiftly as possible. We have already identified dysfunctionality within the futures market. We need to restore that market as quickly as possible so it is a used and useful tool to discover price in tandem with the cash market, which is also a price discovery market in our industry, as well as to provide producers a legitimate and genuine risk management tool that is unavailable when the market is prone to manipulation and distortion, as we witnessed.

Mr. KASWELL. If I may, we would not say don't do anything. We are not trying to deliver that message. I think we are trying to say we respectfully think it should be done selectively. And we think that moving forward on things like central clearing, that is very

important to us, segregation of collateral, that is very important to us. But, in other cases, it is a matter of sequencing; and I think this is where it gets back to the Chairman's question.

We also would like to know what a major swap participant is before we know what those responsibilities entail. It is similar to comments made about the definition of a *swap,* and the sequencing and the clarity to know where we stand so then we will understand, if you are in this category, what does that mean.

There are also some things that the CFTC is proposing that we are troubled about, which is they are proposing to take away one of the exemptions for CPOs, commodity pool operators, which will in effect require those organizations to be duly regulated by the SEC and the CFTC with potentially conflicting regulations. We don't think that is an effective use of regulatory resources at a time when we understand the pressures that everyone is under.

Thank you.

Mr. DAMGARD. And I am not here to apologize for the OTC world, but I do think they make a good case. Ag swaps worked just fine. People trusted their counterparties, and for the most part so did interest rate swaps and the others.

One example is the energy market. We have a very fine energy market in New York, and that is called—belongs to the CME. It is the WTI. It is called the West Texas Intermediate. That is the benchmark trade.

Now the oil is not coming from west Texas, with all due respect. The oil is coming from the Middle East. We are losing that market share. We are losing it every day to the Brent. Because, to the extent that there are going to be position limits in the energy market, any dealer that has customers all over the world may run the risk of exceeding what that position limit may be at any given moment.

Someone mentioned that somebody just got fined the other day, and it was not an intentional—but firms will go to a market where they don't run that risk, and the Brent market is an extremely good market. It is called the International Petroleum Exchange. So we are not only losing market share to foreign markets, we may lose those markets altogether, and the Brent will soon be the benchmark that people will trade.

And I just hate to see the United States lose a business, lose an industry, for the wrong reasons. If we are being out-competed, that is one thing. But if we go overboard and we see the pendulum swing way over to one side, then it is going to be very damaging to business in the United States.

Mr. BERNARDO. Just to add to that, I think that the regulatory transparency should be and could be done quickly, but the regulators need to understand the markets that they are regulating.

Ms. SANEVICH. This is a very diverse market. You can see by the different entities represented here. And at least from our perspective, we are very concerned about unintended—no one meant for a bad consequence to happen, but because everything has to be promulgated so quickly not only is it hard for the regulators to think through a very complicated market but for those who are directly impacted to actually digest and respond and to raise issues. These are very complex issues that are very interrelated. And that is the

angst in our case. There is different regulatory agencies now that are in direct conflict.

The CHAIRMAN. Thank you.

Now, Mr. Welch, you are up next for 5 minutes.

Mr. WELCH. Thank you very much, Mr. Chairman.

As I listened to your testimony and read your testimony, the conflict that seems to be the problem inherent in this is that, on the one hand, you have the physical hedgers, the ones buying the product; and the statistics that you gave, Mr. Bullard, that the futures markets declined from 52 percent and 67 percent respectively for the futures market and in the live cattle market in 1998 to 17 percent and 11.7 percent shows that the participation rate by the physical hedgers has obviously declined.

On the other hand, Mr. Damgard, what you are concerned about, and rightly so, is that if there are rules and regulations that interfere with the work that you are doing for the overall market, then we will lose a good industry.

But what may be good for one end of the futures market, which is essentially the financial transactions, some people would use the term speculation which plays a role in liquidity, the interests of that segment of the market really do seem to be in some conflict with the small feedlot operators who needed this market for a very simple, straightforward hedging position.

And I don't know how we thread that needle. That to me is the question. Because I think we have to have a futures market that protects the folks that Mr. Bullard works for and obviously wants the jobs that your activity represents. And I am just going to ask each of you to tell me what your recommendations are about how to resolve that conflict so we don't hammer the cattle and feedlot dealers and destroy jobs that might go overseas.

I will start are with you, Mr. Bullard.

Mr. BULLARD. Congressman, the futures commodity market is a market that supports an entire underlying industry with those who are, as you indicated, physical hedgers. And what has transpired as a result of the excessive speculation by the index funds and the hedge funds that have entered these markets is that the market has become less and less capable of discovering the fair market value. As a result, we no longer have a market that is actually providing the price discovery function that it should be that would normally occur if you had the majority of physical hedgers in the market.

And our concern also is with the industry itself, the industry that has become so dominated by just four large packers that now control over 80 percent of all the fed steer and heifer slaughter. You have on one side of that physical market essentially four participants and all the rest are the independent feeders who are trying to sell to them. That market has to be protected, and we have already seen that we have severe problems in the market. So that is why we support strongly reductions on the number of speculators that are involved in the market.

And we also believe that it is improper for a packer who may be a physical hedger to step out of the role of a physical hedger and suddenly become a speculator in order to try to manage the direc-

tion of the market, and we believe that that has been ongoing for a number of years.

Mr. WELCH. Thank you.

Mr. Damgard, I will ask you to basically try to, for me, let me understand how we could accomplish what you want without destroying what Mr. Bullard represents, or is it impossible?

Mr. DAMGARD. In defense of the futures markets, let me just say that these markets have grown just exponentially. And I would agree that the CFTC has done an excellent job of—I mean, you don't hear about the Hunt brothers anymore. If there is manipulation in the market, you pay a very, very dear price. So if somebody is manipulating the market, I believe the CFTC is the right place to determine whether that manipulation has taken place, and to the extent that it does take place people——

Mr. WELCH. Let me just address that. Because I don't think that Mr. Bullard is talking about manipulation so much as if the market has gone from essentially something that serves physical hedgers to one that serves financial players, it works differently; and that is I think the dilemma that we are in.

Mr. DAMGARD. I am a corn grower and soybean grower in central Illinois. I use the markets all the time. I decided that at $4.50 that was a pretty good price. That covered my cost and gave me a profit. So I sold a lot of corn at $4.50. Today, it is $7.

Now the real problem for the cattle feeders, in my judgment, is you can't feed animals $7 corn and make any money. So what is happening is you see the herds declining, fewer animals; the price of the animal is more expensive; you are going to pay a whole lot more for a steak; and my ability to grow corn next year and sell it at a good price is going to be limited by the lack of demand from the cattle industry.

Now, we can get into ethanol, but we can also get into the fact that China is a huge buyer of U.S. agricultural products. Most of the corn that I grow today in central Illinois that used to go down the river gets on a train and goes out to Portland, Oregon. Because the bottoms are in short demand, and it is shorter to go from Portland to Beijing or wherever.

My own view is that there may be markets that get so thin that they are no longer useful for the people using those markets. And if that is the case, it is the exchange's problem. I think the exchange went to great lengths to try to change the terms of the cotton contract last year because a lot of people were concerned that the cotton market wasn't working properly. But to blame the whole thing on the lack of regulation is a terrible mistake. We don't want that.

Mr. WELCH. My time is up, but I thank you for your answer.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Scott from Georgia, 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman.

Mr. Kaswell, both last week at the full Committee's hearing, and then this morning at Financial Services, I questioned Chairman Gensler regarding the CFTC's advance notice of proposed rulemaking on margin segregation. And I would kind of like to explore

that with you but particularly on the cost *versus* benefits of regulation and how it relates to this issue.

I have heard from dealers, I have heard from some clearinghouses that margin segregation could dramatically increase costs for everyone involved and will produce only marginal gains in risk protection. Listening to you, you seem to dispute my position and assertion. Is that correct?

Mr. KASWELL. I disagree with that position. I hate to disagree with you, sir.

Mr. DAVID SCOTT of Georgia. Let me ask you this. Have your members been able to quantify what their additional costs may be and how much additional risk mitigation they may receive from a margin segregation regulatory requirement?

Mr. KASWELL. I think we don't know the cost, but I don't think anyone knows the cost, and I think that is part of the concern that we have.

The statute has a preference for segregation of collateral for cleared swaps, complete segregation. We think that reduces systemic risk and provides the greatest stability for the trading system and for the public at large. We know there will be costs in building these clearing systems.

What I think is the fair question is not that it will be expensive but what will be the marginal cost of providing that additional level of protection?

And we think that before we say we can't afford it, even though it would prevent repetitions of problems like Lehman Brothers, we think that we should have a better sense of what those costs are. And once we know that, then I think we will be in a better position to say, yes, we actually think this is not going to be too bad and we can get those benefits, or them to say maybe it is too expensive. But I think those who argue that we don't need the protection and notwithstanding that the statute expresses a preference for it, admittedly with exceptions, that we should look to fully explore it before we discard that option.

Mr. DAVID SCOTT of Georgia. It is true that the Dodd-Frank Act doesn't even require the CFTC to explore this issue.

Mr. KASWELL. Well, I don't think it directs a rulemaking on it, but it does require in the provision for section 724 that it says, for cleared swaps, segregation is required. And it says commingling is prohibited. And then it goes on to create some exceptions so that we can have the range of possibilities that the CFTC has proposed. And so I am not saying that the statute forecloses a discussion on this, but we think it expresses a preference for full segregation.

One of the issues that you face is that if I am a customer in an FCM and I have no ability to know who the other customers are at that FCM, I can't do due diligence. If my good friend John Damgard is another customer, I can't know—I mean, I know he is a great guy. You are good for it. But there is no way I can do due diligence on that. And if his failure could jeopardize that FCM, which could then jeopardize the system, my position as a solvent participant could be harmed and my ability to move my collateral from one FCM to another, or from one clearing entity to another would be compromised and we could be in the soup that we saw with Lehman in Europe.

Mr. DAVID SCOTT of Georgia. Just to clear up, given that we don't require this margin segregation for futures clearinghouses, I would be interested to know why. The question is, why do you think they are looking into this? Did someone come to the CFTC to request this? What was the origination for this? I am just simply—it wasn't required in the law. It is clear that there have been complaints about the expensiveness and the cost and minimal benefits.

Mr. KASWELL. I think you would have to ask the CFTC, but I do know the CFTC has proposed at least four options in the notice. The one that we think makes the most sense is the first, which is the complete segregation of collateral, but they have they laid out various other alternatives.

Mr. DAVID SCOTT of Georgia. And is it not true that perhaps they have undertaken their own investigation to determine whether or not this is a rule they will pursue?

Mr. KASWELL. Well, I believe there is a notice of proposed rulemaking, but I really think these questions are better directed at the CFTC.

Mr. DAVID SCOTT of Georgia. You do not believe that future—just one little bit here—God bless you. I thank you so much.

The CHAIRMAN. You are the only guy to do it so far.

Mr. DAVID SCOTT of Georgia. You are a good man.

Shouldn't futures clearinghouses and derivative clearinghouses be treated the same? And, in general, are your members supportive of this effort of the CFTC and are they all of one mind to do, or do some of them feel that this is not necessary?

Mr. KASWELL. We are strongly in support of the idea of segregation of collateral at the FCM and the clearinghouse level. We think that is the optimal answer.

We understand there are questions and there should be thoughtful inquiry into that. But, again, we think that, before rejecting that which we see is the best alternative, we think we should conclude that the marginal cost is too high and not worth it. And we don't think anybody has made that case, and so, therefore, we think we should pick the best option because it provides the greatest amount of protection for the system and will allow us to avoid problems that have occurred in the past.

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman, for your kindness and generosity.

The CHAIRMAN. The gentleman yields back.

Mr. Hultgren from Illinois, 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman; and thank you all for being here. Thank you for your testimony. Sorry for the busy day we have going here, but I really appreciate your being here on some very important issues that we are going to be facing, going forward.

I do have a couple of questions to Ms. Sanevich.

First, from your testimony, from the written testimony, you made a point under the proposed CFTC rule swap dealers will be required to provide counsel to pension plans that would then make them fiduciaries under the DOL rules. Also, under DOL rules, fiduciaries cannot trade with pension plans so that CFTC results would essentially shut pension plans out of the market altogether. Am I misreading that?

Ms. SANEVICH. Combined with the DOL rules, that is absolutely correct. Pension plans will not be able to engage in swaps if the two rules are promulgated as proposed currently.

Mr. HULTGREN. Is that your sense? Is that the direction it is going? Have you heard anything different on that?

Ms. SANEVICH. The CFTC has been very open to hearing our issues and concerns. It is hard for me to tell where this might be going. But I can tell you that, without very clear statements jointly from both agencies, that the two rules do not conflict in a manner that people tend to read them. It will cause enormous disruptions and will shut pension plans out of the swaps market in the future.

Mr. HULTGREN. I think you started to address this already, but will your counterparties be subject to new liability under Dodd-Frank? And what impact may this have in your ability to engage in the swap markets?

Ms. SANEVICH. Yes, certainly dealers, as was intended in part, will be subject to additional responsibilities; and we are certainly not saying, don't do that. The problem is that a lot of the responsibilities that are contemplated are in direct conflict with how pension plans invest. They already have fiduciaries at many levels acting as prudent experts for the investment in pension plans, so imposing this duty on dealers is not only kind of irrelevant because the pension plans already have lots of layers of prudent experts, but is quite problematic and potentially will shut pension plans out of the market. So, yes.

Mr. HULTGREN. I wonder if you could just briefly describe the real-time reporting rules. They were intended to enhance price transparency and also to reduce costs, but I wonder if you can explain how they might have exactly the opposite impact.

Ms. SANEVICH. Sure. And in this case it is really a question of very much lack of information in connection with a proposed rule. So our concern is that real-time reporting to everyone in the market, for every trade, will increase transaction costs for everyone. The dealers will pass them on ultimately to the other side of the trade and the concern is that these transaction costs will be material. They may differ from different kinds of swaps, but they will increase transaction costs.

And what we have suggested is the agencies should collect the data for a year—there is certainly no problem with them receiving the data—analyze it, and then promulgate rules that will not disrupt the markets and will not have the perverse effect of increasing transaction costs when the whole intent is to decrease the costs.

Mr. HULTGREN. It seems so oftentimes here where intended results arrive at unintended consequences.

Ms. SANEVICH. That is the concern here, is that these unintended consequences—these are some of the ones we happen to have thought of; and lots of very busy, smart people are thinking about these things, including the CFTC and the SEC. But this is such a vast undertaking that there may be many negative unintended consequences that we just can't foresee.

Mr. HULTGREN. One last question, pension plans, from your perspective, how would you encourage them to protect themselves from risks posed by their counterparties.

Ms. SANEVICH. Well, pension plans right now, because their investment advisors are subject to the highest fiduciary standards, they already do that now. Most pension plans certainly are client based, and others we know have lots of termination events. If a counterparty's credit rating declines, they require daily posting of collateral. Many require segregation of their collateral so that it is kept by an independent third party.

And so many plans use any of these tools in combination currently so that, in fact, when Lehman did go under, at least from our experience, to the extent plans lost anything, it was .001 percent of the plan or two or three percentage points of a trade, really insignificant amounts. Because plans already have a lot of these protections embedded in their documents.

Mr. HULTGREN. Mr. Chairman, I see my time is up. Can I ask one more quick question? Would that be all right?

The CHAIRMAN. In fairness to Mr. Scott, yes.

Mr. HULTGREN. Following up on that, basically, to what degree during the financial crisis did pension plans suffer losses due to swap activities? Just briefly.

Ms. SANEVICH. Yes, the losses that we tend to think because of the financial crisis was losses from a Lehman or an AIG going down. And as I mentioned, at least in our experience and from those of others that we have informally talked to, they were really miniscule percentages on a trade and as a percentage of a plan, really nothing, .001, or whatnot percent.

Mr. HULTGREN. Well, thank you so much.

Thank you, Mr. Chairman.

And I do want to thank you all of you for your part. We need your help and involvement as we work through this, the implications of what was passed last year. So thank you very, very much.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back.

The gentleman from Massachusetts, Mr. McGovern.

Mr. MCGOVERN. I want to thank the Chairman.

I should preface my remarks by saying I am new here on the Agriculture Committee. I have the very last seat in the front row when the full Committee is here. And I apologize for missing most of your testimony. I was handling the rule on the continuing resolution. But from the give and take, I just have a couple of questions for clarification.

I get the fact that there are a lot of concerns about how we are proceeding here and what is going on in the CFTC and that you want to make sure that they don't overreach. On the other hand, it seems most people agree that doing something is not necessarily a bad thing, but we have to figure out what that right thing to do is.

I am on the Rules Committee, so I am anticipating whatever might come before the Rules Committee. One of our colleagues, Michele Bachmann, introduced a bill to totally repeal Dodd-Frank. And I would just like to see a show of hands here. How many people support the outright repeal?

Mr. DAMGARD. We can think of parts of it that we would like to get rid of.

Mr. MCGOVERN. But nobody here is advocating an outright repeal.

Now I just came from the floor. We are dealing with a continuing resolution. I heard a number of concerns about making sure that everyone's comments are properly assessed, that the data that needs to be gathered is properly analyzed. They want to analyze the reported swap data that will take more infrastructure and technology is going be necessary. And we were warned that the Commission is estimated to run out of data storage by October of this year.

The continuing resolution that we are dealing with on the House floor right now would reduce the Commission's budget to Fiscal Year 2008 levels. Now when the Chairman was here last week, he talked about the need that they need to expand their staff and their technology in order to do this right, to get it right. And I think, Mr. Damgard, I was hearing you say that they were trying to get you guys to come on board and advocate for an appropriate budget, which seems to me, no matter whether you have concerns about some of the things that are going on or not, would be the right thing to do.

What I am worried about is, are decisions being made without the proper analysis? I am worried about when things get put into place a review of applications taking a long time because there is not the proper staff.

I would think, no matter what your concerns on this, that you would be a little bit concerned about what we are doing on the floor today.

Any response you have I would appreciate listening to.

Mr. DAMGARD. As I pointed out earlier, I am a big believer in self-regulation; and I think self-regulation has worked extremely well in the futures markets. The question that the Congressman asked, how much money did pension funds lose as a result of Dodd-Frank? Futures customers didn't lose anything because of the segregation of the funds. Even Lehman Brothers customers, when Lehman went down, those customers got their money back.

Mr. MCGOVERN. That is not my question. My question is whether or not, given the fact that none of you are on record as calling for the outright repeal of Dodd-Frank, which means that the CFTC has a lot of work to do, I was asking about whether you agreed with the fact that they need to have additional resources to be able to better do their job.

Mr. DAMGARD. And what I said was I think the NFA can relieve an enormous amount of their burden without them needing a lot more money.

Mr. MCGOVERN. So the answer to that is no?

Mr. DAMGARD. It is not no——

Mr. MCGOVERN. I am looking for kind of straight answers here. Because, again, we are dealing with a cut today going down to Fiscal Year 2008 levels. I am wondering whether that is a good idea from your perspective or whether or not you think there are additional resources, cutting back would be a bad idea.

Mr. DAMGARD. You mean I should decide whether or not we should go to 2008 levels or what is in the President's budget? I would say somewhere in the middle.

Mr. MCGOVERN. Well, whatever. Today, we are going back to Fiscal Year 2008 levels. I am wondering whether you think that is a good idea or not. That means less resources.

Mr. DAMGARD. I am not qualified to say that the CFTC is expending all their finances and resources, so I am not qualified to answer the question.

Mr. MCGOVERN. I am making a suggestion that if, in fact, we want to get this right, it is going to require the proper analysis, which means that I do think they are going to need more resources to be able to do that.

Mr. DAMGARD. If the CFTC decides to take it all upon themselves and not delegate to the NFA, it is clearly going to take more resources.

Mr. MCGOVERN. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. Thank you.

Mrs. Ellmers from North Carolina 5 minutes.

Mrs. ELLMERS. Yes. Thank you. Thank you, Mr. Chairman.

For Mr. McMahon, how would you respond to claims that clearing and exchange trading is in the best interest of the end-users, because it prevents swap dealers from charging higher prices to engage in OTC transactions?

Mr. MCMAHON. As I mentioned a little bit earlier, we do use exchange and clear transactions on the gas side for about half of our transactions and about a third of our power transactions, and where it is possible it does make sense in some of our transactions. But in a lot of cases, because of the customized nature, particularly on the power side, and the fact that we are very creditworthy entities and we have a benefit because of that creditworthiness of not having to post margin and tie up that capital in such a way, it benefits our customers not to have to clear those transactions, and we don't get any real net risk reduction in the overall transaction because of not having to post margin.

So forced margining and forced clearing would have a huge negative impact on our industry and result in us having to tie up a lot of capital that we are using right now to enhance the grid to deploy cleaner technologies and do those things and put it into margin accounts, and we just do not see any benefit at all coming back to our customers. And a lot of our OTC swaps are done with longstanding relationships with people we have been trading with for a long time, so we don't really see any benefit to our customers for those swaps.

Mrs. ELLMERS. Thank you. So, in the end, basically, this is going to be more costly, more cumbersome for your particular customers?

Mr. MCMAHON. Yes. Any requirement along those lines would be. And, as I said, when it makes sense and the standardized swaps meet our needs, we use them. But for the ones that we don't, we just don't have that option.

Mrs. ELLMERS. And from a business standpoint, would you say that this then is going to be an increase in costs to you to do these transactions?

Mr. MCMAHON. Yes. I think that it comes down to if we are required to clear these transactions—and some of them are so customized that they probably couldn't be cleared. But if you assume that they could be cleared, it would be a significant increase in

costs to our companies; and, ultimately, that cost would either need to be borne by our customers or else we would need to probably do less hedging and pass that volatility to our customers, neither of which is a good option.

Mrs. ELLMERS. Thank you very much.

I yield back the remainder of my time.

The CHAIRMAN. The gentlelady yields back.

The Ranking Member, Mr. Boswell, for 5 minutes.

Mr. BOSWELL. Thank you.

Interesting discussion. I thank you for being here again.

Mr. Bullard, you talked quite a bit about the discovery process. Is it working? In the sense—and, Mr. Chairman, you join in if you want to, because we had some interesting side discussion here. But I have producers out there that have a couple, three feedlots of cattle and they want to sell them and they don't really know what the price is, at least up to date. I suggest if they went to the auction the day before they might know that. But I don't think that is good enough in today's deal. So I just wanted you to talk about that a little bit.

Mr. BULLARD. Price discovery in the cattle market is extremely difficult, and it is because there are so many various options with which to sell cattle. You have formula contracts, forward contracts. You have premiums. You have discounts. You have premiums for certain breeds. You have transportation premiums that are factored in.

And you have a cash market that has become so thin in the cattle industry where, in 2005, we had 52 percent of the volume of cattle were sold on the cash market. By 2010, that volume had shrunk to about 37 percent. In some markets like in Colorado, we are down below 20 percent.

So you now have a minority of the cattle that are sold in the cash market where the price discovery occurs; and then all of the other cattle, whether it be on a forward contract, a marketing agreement, the base price is all tied to that thin cash market that hasn't discovered the true market value of cattle.

The same is occurring in the futures market where you are now dominated not by the physical hedgers in the market but rather by speculators.

So we are having an extremely difficult time to ascertain what is the fair market value of cattle at any given point in time because of the complex nature of the industry and the thinning of the markets that have historically been used for price discovery.

Mr. BOSWELL. It brings to what you just said much better than I could have. That is my point. You made my point. It seems like we are just running as fast as we can go on the cattle side to see if we can get vertical integration to the point we don't have a cash market.

Mr. BULLARD. We have already seen that, Congressman, in the hog industry. The hog industry has essentially lost its cash market. And we saw a reduction in the number of hog producers fall over about 90 percent. We had 667,000 independent hog producers in the United States back in 1980. We now have about 67,000. We eliminated 90 percent of the producers. That means that the rural communities that were supported by these hog producers are now

no longer receiving the economic vitality that these producers brought, and that is why we are seeing a hollowing out in rural communities all across the U.S.

Mr. BOSWELL. Well, it has a lot to do with it. And one of the things we have heard here in this room over and over with the rural development, and as I see this happening where I come from and some of the other places I have traveled, I think you are hitting a very salient point. And I don't know what we can do about it.

Maybe somebody else would have some idea at the table there. But is this a concern or is this just something for a few of us? Is it a concern for others? Anybody?

Mr. DAMGARD. I was in the hog business in Illinois, and we had a marketing problem when they closed down Joliet. All the hogs were being sent down to North Carolina. So I just got out of the hog business and went straight to grain. Turns out it was pretty good idea.

Mr. BULLARD. Congressman, I would like to add, too, and that is exactly what is happening in the cattle industry. We can't let the cattle industry, which is the single largest segment of American agriculture, go the way of the hog industry. Illinois used to be one of the top hog-producing states in the nation. Back in 1980, it was among the top three states. And then the meat packers, having vertically controlled the industry, decided to uproot from the Midwest and move to North Carolina. Illinois got booted out of the status of having among the largest hog-producing states of the United States. And this is the result of lack of competition and anti-competitive practices that are occurring as a result of the dominance by the meat packers who are essentially unrestrained, unrestrained in the futures market and unrestrained in the cash market.

Mr. BOSWELL. Well, you are making a point that I am concerned about.

I don't know, Mr. Chairman, is there something that we can look at further down the road or whatever? But it seems like it is happening, and I have been worried over this now for a number of years, and it seems like the pace is keeping up. And I have seen that happen to the hog market, and we have heard some testimony just here now. And it seems like we are at a fast pace of it happening to the cattle market. So I guess we can talk some more on that. But I am concerned.

My time is up. I yield back.

The CHAIRMAN. Thank you, Mr. Boswell.

And I am not sure if you can blame it all on—things change. At some point in time, somebody built the latest, greatest, best buggy whip manufacturing facility known to man, and times change. I don't know how much a differential that is.

But back to the broader point, from a sequencing standpoint, if the CFTC does, in fact, roll out a swaps definition rule, which surely they have to do, and your comments from the folks about if they did the definitions first and rolled those out so that you then knew for sure you were either a major swap participant or the transactions you were doing were swaps or whatever, how much time would you need to turn around your comments back to the CFTC

to absorb what the new definitions are and then look at what the regulatory umbrella looks like once we understand what the definitions are? Is there a time step you can help us understand?

Mr. DAMGARD. I would say historically when rules are rolled out, we have taken an awful lot of time to implement them to make sure that it wasn't disruptive to the market.

And there is no set time table, depending on how complicated that rule might be. But I think discretion is the important thing to consider here. I mean, we really need to take our time and get it right. I have heard Mrs. Shapiro say that. I have heard Gary Gensler say that. And rushing these things through to meet these arbitrary deadlines, which are unreasonable, is not the way to go.

The CHAIRMAN. Other comments?

Mr. KASWELL. I think there are some things that we feel need to move more quickly than others, and I think I have mentioned that. But the sequencing on these definitions that you have addressed, Mr. Chairman, I think those are of great concern, and I think that would make the process move much more logically so that we come out to a set of rules that we all feel we can work with and play by.

The CHAIRMAN. Last week we had the Chairman in. He said he had all of the authority he needs. While he has a statutory limit of 360 days to get the rules finalized, he has extensive authority to pace the rollout and/or the implementation over a much longer period of time.

Do you all think he has that authority to do that implementation issue over a more reasonable approach than he has in terms of developing the rules themselves?

Mr. DAMGARD. There are issues of whether he has the authority to do a number of things.

For instance, position limits, in the legislation, he has the authority to put in position limits subject to the CFTC making a determination that somehow position limits were part of the problem. And they made no such effort to do that.

So my sense is that the last thing we want to do is attract a lot of lawsuits that would tie things up for much, much longer. I mean, Mr. Kaswell, mentioned the fact that for 70 years, segregation has been segregating the customer's money from the firm's money. And it worked very well. It has worked well for 70 years. To go a step beyond that may or may not be allowed without some sort of change either in the bankruptcy law or the Commodity Exchange Act and lawyers are going to argue about that one way or the other.

I would hate to see this being stalled 2 or 3 years while we wait for a legislative solution. And as a result, I think that the industry is looking for more time to figure out what these costs are going to mean, whether or not there are unintended consequences that we should worry about.

But yes, there will be legal challenges to some of these things based on what some of the lawyers have said to me.

Mr. KASWELL. I think on full segregation, I think there is pretty good clarity, with all due respect. But I think that—but again, on some of the definitions, the sequencing is very important.

The CHAIRMAN. All right. Comments from others?

Ms. SANEVICH. Well, I have two quick points to make.

It is really that certainly there will need to be some time after the rules are finalized to give everyone time to put processes in place to implement. I mean, there are lots of different aspects to it. But even in thinking through the rules as to who comments on what, I mean, that is an important sequencing aspect as well. No one knows what a swap may be or an MSP or, in our case, what the DOL is going to do. And so it is very hard to seek to wrap your head around everything that may or may not apply because you are not quite sure how it will affect you.

And importantly from the pension plans perspective, both as it relates to the DOL issue and others, uncertainty in the market as to whether we may be covered by this or not covered by that, or whether we are going to get hit with an anti-avoidance issue because our swaps are not—are customized and maybe they should have been cleared, those are huge issues. And any uncertainty in the market will significantly hamper a pension plan's ability and maybe others as well to engage in these kinds of instruments.

The CHAIRMAN. All right.

Mr. BULLARD. Mr. Chairman?

The CHAIRMAN. Yes.

Mr. BULLARD. From our perspective, we think the most important thing here is to bring transparency to the opaque markets, like the swaps and the over-the-counter trades. And so we think the priority for Mr. Gensler should be to implement those as quickly as possible, because it is one thing for an industry to change because of competitive forces; it is quite another for another industry to be fashioned because of the anti-competitive conduct that is occurring in the market and we don't know about it.

So we need transparency so the regulators can see with certainty what involvement the dominant participants are having in marketplaces that are as important to the cattle industry as is the cattle futures market.

The CHAIRMAN. Thank you.

Any Members have other questions?

Anybody else?

Well, I want to thank the panel.

One of the things that was said to Chairman Gensler last week was he put on the record the extensive work he and his team have done to reach out to you and your colleagues and any interested party in the deal, all of the participants, and the feedback he has gotten, the thousands of this and the hundreds of those and these kinds of things.

And what I asked him to do was—we have to propose rules. You have had all of this public help. I am hopeful that they will be able to look at the final rules and see meaningful improvements from the proposed rule to the final rule and that the funnel that is getting created by the tyranny of time by the hard date in the legislation doesn't in fact create some sort of a *de facto* fallback to the proposed rule because they run out of time and they just kind of roll that back.

So any insight that you can help us with that to see where we all listen but whether or not you change what you were going to do based on what I said is the bigger point.

So anybody else have a comment before we adjourn.

Okay. This is our first Subcommittee hearing. So we are a little disjointed.

Under the rules of the Committee, the record for today's hearing will remain open for 10 calendar days to receive additional material and supplementary written responses from the witnesses to any questions posed by a Member.

This hearing on the Subcommittee on General Farm Commodities and Risk Management is adjourned.

Thank you.

[Whereupon, at 3:28 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS; ON BEHALF OF HON. GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVES ASSOCIATION

Mr. Chairman, Ranking Member Boswell, and Members of the Subcommittee. Thank you for holding this hearing to address the role of over-the-counter (OTC) derivatives in helping electric cooperatives keep electric rates 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 cooperative systems, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering ¾ of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties. Our member cooperatives serve nearly 1.5 million member owners in Congressional Districts represented on this Subcommittee.

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

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

From the viewpoint of the rural electric cooperatives, the over-the-counter or "OTC" derivatives market can be boiled down to a single, simple concern that I know you have heard me articulate before: affordability.

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. 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 inputs. It is important to understand that electric co-ops are engaged in activities that are pure hedging, or 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 trades on the OTC market. Many of these trades are made through a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing, which 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 derivatives markets. This market is estimated at $600 trillion dollars. Our members have a miniscule fraction of that sum at stake and are simply looking for an affordable way to manage 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 will be passed on to the consumer, where they are 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 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." Unfortunately, however, after over 40 "swap" rulemakings to date, the CFTC has not yet explained what transactions it believes constitute swaps. NRECA is concerned that if the CFTC defines that term too broadly, it could bring under the CFTC's jurisdiction numerous 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 contracts between non-financial entities that have never been considered "derivatives" or employed for speculative purposes. They protect the reliability of the grid by ensuring that adequate generation resources will be available to meet the needs of consumers and do not impose any systemic risk to the financial system. Yet, if they were to be regulated by the CFTC as "swaps," it could impose enormous new costs on electric consumers and could undermine reliability of electric service if the costs forced utilities to abandon these long-term arrangements.

In the Dodd-Frank Act, Congress excluded from the definition of "swap" the "sale of a non-financial commodity . . . so long as the transaction is intended to be physically settled." NRECA asks Congress to insist that the CFTC read this language as it was intended to exclude from its regulation these kinds of contracts utilities use to meet the needs of 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, may choose to forgo the requirements to trade their swaps on regulated exchanges or to pay "margin" (collateral) on 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 contracts 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 the "working" 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 costs, abandon hedging, or dramatically raise rates to consumers to raise the capital. Of course, whatever choice co-ops made would lead to the same result: increased electric rates for cooperative members.

Reporting Requirements

Mr. Chairman, 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 Subcommittee 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, and 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 swap market and pose no systemic risk to that market, 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 non-public 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 municipal 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. 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

Mr. Chairman, at the end of the day, we are looking for a legitimate, transparent, predictable, and affordable device with which to hedge risk and volatility for our members. If we are to do that, the CFTC must define "swap" narrowly to exclude those pure hedging transactions the industry uses to preserve reliability and manage long-term power supply costs; must give meaning to Dodd-Frank's end-user exemption; must limit unnecessary 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 to provide affordable power to its consumers.

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

Thank you.

SUBMITTED LETTER BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS; ON BEHALF OF BILL DONALD, PRESIDENT, NATIONAL CATTLEMEN'S BEEF ASSOCIATION

February 15, 2011

Hon. K. MICHAEL CONAWAY,
Chairman,
Subcommittee on General Farm Commodities and Risk Management, House Committee on Agriculture,
Washington, D.C.

Dear Chairman Conaway:

As you prepare for today's Subcommittee hearing to review implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, I wanted to give you some perspective from the cattle industry. Futures markets originated with agricultural commodities as a way to establish value. For more than 100 years, these markets have provided a mechanism to discover value, and more importantly, have provided a tool to help cattle producers manage the inherent risk that comes with marketing cattle.

As the Subcommittee looks at the Act, it is important to ensure that implementation of the Act's provisions are done in a thorough and methodical fashion. Rushing to implement this Act could result in unintended consequences that could actually harm or hinder the marketplace. Cattle producers are already being harmed by the unintended consequences of other regulatory actions such as dust enforcement by the Environmental Protection Agency (EPA) and the proposed Grain Inspection Packers and Stockyards Administration's (GIPSA) marketing rule. We cannot afford to let another rulemaking further hamper our ability to stay in business.

Commodity markets work and have provided risk management tools benefiting U.S. producers. The commodity markets have not forced producers out of our industry. On the contrary, their risk management products have provided non-government program safety nets that have protected producers. Transparency and regulation of the market is needed, but not to the extent that it actually hampers trade and distorts the most efficient means of price discovery in agricultural markets.

We ask you to thoroughly review the regulatory actions taken by the Obama Administration to implement this Act in order to maintain our ability to use the commodity markets as a beneficial tool in managing ever increasing risks in agricultural marketing.

Sincerely,

BILL DONALD,
President.

SUBMITTED LETTER BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS; ON BEHALF OF NATIONAL CORN GROWERS ASSOCIATION AND NATURAL GAS SUPPLY ASSOCIATION

February 9, 2011

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture
Washington, D.C.

Subject: Dodd-Frank Wall Street Reform and Consumer Protection Act, Implementation of Swap Dealer Definition

Dear Chairman Lucas and Ranking Member Peterson:

The Commodity Futures Trading Commission's (CFTC) implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) is critical to maintaining the economic protections provided by the Dodd-Frank Act to end-users.

The National Corn Growers Association (NCGA) and the Natural Gas Supply Association (NGSA) were active participants in the shaping of the Act during its passage and are taking an active role in the Act's successful implementation through participation in the CFTC's rulemaking process.

Financial reform must not come at the expense of America's energy and commodity producers, consumers, and ultimately, the entire U.S. economy. Absent careful CFTC implementation of the swap dealer definition, the practical effect of the Dodd-Frank Act could be mandatory clearing for many commercial end users. Imposing a clearing requirement on commercial end-users does not further the goal of ensuring financial system integrity, and instead, centralizes risk that would have otherwise been diversified, *increasing* systemic risk and unnecessarily removing productive capital from the economy.

Mandatory clearing of derivatives transactions will drain the economy of more than $650 billion* in capital. Keeping U.S. industry's capital at work in a recovering economy through the sound implementation of the end user protections in the Dodd-Frank Act will help create jobs, energy and products for U.S. consumers without compromising the integrity of the U.S. financial system.

A primary purpose of CFTC regulation of the "over-the-counter" (OTC) markets is to protect consumers from systemic risk. The CFTC's definition of Swap Dealer should balance the goals of protecting consumers from systemic risk and ensuring no unnecessary harm to the economy. Thus, the CFTC must carefully scope the definition of Swap Dealer because an unnecessarily broad definition will sweep in end-users, limiting one of the key protections for the economy incorporated into the Dodd-Frank Act.

In November 2010, NCGA and NGSA offered the following pre-proposal comments to the CFTC, outlining what we believe is a workable solution to the implementation of the swap dealer definition. NCGA and NGSA intend to provide further comments to the CFTC on this issue later this month but believe that the approach to the definition of Swap Dealer might be also be helpful in your review of the implementation of Title VII of the Dodd-Frank Act later this week.

Trading in Swaps Should Not Make a Company a Swap Dealer. The CFTC should implement the Swap Dealer definition by ensuring that both the law's general exception and the *de minimis* exception are properly applied. The general exception applies to entities entering into swaps for their own account (*e.g.,* traders). The *de minimis* exception allows for the exclusion from a Swap Dealer designation of entities that engage in a *de minimis* quantity of swap transactions "with or on behalf of" their customers. These two exceptions are essential because they allow entities that use swaps to hedge or mitigate commercial risks, such as those risks that stem from the production of energy and agricultural commodities, to avoid being designated as Swap Dealers, a designation that would preclude eligibility for the end-user clearing exception. Entities designated as Swap Dealers would be required to transact their swaps on an exchange or to clear such transactions, subjecting them to costly margin and clearing expenses and draining the economy of billions of working capital dollars.

The CFTC Should Use the Concept of "Intermediation" to Define Swap Dealer. To achieve Congressional goals, the CFTC should use a two-step process based on the Securities Exchange Act and the concept of intermediation (transacting to satisfy a customer order or, simply put, acting on behalf of a customer) to first

*Estimate based on the U.S. portion of global credit exposure that is not already collateralized. Data sources include the Bank for International Settlements, Monetary and Economic Department OTC Derivatives Market Activity Report, "Cross-border derivatives exposures: how global are derivatives markets?" by Sally Davies of the Division of International Finance, Board of Governors of the Federal Reserve System, and Country Exposure Report that shows U.S. banks' exposure from derivatives. For the detailed calculation methodology, please contact the Natural Gas Supply Association at [**Redacted**].

implement the general exception and then implement the *de minimis* exception in the Swap Dealer definition. The Securities and Exchange Commission (SEC) precedent † on the designation of a dealer provides a comprehensive way to distinguish trading from dealing. Central to the SEC case law that distinguishes "dealing" from "trading" is the concept of intermediation. To implement the two exceptions, the CFTC should use the concept of intermediation as the basis for filtering dealers from traders, many of whom use swaps to hedge business risk. This approach will ensure that financial entities engaging in swaps with or on behalf of customers remain in the regulatory purview of the CFTC without diminishing the integrity of the end-user clearing exception.

Step one: Use the SEC model for distinguishing between "dealers" and "traders" to implement the general exception. Built into the Swap Dealer definition is a general exception excluding "persons that enter into swaps for that person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business"—from designation as a Swap Dealer. Put another way, the general exclusion establishes that only an entity trading swaps that are not for its own account (*e.g.,* done in an intermediary capacity) is a Swap Dealer. In securities markets, the SEC and the courts have identified a number of characteristics for dealing activity. While the securities market activities do not translate precisely to the commodity swaps market, the concept of "intermediation" does translate. (See inset below.) The concept of intermediation can be used to implement the general exception as the starting point for sorting dealers from traders so that the integrity of the economic protection provided by the general exclusion can be maintained.

Step two: Implement the *de minimis* exclusion by considering the level of "dealing" transactions relative to total swap transaction activities. An entity would not qualify for the general exception if it both trades and deals. While not universal, many commercial entities with

Securities Market *Intermediation* Concept Translates to Commodity Swaps Market Swap Dealer Characteristics

- performing an intermediary role in swaps markets by engaging in swap transactions with customers;
- remaining essentially neutral to price movements with respect to the swap and underlying commodity;
- quoting a two-sided market for swaps and standing ready to take the opposite side of customer orders; and
- providing financially-related, ancillary dealer activities (*e.g.,* advising on investments).

astute trading capabilities also enter into transactions with their traditional customers that may ultimately resemble dealing. Often this "dealing" is the result of the customer's interest in transacting financial hedges with a counterparty that has physical assets and a history in bringing physical product to market. This is where the *de minimis* exception plays a critical role. For entities that trade swaps and engage in this limited form of dealing, the CFTC should design the *de minimis* exception so that the level of dealing (defined by using the concept of intermediation as reflected in the SEC regulations) is compared to their total swap transactions (*e.g.,* trading and dealing). If the level of dealing relative to the total is small, in other words, if the entity primarily trades swaps, the *de minimis* exception is satisfied.

The right Swap Dealer approach works for consumers and the economy. Using the concept of intermediation to implement the general and *de minimis* exceptions will allow the CFTC to sort true swap dealers from those entities that trade swaps to hedge commercial business risk. This approach is consistent with existing case law and the Congressional goal of avoiding unnecessary harm to the economy. Finally, the solution provides the CFTC with a practical and valid way to regulate Swap Dealers that buy and sell swaps to satisfy customer orders, without the harm to the economy that would result from avoidable and unnecessary increases in business risk management costs. Appropriate implementation of the Swap Dealer defini-

† Vol. 15, Broker-Dealer Regulation, David A. Lipton, Section 1:6 at 1–42. 11, n. 4.

tion is essential to maintaining the integrity of the end-user protection provisions that were central to the passage of the Dodd-Frank Act.

Founded in 1957, NCGA is the largest trade organization in the United States representing 35,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 48 affiliated state associations and checkoff organizations work together to create and increase opportunities for their members and their industry. Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States.

Please do not hesitate to contact Sam Willett, Senior Director of Public Policy for NCGA at [**Redacted**] or Jenny Fordham, Vice President, Markets for NGSA at [**Redacted**], if we can provide any additional information. Thank you for your review of the implementation of title VII of the Dodd-Frank Act.

Sincerely,

National Corn Growers Association;
Natural Gas Supply Association.

SUBMITTED QUESTIONS

Questions Submitted by Hon. Collin C. Peterson, a Representative in Congress from Minnesota

Response from John M. Damgard, President, Futures Industry Association

Question 1. CFTC Commissioner Dunn, in various public comments, appears to be making the argument that the CFTC's budgetary uncertainly could lead the agency to put forth a rules-based regulatory regime as opposed to a principles-base regime. Do any of you agree with his comments?

Answer. We respectfully disagree with Commissioner Dunn. With the enactment of the Commodity Futures Modernization Act of 2000 (CFMA), which replaced the overly prescriptive regulatory structure that previously had so restricted the conduct of designated contract markets (DCMs) and derivatives clearing organizations (DCOs) with the core principles, Congress confirmed that the CFTC's appropriate role is as an oversight agency, with direct supervisory responsibility exercised by the several self-regulatory organizations, NFA and the DCMs.

The CFMA facilitated a period of unprecedented growth and innovation in the futures industry, without requiring any significant increase in CFTC staff. A rules-based regulatory regime, on the other hand will require additional staff, as staff would be required to review and approve virtually all DCM and DCO proposed rules to assure that they fall within the four corners of the CFTC-prescribed rules. A rules-based regulatory regime will also stifle innovation, which is essential to promote competition in the market for cleared swaps, which is in its initial stages. The CFTC's proposed rules are already highly prescriptive and are based primarily on current market practices. DCMs and DCOs will not be able to respond to changes in the international market in a timely manner in a rules-based regulatory regime.

Question 2. Your testimony states that FIA has presented an alternative ownership and control rule which would achieve the same purposes as the CFTC's proposed rules at less cost. Can you explain your proposal in more detail and tell us your estimate of the cost differences?

Answer. A copy of our comment letter on the CFTC's proposal, which describes our alternative in detail, is attached for your review. As explained in the appendix to the letter, we estimate that, compared with the CFTC's proposal, the FIA alternative would result in an average first-year cost savings of approximately $18.8 million. As described in the charts at the end of the appendix, the first year costs of the CFTC's proposal is four times greater than the median costs incurred by FCMs under the FIA alternative.

We recently met with the CFTC staff on this proposal and responded to questions they had.

Question 3. Your testimony mentions the CFTC should delegate some responsibilities to the National Futures Association, a self-regulatory organization that already performs several oversight functions for the CFTC. What responsibilities do you believe should be delegated to the NFA and which ones should the CFTC retain?

Answer. As described above, we believe the CFTC should be an oversight agency, with primary responsibility for supervising CFTC registrants vested in NFA and the exchanges. Chairman Gensler has already announced that NFA will process registration applications for swap dealers and major swap participants. Since NFA cur-

rently processes all other CFTC registration applications, this is not only appropriate, but necessary. It is not clear that the CFTC has the necessary infrastructure any longer to process applications.

Primary responsibility for the oversight of FCMs and other intermediaries is currently allocated among NFA and the exchanges in accordance with the Joint Audit Plan. There is no reason why these SROs could not perform the same activities with respect to swap dealers. Our understanding, however, is that the CFTC has only recently begun to talk with NFA about the role NFA can play in implementing the regulatory program for swaps.

NFA should also be responsible for developing and enforcing rules regarding the obligations of chief compliance officers of registrants and, more generally, business conduct rules governing swap dealers, major swap participants and other CFTC registrants. As we noted in our comment letter, FINRA has this responsibility on the securities side, and the CFTC proposal conflicts in several significant ways with the FINRA rules. Since most FCMs are also registered with the SEC as broker-dealers and are FINRA members (and we expect that most swap dealers will also be security-based swap dealers), it is critical that these firms not be subject to conflicting business conduct and other rules.

SROs also have enforcement authority and should have primary responsibility for taking enforcement action against members that violate SRO rules. These rules also require their members to comply with applicable provisions of the Commodity Exchange Act and CFTC regulations. Of course, the CFTC also has an important role to play in enforcing the CEA. However, the CFTC has recently begun to take over enforcement investigations which had been initiated against market participants by an exchange and which could properly have been resolved there. This results in a duplication of effort and an unnecessary demand on CFTC enforcement staff resources. (It may also significantly increase costs on respondents.)

Question 4. In mentioning that the CFTC should delegate some responsibilities to the National Futures Association, you state that the NFA is funded entirely by its participants. Given that the CFTC is not funded directly by the participants in the markets it oversees, but by taxpayers, wouldn't direct NFA oversight place a greater cost on the industry than direct CFTC oversight?

Answer. The industry does not object to paying fees to support the regulatory activities of NFA, because the industry believes it is appropriate to share the cost of assuring market integrity. The current regulatory regime strikes the appropriate balance, with the industry assuming responsibility for direct supervision of market participants, and taxpayers assuming responsibility for oversight of NFA, DCMs and DCOs.

ATTACHMENT

By Electronic Mail *Revised*

December 23, 2010

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

Re: Account Ownership and Control Report, 75 *Fed. Reg.* 41775 (July 19, 2010)

Dear Mr. Stawick:

This letter supplements and replaces the October 7, 2010 letter that the Futures Industry Association ("FIA")[1] filed in response to the Commodity Futures Trading Commission's ("Commission's") request for comment on its proposed rules requiring designated contract markets and other "reporting entities," as defined in the proposed rules,[2] to submit certain ownership and control reports ("OCR") to the Com-

[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. Among FIA's associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[2] A "reporting entity" is defined as "any registered entity required to provide the Commission with trade data on a regular basis, where such data is used for the Commission's trade practice or market surveillance programs." Reporting entities include, but are not limited to, designated contract markets and exempt commercial markets with significant price discovery contracts. Proposed Commission Rule 16.03(a). In addition, the Commission anticipates that it would also

mission weekly ("OCR Rules"). The OCR Rules would require each reporting entity to provide the Commission detailed information, consisting of approximately 28 separate data points, with respect to each account reported in its trade register. "The OCR will necessitate each reporting entity to collate and correlate these and other data points into a single record for trading accounts active on its trading facility, and to transmit such record to the Commission for regulatory purposes."[3]

As the Commission further explains in the *Federal Register* release accompanying the proposed OCR Rules:

> The OCR will serve as an ownership, control, and relationship directory for every trading account number reported to the Commission through reporting entities' trade registers. The data points proposed for the OCR have been specifically selected to achieve four Commission objectives. These include: (1) identifying all accounts that are under common ownership or control at a single reporting entity; (2) identifying all accounts that are under common ownership or control at multiple reporting entities; (3) identifying all trading accounts whose owners or controllers are also included in the Commission's large trader reporting program (including Forms 40 and 102); and (4) identifying the entities to which the Commission should have recourse if additional information is required, including the trading account's executing firm and clearing firm, and the name(s) of the firm(s) providing OCR information for the trading account.[4]

Broadly, the Commission asserts that the information collected will: (i) enhance market transparency; (ii) increase the Commission's trade practice and market surveillance capabilities; (iii) leverage existing market surveillance systems and data; and (iv) facilitate the Commission's enforcement and research programs.

Although reporting entities would be responsible for submitting the OCR, the Commission acknowledges that these entities do not currently collect a significant amount of this information. The "root sources" for much of the information required rests instead with others. As discussed below, clearing member FCMs will be the primary source of this information. They, in turn, will be required to rely on their customers to provide, and keep current, the required information.[5]

In our October 7, 2010 letter, we advised the Commission that, to assure that both the feasibility of the proposed OCR Rules and their potential impact on the industry were properly assessed, FIA had formed an OCR Working Group, comprised of individuals with significant experience in operations from (i) 16 FCMs, both large and small, with both retail and institutional customers, (ii) the several U.S. exchanges, (iii) the principal back office service providers, and (iv) other experts.[6] The group carefully analyzed each of the data points to be collected under the OCR Rules and identified: (1) the required data that is currently collected; (3) the required data that is not collected; and (3) the required data that would be difficult, if not impossible, to collect. The group then estimated the cost of implementing and maintaining the proposed database.

After fully analyzing the Commission's proposal, the OCR Working Group concluded that the financial and operations burdens imposed by the OCR Rules would be overwhelming. In addition, the OCR Rules would force an unwarranted struc-

---

collect ownership and control information from swap execution facilities and foreign boards of trade operating in the U.S. pursuant to staff direct access no-action letters, provided such letters are conditioned on the regular reporting of trade data to the Commission. FIA is concerned that efforts to extend the OCR Rules to foreign boards of trade may conflict with the laws and regulations of the jurisdiction of that board of trade. Significantly, the definition does not contemplate that FCMs would be designated as "reporting entities."

[3] 75 *Fed. Reg.* 41775, 41776, fn. 1 (July 19, 2010).

[4] 75 *Fed. Reg.* 41775, 41783 (July 19, 2010).

[5] In the *Federal Register* release accompanying the OCR Rules, the Commission implies that it would expect a reporting entity to prohibit members from trading on or through the entity, unless the member complies with any applicable reporting requirements the reporting entity may impose: "Successful implementation of the OCR will require reporting entities to offer their services only on the condition that ownership and control information be provided upon request by the relevant party in possession of such information." *Id.* at 41785. Presumably, member FCMs, in turn, would be prohibited from carrying accounts on behalf of customers that fail to provide, and keep current, the information required with respect to each account. As discussed below, FCMs must rely almost entirely on customers to provide and keep current, information with respect to data such as: (i) beneficial owners; (ii) account controllers; (iii) dates of birth; (iv) primary residence addresses; and (v) date accounts are assigned to current controllers. Although FCMs can advise customers of the information required and contract with their customers to provide such information, FCMs cannot be placed in the position of being guarantors of the information that their customers provide, or fail to provide.

[6] Several members of the group participated in the Commission's September 16, 2010 roundtable on the proposed OCR Rules.

tural change in the conduct of business among U.S. futures markets participants, especially among clearing member and nonclearing member FCMs, foreign brokers, and their respective customers. In particular, the proposed requirement that clearing member FCMs know and report to the relevant clearing organization the identity of each customer that comprises an omnibus account and their respective positions will disrupt, if not destroy, the regulatory and operational synergies among market participants that have developed over decades and are essential to the efficient operation of the markets.

Equally important, the OCR Rules would impose on such FCMs substantial increased regulatory and concomitant financial obligations. As a result, a number of FCMs could be compelled to withdraw from registration and the barrier to entry for potential new registrants will be raised. In addition, a significant number of foreign customers will effectively be denied access to U.S. markets.

Consequently, we advised the Commission that we cannot support the adoption of the OCR Rules as currently proposed. We further advised the Commission, however, that the OCR Working Group was working on an OCR alternative that we would submit to the Commission for its review.

Since the proposed OCR Rules were published in July, and since we undertook to submit an OCR alternative, the regulatory landscape has shifted dramatically. The Commission has published (or shortly will publish) for comment a myriad of proposed rulemakings that, collectively, contemplate a complete overhaul of the recordkeeping and reporting requirements to which FCMs, U.S. exchanges and clearing organizations are subject. These proposals include: (i) the advance notice of proposed rulemaking regarding the protection of cleared swaps customers before and after commodity broker bankruptcies; (ii) core principles and other requirements for designated contract markets; (iii) risk management requirements for derivatives clearing organizations; (iv) information management requirements for derivatives clearing organizations; (v) position limits for derivatives; (vi) core principles and other requirements for swap execution facilities; and (vii) swap data recordkeeping and reporting requirements.

We respectfully submit that these various rulemakings cannot be considered in isolation. All of the pending recordkeeping and reporting requirements, and the estimated costs and benefits of each, must be analyzed and evaluated collectively, not individually. In the absence of such a coordinated analysis, it is impossible to determine whether the pending rules, including the OCR Rules and alternative set out herein, are complementary or conflicting. Neither is it possible to calculate the aggregate financial and operational burdens these various proposals will have on the industry.[7]

In order to assure an efficient and competitive futures industry, it is essential that the financial and operational burdens imposed by a revised recordkeeping and reporting system are necessary and proportionate to benefits realized. In this regard, therefore, we are prepared to expand both the charter and the composition of the OCR Working Group to undertake the necessary analysis. We encourage the participation of the Commission staff in any manner the Commission deems appropriate.

In light of the foregoing, the OCR alternative included herein at *Appendix A* and *Appendix B* should not be viewed as an industry-approved alternative, but solely as a basis for further discussions among the Commission, the futures industry and other interested parties. Consistent with the Commission's request, the estimated costs of implementing this OCR alternative are also set out in *Appendix A.* Although these costs are significantly less than the estimated costs of implementing the OCR Rules, they are substantial nonetheless (even without taking into account the other rule proposals summarized above) and emphasize the importance of analyzing the Commission's proposed recordkeeping and reporting requirements as integrated parts of a single unit rather than distinct requirements.

For the convenience of the Commission, set out below, with certain non-substantive revisions, is the body of our October 7, 2010 letter on the OCR Rules.

The OCR Rules Would Impose Substantial Costs on FCMs

Because the OCR Rules would require FCMs to collect and report a substantial amount of information that either is not collected in the manner the Commission may anticipate or is not collected at all, the proposed rules would require a complete redesign of the procedures, processes and systems pursuant to which FCMs create and maintain records with respect to their customers and customer transactions.

[7] Among other burdens, these various proposal, if promulgated, are likely to severely strain the resources of FCMs' information technology staffs as well as the staffs of the principal back-office software vendors.

Such redesign would take far longer and be far more expensive than the Commission suggested in the *Federal Register* release accompanying the proposed rules.

In this latter regard, we respectfully submit that the Commission erred in basing its cost analysis under the Paperwork Reduction Act only on anticipated costs to be incurred by registered entities.[8] FCMs are the root source of approximately ½ of the data points the Commission is proposing to collect. The cost to FCMs of building an OCR database, collecting the required information and transmitting it to the relevant exchange will be substantially greater than the Commission's estimate of the costs that will be incurred by the exchanges alone. Such costs will be particularly burdensome on smaller FCMs, which frequently carry a proportionately higher number of accounts, comprised of non-institutional hedgers and individual traders.[9]

We are concerned that the cost of opening and maintaining these smaller accounts in compliance with the OCR Rules may result in certain FCMs withdrawing from registration, raising the bar to entry, and denying certain customers, including certain non-institutional hedgers, access to the futures markets. To obtain and maintain the required information, an FCM would be required to: (i) re-negotiate all active customer agreements to require customers to provide and routinely update the necessary data points; (ii) build systems to enter the data; (iii) manually enter the data for each active account; (iv) put in place resources and processes to maintain the data; (v) provide it to the reporting entity on a weekly basis; and (vi) monitor changes daily in order to update the database.

FIA received cost estimates for building and maintaining an OCR database from 12 FIA member firms. The cost analysis included:

- operational costs, such as notifying beneficial owners and account controllers, collecting and recording data;
- technology costs of building databases, developing user interfaces, storing additional data, and developing a transmission mechanism; and
- legal costs of client notification, and re-executing client agreements.

These cost estimates do not include rebuilding systems/processes to manage account numbers, including vendor costs, which will be passed on to each FCM. They also do not include the cost of tracking beneficial owner and account controller information through the omnibus chain.

Our sample of 12 firms represents approximately 16 percent of the approximately 70 FCMs that execute and clear customer accounts. These firms handle in excess of $83.8 billion of customer funds, or approximately 62 percent of customers' segregated funds (as of July 31, 2010, according to monthly financial reports filed with the Commission). We found that the median firm would face total costs of roughly $18.8 million per firm, including implementation costs of roughly $13.4 million, and ongoing costs of $2.6 million annually. On a per account basis, the median cost would be $623 per account.[10]

FCMs' CFTC Proposed Rule Cost Estimates [1]

	Affected Accounts	Start-up	Ongoing	Total Start-up and Ongoing/First-Year Costs	First-Year Costs Per Account
Firm A	90,000	$49,280,000	$6,768,844	$56,048,844	$623
Firm B	75,300	$13,395,600	$2,625,500	$16,021,100	$213
Firm C	50,000	$28,000,000	$3,000,000	$31,000,000	$620
Firm D [2]	39,979	N/A	N/A	$18,208,863	$455
Firm E	34,700	$22,000,000	$3,750,000	$25,750,000	$742
Firm F [3]	30,000	$10,000–$35,000	$540,000	$560,000–$575,000	N/A
Firm G	19,473	N/A	N/A	$50,000,000	$2,568
Firm H	14,000	N/A	N/A	$21,525,000	$1,538
Firm I	250	$50,000+	$150,000+	$200,000+	$800+
Firm J*	130,000	$2,000,000–$2,500,000	$200,000	$2,200,000–$2,700,000	$19
Firm K*	40,000	$2,900,000	$280,000	$3,180,000	$80

[8] We take no view on the analysis presented in the *Federal Register* release of the costs to be incurred by exchanges. We anticipate that the designated contract markets will submit comments in this regard.

[9] Implementation of the OCR Rules would also place smaller exchanges and potential new exchange entrants at a significant disadvantage.

[10] We understand that the Commission requested that cost data be presented with respect to specific firms and not on an aggregate basis. However, because this cost data constitutes confidential business information, the firms that provided the data have not been identified by name.

FCMs' CFTC Proposed Rule Cost Estimates [1]—Continued

	Affected Accounts	Start-up	Ongoing	Total Start-up and Ongoing/First-Year Costs	First-Year Costs Per Account
Firm L*	550	$3,600,000	$1,150,000	$4,750,000	$8,636

Notes:

[1] The 12 firms in the sample handle in excess of $83.8 billion, or almost 62% of customers' segregated funds (as of July 31, 2010, according to monthly financial reports filed with the CFTC).

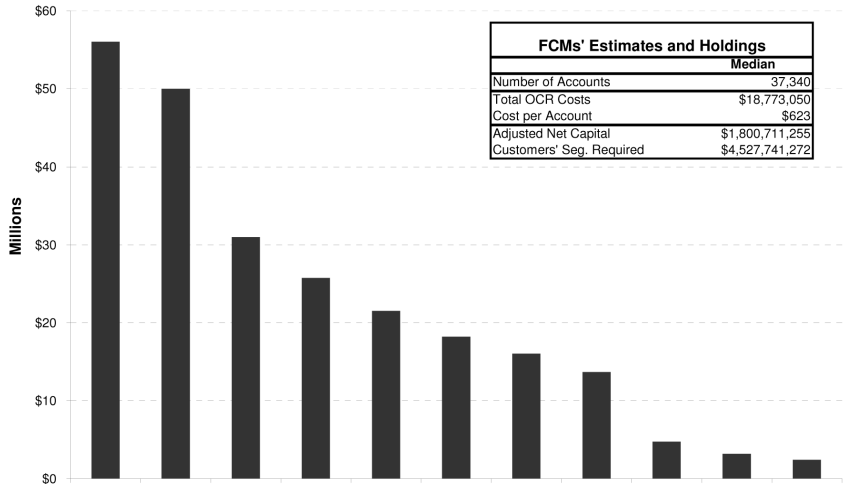
[2] Total cost estimate is based on estimate for affected accounts and average cost per account.

[3] Firm's estimates exclude IT costs.

* Firm did not provide cost estimates for the Industry Solution.

Cost Analysis

FCMs' CFTC Proposed Rule Cost Estimates



Notes and Sources: Data from estimates provided to the FIA by 12 FCMs. Not every FCM provided an estimate for each field. Adjusted net capital and customers' segregated funds data are from monthly financial reports filed with the CFTC for the period ended July 31, 2010. Total customers' segregated funds for this period for all reporting FCMs was $136.5 billion.

Based on the foregoing, we submit that the cost of building and maintaining a database to comply with the OCR Rules is overly burdensome for FCMs and some reporting entities. This is particularly true, since FIA found that the size of the FCM had little to do with the projected costs. As noted earlier, smaller FCMs may have a large number of retail accounts, *i.e.,* non-institutional hedgers and individual traders. Taking into consideration today's extremely low commission rates, it could take years for firms to recoup the cost of OCR implementation and maintenance. Most firms will certainly elect to pass on those costs to end-users. FCMs may avoid smaller accounts altogether, since the commissions earned would be far less than the cost of establishing and maintaining the account.

In addition, although the costs for a reporting entity may not seem significant for the larger, well-established exchanges, they are significant for the smaller exchanges and other entities such as swap execution facilities that the Commission has indicated may be required to be reporting entities. At a time when legislators and regulators are trying to encourage transparent execution venues and centralized clearing, the scope of the OCR seems counterproductive.

The Commission and the Industry Must Work Together

Notwithstanding the foregoing, and as noted earlier, FIA supports the Commission's goals. We are committed to working with the Commission and the other futures market participants to develop a meaningful alternative to the proposed OCR

Rules. To this end, FIA is submitting herein for the Commission's review an alternative proposal that has been developed by FIA's OCR Working Group.[11]

The alternative seeks to maximize the use of existing data; automate and enhance the current, largely manual, large trader reporting system;[12] provide the Commission with an efficient means of monitoring trading behavior based on volume thresholds; and linking ownership data to the trade registers. The large trader reporting system already provides the Commission the ability to aggregate certain customer activities across clearing firms. In addition to automating the large trader system, the OCR Working Group's alternative would enhance this system, in part, by extending reporting requirements to traders that engage in a certain volume of transactions without regard to their open positions. As under the proposed rules, the Commission would remain responsible for linking accounts across exchanges and FCMs.

The OCR alternative would achieve the essential regulatory purposes underlying the proposed OCR Rules, while reducing the regulatory, operational and financial costs that would be imposed by the OCR Rules.[13] Importantly, these costs would be distributed more fairly across the industry, thereby easing the potentially adverse competitive impact of the OCR Rules.

The alternative represents our best collective efforts to date. However, we must emphasize here, as we did at the staff roundtable on September 16, the importance of Commission participation in this project. We submit that nothing is gained by the Commission and the industry working on parallel yet separate tracks. Without the active participation of Commission staff, the industry runs the considerable risk of expending substantial time and resources developing an alternative that the Commission will ultimately conclude does not achieve its goals. FIA, therefore, encourages the Commission to authorize the staff to meet with industry representatives (and other participants as the Commission may select) to develop a mutually acceptable alternative to the OCR Rules or, at the very least, to provide necessary feedback to the industry's initiative.[14]

Proposed Data Points

The balance of this letter will first discuss each of the data points that the proposed OCR Rules would require FCMs and reporting entities to collect and maintain. We will describe (i) the data that is currently collected, (ii) the data that is not currently collected, and (iii) the data that the OCR Working Group has concluded would be difficult, if not impossible, to collect.[15] We conclude with a discussion of the tremendous structural changes the OCR Rules would impose.

In general. Because FCMs, not reporting entities, establish and maintain the customer relationship, much of the information that would be required to be collected and reported under the OCR Rules would be collected in the first instance by FCMs. Of the approximately 28 data points listed in OCR Rules, FCMs are the root source for 10–12.

Exhibit A, set out on the following page, identifies the data points that the Commission is proposing to be collected and reported in the OCR for which FCMs would be the root source. The exhibit identifies the data points that currently: (i) are captured electronically; (ii) are captured in hard copy; and (iii) are not captured at all. To the extent these data points are currently captured, they reside in a variety of

---

[11] As discussed above, the OCR Working Group that FIA formed includes (i) 16 FCMs, both large and small, representing retail and institutional customers, (ii) exchanges, (iii) back office service providers and (iv) other experts.

[12] Currently, once an account becomes reportable, the carrying FCM assigns it a "special account number" and submits ownership and control data to the Commission and the exchanges on Commission Form 102. This form is submitted by facsimile or e-mail, and the Commission staff then enters the information into its systems. (We understand that some exchanges, but not all, enter this information into an exchange database.) At the request of the Commission, a customer may be required to file a separate report effectively confirming and supplementing the information provided on the Form 102. This Statement of Reporting Trader, Commission Form 40, is also filed with the Commission by facsimile or e-mail. The carrying FCM frequently does not receive a copy of the Form 40.

[13] To the extent the OCR Working Group alternative would not provide the Commission the full scope of information contemplated under the proposed OCR Rules, the Commission would be able to use its special call authority to obtain such information.

[14] FIA has no objection to opening these meetings to the public, if the Commission were to determine that it would be necessary or appropriate to do so.

[15] The information with respect to the proposed data points is based in substantial part on information that was provided to FIA by 13 of its member FCMs. In the aggregate, these FCMs carry approximately 530,000 accounts. As noted earlier, the number of accounts carried by an FCM is not necessarily proportional to the FCM's size, *i.e.,* its adjusted net capital. Several smaller FCMs carry significantly more accounts on behalf of noninstitutional hedgers and individual traders.

systems and formats. Importantly, no system consolidates this information in a single location, where it can be easily reported to an exchange. Rather, FCMs use mapping tables and a variety of reconciliation tools to manage the accounts they carry or for which they act as an executing broker.

In order to collect the information as proposed in the OCR Rules, therefore, an FCM would have to overhaul completely its existing procedures, processes and systems. As noted earlier, an FCM would be required to: (i) re-negotiate all active client agreements to require a customer to provide and routinely update the necessary data points; (ii) build systems to enter the data; (iii) manually enter the data for each active account; (iv) put in place resources and processes to maintain the data; (v) provide it to the reporting entity on a weekly basis; and (vi) monitor changes daily in order to update the database.

Exhibit A

Proposed OCR Data Elements

Proposed OCR Data elements			Front Office					Back office	
			Client documents	Form 102	Form 40	Order routing platform	Exchange Trading platform	Other internal IT systems	3rd Party Vendors
1.	Trading Account #		X	X		X	X	X	X
2.	i. Trading account's ultimate beneficial owner who is a natural person	a. First and last name	X	X					X
		b. Middle name							
		c. Date of birth							
		d. Address of primary residence	X	X	X			X	X
	ii. Trading account's ultimate beneficial owner who is NOT a natural person	a. Name and primary business address	X	X	X			X	X
		b. NFA identification (if any							
3.	i. Trading account controllers (must be natural persons)	a. First and last name	X	X	X				
		b. Middle name							
		c. Date of birth							
		d. Name and primary business address of the entity that employs each controller	X	X	X				
		e. NFA ID							
4.	Date on which trading account assigned to current controller								
5.	Designation of trading account used exclusively or partially by a natural trading system								
6.	Special account number associated with trading account		X				X	X	
7.	Indicator whether trading account is part of a reportable account under the Commission's large trader reporting system		X				X	X	
	For a trading account that becomes part of a reportable account under the large trader reporting system after 12/31/2011, the date on which the trading account first becomes part of a reportable account								
8.	Omnibus account indicator and if so, name of firm		X				X	X	
9.	Name of the executing firm for the trading account and its unique ID reported in the reporting entity's trade register						X	X	
10.	Name of the clearing firm for the trading account and its unique ID reported in the reporting entity's trade register		X		X	X	X	X	
11.	Name of each root data source providing the reporting entity with information with respect to the trading								
	account								
12.	Name of the reporting entity submitting the OCR to the Commission		X						
13.	OCR transmission date		X	X			X	X	

Data Captured In Hardcopy

Data Captured Electronically

Data Not Captured

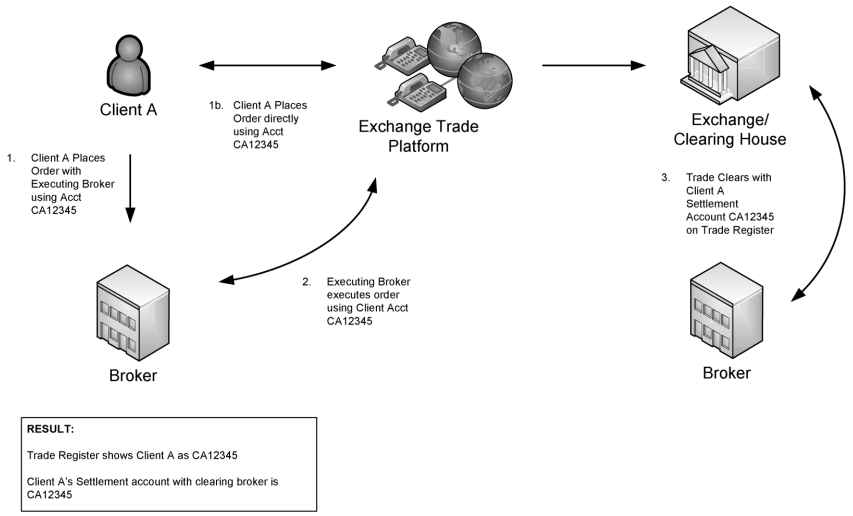
We now turn to a discussion of the various data points identified in the OCR Rules. As indicated above, we will identify those data points that currently are not collected and would be particularly difficult to obtain.

Account numbers. Account numbers are the key to identifying trading activity but present significant challenges in tying account ownership and control information to the trade register, as proposed in the OCR Rules. Account numbers assigned by FCMs when the account is opened are not standardized across the industry. The field that carries account numbers varies from system to system, firm to firm and exchange to exchange. Some fields allow six characters; others allow nine characters. Some justify left; others justify right. Some recognize spaces; others do not.

In addition, a customer may have multiple account numbers, representing various trading strategies, funds, or traders. For example, FIA understands that one major fund manager has 1,500 account numbers at a single FCM. Further, certain customers may have their own account numbers, which they provide to their carrying FCM. The FCM assigns an account number that follows the FCM's account number conventions, which it then maps to the customer provided account number.

Critically, the account numbers reflected in the trade register will not always match the account numbers assigned by the carrying FCM. Among other reasons, these differences arise from the use of: (i) give-up transactions; (ii) short codes; and (iii) average pricing. Give-up transactions and average price transactions, for example, are often allocated to suspense accounts using short codes, pending completion of the trade and allocation among the receiving customers and carrying FCMs.[16] FCMs use mapping tables and reconciliation tools extensively to manage account numbers.

In many cases, of course, the ownership information can be tied to the trade register through the account number (*Diagram 1*). "Trade Order Routing Flow" shows at a high level how orders are initiated from a customer or trader, either directly or through an executing broker, and are processed through the various systems in the trade management chain of systems. An account identifier is used by the executing firm and clearing firm to identify the customer account associated with the individual trades/positions. The account identifier is entered into trade management systems by the customer or traders (directly), or by the executing broker trading on behalf of the customer. The account identifier is captured in trade management interfaces, passed through to the exchange trading platforms and is stored in the exchange/clearinghouse clearing systems. These same account identifiers are reported to regulatory agencies through trade register files.



[16] The use of short codes is consistent with Commission Rule 1.35(a–1), which does not require that an FCM record the customer's account number when submitting an order for execution. The rule simply requires that the order include an account identification.

Diagram 1: Trade Order Routing Flow

Account identifiers are maintained in firm accounting systems. As FCMs allocate trades to different customer accounts, their account systems notify clearing systems of these changes to keep the trade register synchronized with the FCMs' books.

There are several instances, however, when the account identifiers recorded on the trade register do not reflect the actual customer or traders (*Diagrams 2–4*). In these instances, the account identifiers on the trade register cannot be used to identify trade account ownership.

In *Diagram 2,* Client A places an order with the executing broker. The executing broker enters the order using account identifier "12345," which represents the company making the trade and not the individual executing the trade. The order is given up to the clearing broker, which assigns the account identifier "ABCDE," which is a short code that allows the clearing broker to tie the trade back to the individual trader at Client A. The clearing broker converts the short code to the Client A settlement account identifier in its internal system. The trade register contains the short codes used by both the executing and clearing brokers, but not the client's settlement account number (123–ABCDE).

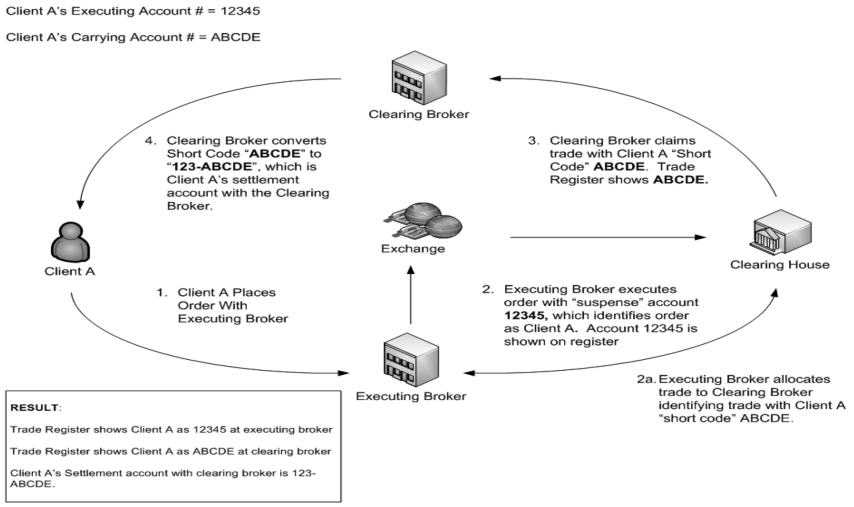


Diagram 2—Give-Ups

Executing broker records client order using "short code" and allocates give-up to Clearing Broker. Clearing broker claims give-up using short code, and converts to firm client settlement account identifier. Settlement account number differs from account number on original execution and give-up allocation.

Diagram 3 describes how the use of "short codes" adversely impacts the ability of the trade register to identify account ownership. In this diagram, the customer/trader executes a trade using the short code "ABCDE". The executing broker also executes a trade for a client using the short code "UVXYZ." The clearing broker receives both the client executed trade (ABCDE) and the broker-executed trade (UVXYZ) for Client A. The clearing broker then converts both short codes to Client A's settlement account 123–ABCDE. As in the previous example, the trade register does not contain Client A's settlement account identifier.

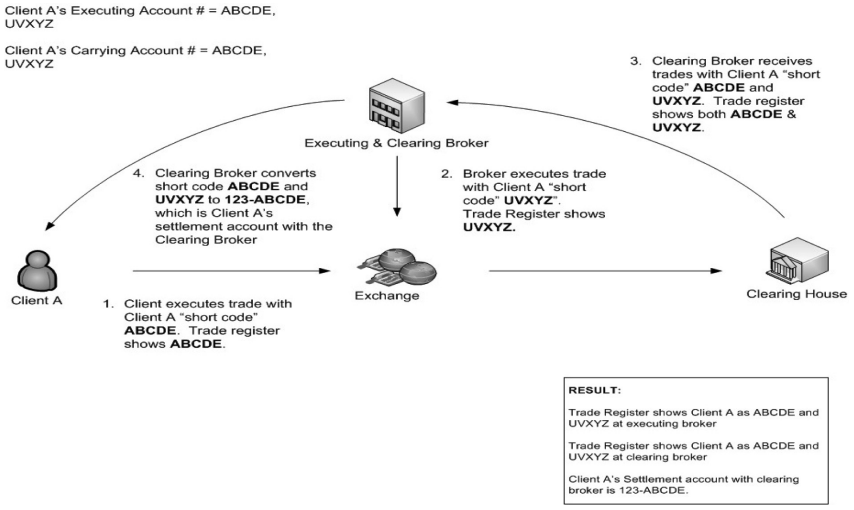


Diagram 3—Broker and Self-Executed Trades

Client "self executes" a trade and the executing broker records transaction under a short code. Executing broker executes a trade for same client using a different short code and gives up both trades to clearing broker with both short codes. Clearing broker converts both short codes to same client settlement account.

Diagram 4 shows processing for average priced transactions executed by one firm and given-up to the carrying FCM. Average priced trades represent transactions traded as a group with an average price applied to them. In many cases, they are given up using an account identifier for the average priced group. In the diagram, an average priced trade for account "APS12" is executed. The trade is then given up to the clearing broker using the clearing broker's short code 123–APS12. The clearing broker subsequently allocates the trades into Client A's settlement account 123–ABCDE, which is not represented on the executing firm's records or on the trade register.

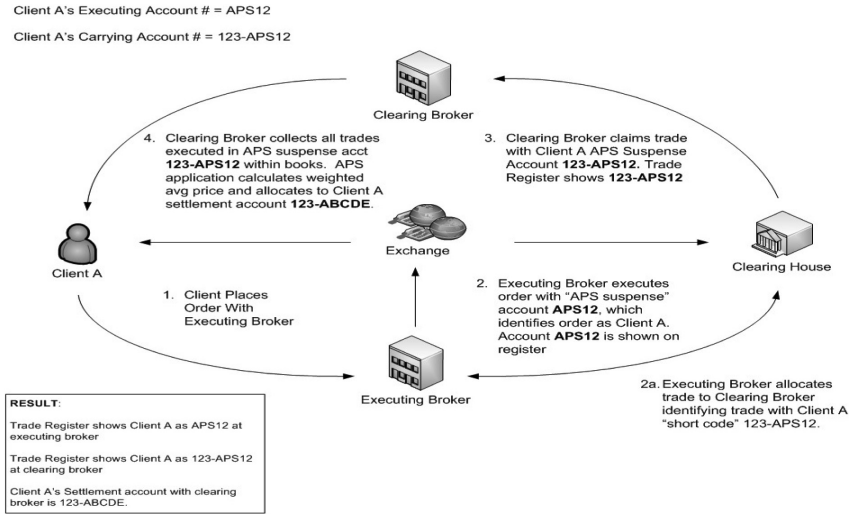


Diagram 4—Average Price Trade

Executing broker executes Client A's order and books the trade to an "APS short code" or suspense account. Executing broker allocates client's trade to clearing broker using a short code. Clearing broker claims APS transaction to its own short code, and then calculates weighted average price and allocates to its own Client A settlement account identifier.

Ultimate beneficial owners. An FCM currently collects only limited information on certain ultimate beneficial owners of an account. This information is obtained only when the account is opened and is generally not updated. For example, when an account is opened for a managed fund (*e.g.,* a commodity pool), the FCM generally will ask the fund manager for the identity of any investor that holds more than a 10 percent interest in the fund. The FCM employs its customer identification program to verify the identity of these investors. However, FCMs have no means to independently verify the fund's beneficial owners and rely completely on the fund manager to identify these investors.

Moreover, investors may increase or decrease their investment throughout the life of the fund (or may withdraw entirely), and new investors will be accepted on a regular basis. FCMs generally do not receive information with respect to changes in the composition of the investors in a fund once an account is opened. Although FCMs will ask for a copy of the fund's annual report, this report does not reflect changes in the composition of investors.

When a corporate account is opened, FCMs will obtain information on the parent company, if any, and on the individual or entity that controls the trading in the account. However, once the account is opened, FCMs generally do not monitor the customer for changes in its organizational structure and relies on the customer to inform the FCM of any changes. As a practical matter, FCMs do not receive updates to this information on a regular basis.

Owner's Name. While an individual account owner's name is certainly kept within a firm's books and records, it can be difficult to compare names across systems. One firm may enter a customer name in full while another may use a version of the customer name. For example, the name for John Smith could be entered in an FCM's records as follows: (i) John Smith; (ii) John R. Smith; (iii) John Ronald Smith; (iv) John R Smith; (v) J R Smith; or (vi) J. R. Smith. Each variation of this name refers to the same individual account owner. However, because of manner in which names are stored electronically, electronic systems cannot detect that each of the six names refers to the same account owner.

The same is true for accounts that are owned by entities. For example, when setting up a database for give-up agreements, FIA found 52 versions of the name ABN Amro.

Date of birth. An FCM generally does not record the date of birth of a customer or account controller that is an individual. An FCM may be required to confirm the age/date of birth of the customer for purposes of NFA Compliance Rule 2–30[17] or compliance with anti-money laundering rules, but neither rule requires an FCM to capture that information in its systems. Therefore, an individual's date of birth generally is not stored electronically. When it exists in the records maintained by the FCM, it is stored in the form of a paper copy of a driver's license or passport.[18]

Primary residence. An FCM may collect the residential address of its individual customers. However, in some cases this information is subject to data privacy laws. Further, residential address information is not routinely updated, particularly when customer statements are delivered electronically). Moreover, if the beneficial owner participates in a fund or is part of an omnibus account, FCMs would not have the individual's primary residence address. In any event, primary address information

---

[17] NFA Compliance Rule 2–30, Customer Information and Risk Disclosure, requires NFA member firms to obtain certain information about its customers who are individuals, including the customer's approximate age. The rule does not require member firms to pierce through a customer that is an entity and collect information regarding the beneficial owners of the customer. Further, a customer may decline to provide certain information.

Effective January 3, 2011, NFA Compliance Rule 2–30, has been amended to provide, in relevant part: "For an active customer who is an individual, the FCM Member carrying the customer account shall contact the customer, at least annually, to verify that the information obtained from that customer under Section (c) of this Rule [*i.e.,* name, address, occupation, estimated income and net worth, approximate age, and previous investment experience] remains materially accurate, and provide the customer with an opportunity to correct and complete the information."

[18] FIA further understands that it is considered a violation of privacy to ask for date of birth in certain countries, including Germany and Canada. We understand that privacy laws in foreign jurisdictions generally may prevent the routine disclosure of other proposed data points relating to individuals.

is entered in a free form field in the FCM's system and is not standardized. Therefore, to the extent this information is collected to meet the OCR Rules, it would have to be re-entered in a standardized format.

NFA identification number. Not all entities or individuals are registered with the Commission and members of NFA. Subject to NFA Bylaw 1101, FCMs generally do not request or record this information. If the Commission were to insist on this data point, an FCM would be required to separately confirm with NFA whether each account owner, beneficial owner or account controller had an NFA identification number (or whether the number provided was accurate).

Account controllers (who must be natural persons). Our comments with respect to the difficulty in obtaining and maintaining records with respect to name, address, date of birth and NFA identification number of account owners (and beneficial owners) of accounts apply equally to account controllers. More important, the broad definition of an account controller is troubling. The OCR Rules define an account controller as "a natural person, or a group of natural persons, with the legal authority to exercise discretion over trading decisions by a trading account, with the authority to determine the trading strategy of an automated trading system, or responsible for the supervision of any automated system or strategy."[19]

This definition cuts too broad a swath and would require information on individuals that never actually exercise trading authority over an account but, because of their position with the customer, as a owner or officer, would be deemed to have this authority.[20] FCMs do not collect information on officers or employees of a customer who place orders for the customer's account.[21]

FIA believes the definition of an account controller should be consistent with the Commission's definition of control as set out in Commission Rule 1.3(j) and generally applied at exchanges. That is, unless a customer specifically provides discretionary trading authority to a third party that is either registered with the Commission as a commodity trading advisor or is excluded or exempt from registration, the account controller should be deemed to be the owner of the account.

Date account is assigned to the current controller. This information is not captured by FCMs. The cost of capturing this information would outweigh the regulatory benefit.

Designation of the manner in which the trade is executed. FCMs do not currently capture information with respect to whether a trade is executed by a natural person, automated trading system or both. We believe any effort to do so would be difficult at best. Many account controllers, as broadly defined in the OCR Rules, input orders in a variety of ways for a variety of reasons. Simply because an account controller generally executes trades through an automated trading system does not mean that certain trades will not be executed manually.

Special account number. Special account numbers associated with an account are generally assigned by an FCM's compliance or operations department. The number is not included with the customer information that is submitted with a trade and, therefore, is not included on the trade register. Rather, the special account number is added to the position file at the end of the day.

Date the account becomes reportable. FCMs currently do not record when an account becomes reportable, since this information appears to be of limited regulatory value.[22]

Omnibus accounts. Although FCM systems identify accounts as omnibus accounts, the name of the account may be different at each carrying FCM, making it difficult to compare names across systems.

Name of the executing firm and its unique identifier reported in the reporting entity's trade register. This information is not included in the trade reg-

---

[19] The authority to exercise discretion is sufficient, regardless of whether such authority is actually exercised. Proposed Rule 16.03(c).

[20] Although certain exchanges have adopted programs that require customers afforded direct access to the exchange trading platform be identified to the exchange (*e.g.,* CME Tag 50), the individual responsible for data input may not be the account controller. Correspondingly, account controllers are not always identified through such programs.

[21] At one point, FCMs collected this information but stopped this practice many years ago after finding that a customer's authorized traders changed frequently, but customers advised FCMs of such changes infrequently, if at all. As a result, FCMs were placed in the untenable position of either refusing to accept an order from an individual that was not on the approved traders list, potentially adversely affecting the customer's trading strategy, or accepting a trade from an individual with apparent authority, potentially exposing the FCM to liability for accepting an order from an unauthorized individual. FCMs generally concluded that the responsibility for maintaining control of an account belonged to the customer, not the FCM.

[22] Since the alternative described below will effectively automate the Form 102, information with respect to all reportable accounts will be provided to the Commission weekly.

ister. A customer may use a variety of executing brokers and the carrying firm does not record this information at the account level.

Name of the clearing firm for the trading account and its unique identifier reported in the reporting entity's trade register. This information is contained in the trade register and carried at the account level.

Name of root data source. Providing the reporting entity with information with respect to the trading account. This point needs additional clarification. The root data source is typically the beneficial owner or account controller. The FCM, however, would provide the data to the reporting entity. This data point appears to be unnecessary and would add complexity to the OCR database.

Reporting entity. Name of the reporting entity would be added when submitted to the Commission.

OCR transmission date. The OCR transmission date would be added automatically upon transmission of the data to the Commission.

The OCR Rules Would Force a Structural Change in the Conduct of Business

As we noted at the outset of this letter, implementation of the OCR Rules would force an unwarranted structural change in the conduct of business among U.S. futures markets participants, especially among clearing member and non-clearing FCMs, foreign brokers, and their respective customers. Because the proposed rules would require clearing member FCMs to know and report to the relevant clearing organization the identity of each customer that comprises an omnibus account and their respective positions, the ability to maintain omnibus accounts would be significantly impaired, if not eliminated.

Omnibus accounts, which are treated as the account of a single customer for all purposes on the books and records of the carrying FCM or clearing organization, have been an integral part of the futures markets since well before the Commission was created in 1974. Foreign brokers and FCMs that are not members of a particular clearing organization maintain omnibus accounts with clearing members; clearing member FCMs, in turn, maintain omnibus accounts with the relevant clearing organization.

Omnibus accounts serve both a practical and regulatory purpose. FCMs, whether clearing members or non-clearing members of a particular clearing organization, compete for customers.[23] Non-clearing FCMs, therefore, do not want to disclose the names of their customers to the FCM that clears their customers' accounts. The same practical considerations lead foreign brokers to open customer omnibus accounts with the FCMs that clear their customers' positions.[24]

For their part, clearing member FCMs may not want to incur the operational expense of maintaining an extensive branch office network. They rely instead on non-clearing FCMs that are often physically closer to their customers and, as result, are better able to serve them and evaluate more fully any credit risk they may pose.[25] In these circumstances, the non-clearing FCM is the clearing member FCM's customer, and the clearing member FCM will conduct due diligence on the non-clearing FCM to be certain that it understands the nature of the business in which the non-clearing FCM is engaged, the types of customers that non-clearing FCM serves and the non-clearing FCM's risk management practices. Because non-clearing FCMs stand between their customers and the clearing member FCM, the clearing member FCM has to consider only the credit of the non-clearing FCM.

---

[23] An FCM may choose to become, or elect not to become, a member of a particular clearing organization for a number of reasons. For example, the cost of becoming a member of a clearing organization may be too high or the volume of business that the FCM would clear through the clearing organization may not justify the operational and financial costs.

[24] The Commission's recognition of the essential purpose of omnibus accounts was described in a 1984 exchange of correspondence between the Commission's Division of Trading and Markets (now the Division of Clearing and Intermediary Oversight) and the Federal Deposit Insurance Corporation ("FDIC"), in which the FDIC confirmed that, provided that the books and records of bank and the relevant FCMs properly indicate that the funds in the account are being held in a custodial capacity, FDIC insurance would be afforded each ultimate customer's interest in an omnibus account in which the transactions of two or more persons are carried by a carrying FCM in the name of an originating FCM. Interpretative Letter No. 84–14, [1984–1986 Transfer Binder] Comm. Fut. L. Rep. ¶22,311.

[25] For these same reasons, a customer may prefer to deal with a non-clearing FCM that is able to provide more personal service and make an informed judgment concerning the credit risk the customer may pose. Alternatively, an institutional customer holding positions cleared through a smaller clearing organization may prefer to have its trades carried by a non-clearing FCM that has substantially greater capital than a clearing member FCM of that clearing organization.

From a regulatory perspective, omnibus accounts facilitate the conduct of business by a clearing member FCM, in particular, in connection with customers located outside of the U.S. A clearing member FCM's ability to carry an omnibus account of a foreign broker allows the FCM to carry the accounts of foreign customers without having to be registered in the home jurisdiction of each customer.

The Commission historically has taken the position that a firm acting in the capacity as an FCM is required to be registered as such if either the firm is located in the U.S. or the firm's customers are located in the U.S. Under the Commission's Part 30 rules, the only exception to this requirement the Commission has made is with respect to foreign firms that carry a customer omnibus account on behalf of a U.S.-registered FCM.[26]

Foreign jurisdictions generally take the same position. That is, a U.S. FCM would be prohibited from soliciting or accepting orders directly from a foreign person for execution on a U.S. contract market, unless the FCM were properly registered in the foreign person's home jurisdiction. A U.S. FCM, however, may carry the customer omnibus account of a foreign broker without being so registered.

More generally, because the omnibus account is treated as a single customer, a clearing member FCM's rights and responsibilities under the Act and Commission rules are solely with respect to the omnibus account. The clearing member FCM has no obligation to pierce through the omnibus account to know the identity of each of the customers that comprise the omnibus account.

Thus, the omnibus account is treated as a single account for purposes of compliance with: (i) the provisions of section 4d(a)(2) of the Act and Commission Rules 1.20–1.30, including the investment of customer funds under Rule 1.25; (ii) the early warning requirements under Rule 1.12(f)(3); (iii) the provisions of Rule 1.33 regarding confirmations and monthly statements; (iv) the provisions of Rule 1.35 regarding records of futures and options on futures transactions; (v) the provisions of Rule 1.36 regarding records of securities and property received from customers; (vi) the provisions of Rule 1.37 regarding the name, address and occupation of customers; (viii) the large trader reporting requirements of Part 17; and (ix) the provisions of Rule 166.3, which require an FCM to supervise diligently the handling of all commodity interest accounts carried, operated, advised or introduced by the FCM and all other activities relating to its business as a Commission registrant. Significantly, the omnibus account also is treated as a single account for purposes of compliance with the PATRIOT Act, including an FCM's anti-money laundering and suspicious activity reporting requirements.

If the Commission were to require clearing member FCMs to know and report to the relevant clearing organization the identity of each customer that comprises an omnibus account and their respective positions, the carefully crafted provisions of law and rules that have governed the conduct of omnibus accounts for decades would be destroyed. We do not believe—and more importantly, do not believe that the Commission has ever taken the position—that an FCM can know the identity of customers in an omnibus account, as well as the positions that are attributable to such customers, with incurring the concomitant obligations of treating those customers as customers of the FCM for all purposes.

In the absence of a Commission rule to the contrary,[27] which would specifically relieve a clearing member FCM of such obligations, once the FCM knows the identity of such customers, the FCM would have to assume that it would have the obligation with respect to each such customer, individually: (i) under Rule 166.3, to supervise the handling of each customer's accounts; (ii) under section 4d(a)(2) of the Act and Commission Rules 1.20–1.30, to segregate each customer's funds; (iii) under Rule 1.33, to provide each such customer with a confirmation of each trade and a monthly statement; (iv) under Rule 1.35, to make a record of each customer's transactions; (v) under Rule 1.36, make a record of the securities and property received from each customer; (vi) under Rule 1.37, record the name , address and occupation of each customer; and (vii) under Part 17, file a large trader report with respect to each customer.

The clearing member FCM would have no choice but to restructure completely the way in which it conducts business. It would be required to make each customer within the omnibus account a direct customer, thereby negating any need or reason for maintaining a relationship with the nonclearing member FCM. The result would be a further contraction of the number of FCMs able to compete for customer business. Further, without the intermediation of a non-clearing member FCM willing to

[26] Commission Rule 30.4(a).

[27] The Treasury would also have to grant relief from the applicable PATRIOT Act requirements.

assume the credit risk of customers not known to the clearing member FCM, those customers would probably not be able to maintain a trading account.

The abolition of omnibus accounts could have potentially serious effects as well on smaller exchanges and their affiliated clearing organizations. As noted earlier, an institutional customer holding positions cleared through a smaller clearing organization may prefer to have its trades carried by a non-clearing member FCM that has substantially greater capital than a clearing member FCM of that clearing organization. If the institutional customer is required to open an account directly with the smaller clearing member FCM, it may simply decline to trade on that smaller exchange.

Perhaps most severe could be the potential impact on the ability of foreign customers to trade on U.S. markets. If U.S. FCMs were required to be registered in the home country of each foreign customer whose account it carried, the FCM would be subject to potentially conflicting regulatory requirements. Even if the conflicting regulatory requirements could be managed, the operational and financial burdens would be such that only the most highly capitalized FCMs could even contemplate conducting business on behalf of foreign customers. The more likely result would be that foreign customers would be effectively shut out of the U.S. markets.

Unique Account Identifier

The Commission has invited comment on how the futures industry could develop and maintain a system to assign unique account identification numbers ("UAIN") to all account owners and account controllers. We do not believe such a project is feasible. On the surface, assigning each customer a unique identifier that would be used by all firms and exchanges would appear to solve many of the issues with creating an OCR database. However, UAINs would require a massive change in all systems in the trading cycle. Every system in the industry would have to be modified, including all front-end systems, customer order entry systems, middleware and back-end systems, as well as exchange trading and clearing systems. We have not computed this cost. The addition of a UAIN also adds data/risk to the clearing systems which are already facing capacity issues.

Conclusion

For all of the above reasons, FIA regrets that we cannot support the OCR Rules as proposed. We nonetheless appreciate the deliberative manner in which the Commission has approached this project, and we look forward to having the opportunity to work with the Commission and staff in developing an OCR database and reporting system that will achieve the Commission's goals in an effective and efficient manner. In the meantime, if the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel.

Sincerely,

JOHN M. DAMGARD,
President.

Honorable GARY GENSLER, *Chairman;*
Honorable MICHAEL DUNN, *Commissioner;*
Honorable JILL E. SOMMERS, *Commissioner;*
Honorable BART CHILTON, *Commissioner;*
Honorable SCOTT O'MALIA, *Commissioner;*

Division of Market Oversight:

RICHARD SHILTS, *Acting Director;*
RACHEL BERDANSKY, *Deputy Director;*
SEBASTIAN PUJOL SCHOTT, *Associate Deputy Director;*
CODY J. ALVAREZ, *Attorney Advisor.*

APPENDIX A

Ownership and Control Reports Proposed OCR Alternative

The Futures Industry Association ("FIA") hereby submits for the Commission's review the following OCR alternative, in lieu of the ownership and control reporting requirements that the Commission has proposed to impose on "reporting entities." 75 *Fed. Reg.* 41775 (July 19, 2010) The OCR alternative was developed by the OCR Working Group, which was formed by FIA and is comprised of a broad cross-section of the futures industry. Its members include representatives from (i) 16 FCMs, both

large and small, serving retail and institutional customers, (ii) the several U.S. exchanges, (iii) back office service providers, and (iv) other experts. By no means perfect, the OCR alternative nonetheless presents a more cost effective and practical mean to create an OCR database, which is user-friendly and familiar to the Commission staff and investigators. It should not be viewed as an industry-approved alternative, but solely as a basis for further discussions among the Commission, the futures industry and other interested parties.

Based on the Commission's large trader reporting system, the OCR alternative may be implemented more effectively across multiple exchanges. The alternative integrates the existing trade register data generated by the exchanges with the fundamental OCR data collected by FCMs, thereby allowing the Commission to access the data more quickly and aggregate account-level information across multiple exchanges. Although the OCR alternative would require clearing-member FCMs to make significant changes in the collection, storage and transmission of customer and trade-related data, the alternative would be less costly and could be implemented more quickly. As important, the alternative would achieve the essential regulatory purposes underlying the proposed OCR Rules, as outlined in the *Federal Register* release accompanying the proposed rules.

Specifically, the OCR alternative would: (i) help integrate data found in the Integrated Surveillance System and the Trade Surveillance System by linking individual transactions reported on exchange trade registers with aggregate positions reported in large trader data; (ii) identify small and medium-sized traders whose open interest does not reach reportable levels, but whose intra-day trading may aversely affect markets during concentrated periods of intra-day trading; (iii) reduce the time-consuming process of requesting and awaiting information from outside the Commission to identify the entity associated with the account number and aggregate all identified entities that relate to a common owner; (iv) link traders' intra-day transactions with their end-of-day positions; (v) calculate how different categories of traders contribute to market-wide open interest; and (vi) categorize market participants based on their actual trading behavior on a contract-by-contract basis, rather than on how they self-report to the Commission (*e.g.,* registration type or marketing/merchandising activity on Commission Form 40).

At a high level, the alternative proposes that clearing firms will provide a weekly OCR file to exchanges and the Commission that will facilitate the linking of trading activity to owners and controllers across firms and exchanges. This file would be provided for each trading account exceeding an agreed upon volume threshold. Much of the data currently collected on Form 102 would be included in the OCR file, thereby automating the Form 102 process.

In developing this proposal, the OCR Working Group was guided by the principle that, to the extent practicable, the alternative should:

- extract certain data from existing systems to create and maintain an OCR file;
- rely on data currently available in existing systems;
- minimize new data recording requirements; [28]
- confine collection of the data to the clearing-member FCM; and
- use volume thresholds to determine the accounts that should be subject to OCR.

The OCR alternative contains the following assumptions:

- The definition of "control" would be limited to that which is currently used for purposes of the large trader reporting system (*i.e.,* a person other than the account owner will be deemed to "control" an account only if the person is a third party with discretionary authority to trade the account; the account owner's employees will not be deemed to "control" the owner's account).
- Non-disclosed omnibus accounts would report the name of the omnibus account only; disclosure of all accounts within the omnibus will not be required.
- OCR data would be captured for end-of-day cleared accounts at the carrying broker level.[29]
- The Commission will acquire additional information required for OCR that is not currently captured or stored by clearing member FCMs directly from account owners/controllers (*i.e.,* through Form 40 reporting).

[28] The new data required to be collected would be limited to the short codes employed in exchange trade registers and customer e-mail addresses.

[29] Executing brokers do not usually have, and should not be required to provide, account ownership and control information.

- The OCR Working Group would work with the Commission to determine an appropriate volume threshold. For purposes of estimating costs, however, the OCR Working Group limited the number of accounts that would be reported to accounts that traded more than 250 contracts weekly.[30]

Account Ownership Data

As indicated above, the alternative would leverage and automate the Form 102, which FCMs file with the Commission whenever a customer exceeds the large trader reporting thresholds.[31] Form 102 would be updated to reflect the current trading environment, in particular, significant intraday trading activity, and collect information with respect to accounts that exceed either position or volume thresholds.

Although Form 40 provides more detail regarding account owners and account controllers, if any, this form is completed by customers and, in most cases, is forwarded directly to the Commission. FCMs generally do not receive a copy of the Form 40 and, in any event, do not record the information electronically. We appreciate that the Commission may want to amend the Form 40 to enhance the information that the Commission receives. However, the OCR alternative does not contemplate any change in the current procedures regarding the Form 40.

The OCR Alternative

The OCR alternative would require each FCM to develop and maintain an electronic reporting system containing the following fields of information. *Appendix B* hereto summarizes the data to be collected and identifies whether the information currently resides in FCM back-office systems or the Form 102.

Trading Account Number. Account numbers are the key to linking account ownership and control information to the information contained in the exchange trade registers. The OCR alternative overcomes the problems described earlier in our comment letter by providing the means to relate the trading account and short codes to the ownership and control information.

Special Account/Reportable Account Number. This field contains the large trader reportable position account number that the FCM assigns, if applicable.

Short Code. Exchange trade registers contain the account numbers submitted by both executing and carrying firms for each transaction executed on the relevant exchange. Although these account numbers can be used to identify account owners, as explained earlier, the account number in the trade register is often a "short code", or proxy number, that does not tie directly to the account owner. FCMs maintain internal mappings for these account schemes, but these "short codes" are not always in the firm's account reference file. Middleware systems are used to translate short codes to actual account numbers for firms' internal books; these translation rules can be leveraged to create mapping tables for matching trades to the OCR. The alternative would require firms to include the short code mappings in the back-office identification of the account ownership and control information.

Owner Name. This field will include owner first name and last name, and middle name as available, if the owner is a natural person.

Owner Organization. This field would include the name of the entity, if the owner is not a natural person.

Owner Address. Multiple address fields would include the street address, city, ZIP Code and country for the account owner.

Owner E-mail Address. This field would include the e-mail address of the owner, if a natural person. E-mail addresses hold promise as a unique identifier for customer accounts. However, implementation and maintenance would have operational challenges as well as financial costs. At present, some FCMs have no robust process for collecting and maintaining customers' e-mail addresses and would need to upload (and update) e-mail addresses manually. Therefore, the customer's e-mail address initially would be a non-mandatory data field.

Controller Name. This field would include the first and last name of the controller, if the controller is a natural person.

Controller Organization. This field would include the name of the business or organization that controls the account if the controller is not a natural person.

Controller Address. Multiple address fields would include the street address, city, ZIP Code and country for account controller.

---

[30] The OCR Working Group also discussed pegging the volume threshold to current large trader position reporting levels.

[31] The Form 102 provides essential information about the account: (1) type of account, *e.g.,* house, customer omnibus, corporation, limited liability company, individual: (2) name of account owner; (3) address; (4) registration category, if any; (5) commodities hedged, if any; and (6) identity of account controller, if any. Certain information currently collected on the Form 102 would not be collected under the OCR alternative.

Controller E-mail Address. This field would include the e-mail address of the account controller.

Controller Type. This field would indicate whether the customer represents a fund or a CTA/CPO.

FCM Identification Number. This field would includes the number assigned to the clearing FCM by the Commission.

Omnibus Flag. This field would indicate whether the account is an omnibus account.

Trading Account Effective Date. This field would include the date on which the account was established in the clearing FCM's back office accounting system.

OCR Construction Work Effort

Although the alternative would use data that is currently stored in existing systems, those systems would be required to be modified to extract, report, and transmit OCR-related information. In addition, it would be necessary to build certain databases to support the OCR.

Firms would be required to supply information to build the OCR file. Firms would need to:

- modify systems to build an OCR file for daily or weekly submission to the Commission;
- create processes to identify trading accounts that exceed volume thresholds;
- acquire ownership and control information for the initial construction of the OCR file; and
- create operational processes to maintain the OCR file on an ongoing basis.

Cost Analysis of OCR Alternative

The OCR Working Group estimates that, compared with the Commission's proposal, the OCR alternative would result in an average first-year cost saving of approximately $18.8 million. As described in the charts at the end of this Appendix, the first year costs of the Commission proposal is four times greater than the median costs incurred by FCM's under the alternative.

The first-year cost estimates were collected from a sample of 12 FCMs.[32] Three of the FCMs that responded to this survey were not among the 12 firms that provided estimates of the costs of implementing the Commission's proposed OCR Rules and the assumptions underlying one firm's estimates were inconsistent with the assumptions of the remaining nine FCMs. For comparison purposes, therefore, we used only the estimates provided by the eight FCMs that responded to both surveys applying comparable assumptions. The cost of building an OCR file containing the data elements identified above and in *Appendix B* ranges from $400,000 to $14,500,000, with the average estimated cost per firm being $4,647,292. The estimated ongoing costs associated with operating and maintaining the OCR data files ranges from $125,000 to $7,000,000 on an annual basis, averaging $1,337,292 per firm.

Each FCM's estimated costs would depend on the number of accounts for which the OCR data must be collected, with larger firms facing greater costs but also realizing economies of scale in implementation. Small FCMs that carry fewer than 250 accounts and would rely exclusively on vendors to implement the alternative may not realize economies of scale.

Although the total costs small FCMs would incur appear reasonable, their first-year cost per account would be significantly greater than the FCMs that are able to rely to a lesser extent on vendors for developing the OCR. The average estimated first year cost for smaller FCMs is $1,850 per account, while the average cost for other firms would be $205 per account.[33] However, it is important to note that these estimates are not firm quotes on cost by the vendors, and the actual cost would depend on the size of the business, optional modules utilized, number of connectors from either vendor or third party back/middle office systems and whether or not the service is hosted by the vendor or deployed in-house at each firm.

Most FCMs found that adopting a volume threshold of 250 contracts per week would decrease significantly the costs of implementing the alternative, by reducing

---

[32] According to the FCM Financial Data reported on the Commission website, as of July 31, 2010, the 12 firms surveyed held segregated customer funds in excess of $96.4 billion, approximately 71 percent of all customer funds.

[33] While this amount is high, the estimated cost per account under the Commission's proposal was also on an order of magnitude greater than most other FCMs. These FCMs are largely dependent on the vendors and have used cost estimates provided by the vendors to formulate their estimates.

the amount of data required to be processed and the associated cost of transmitting large amounts of data to the exchanges and the Commission. The average estimated cost of populating the OCR database using a volume threshold of 250 contracts per week is $1,783,750. In contrast, the estimated total cost for initially populating the OCR file based on a volume threshold that includes all accounts (referred to in our survey as option 1) is $2,134,375.

Some FCMs suggested that a volume threshold could increase the cost of implementing the alternative initially. This is because processes would have to be developed to identify when customers exceed the threshold and logic code would have to be developed to pull the OCR data for transmission to the Commission. Regardless of the impact on the cost burden placed on the FCMs, however, a volume threshold would introduce efficiencies in processing and transmission, and will help avoid data overload for both the FCMs and the Commission.

As we found with the Commission's OCR proposal, the effort to automate the processes and develop the database would be challenging. However, most firms felt that the alternative would be a much more robust process and could be implemented within the 18 month timeframe envisioned by the Commission.

The end result of the developing the alternative system could ultimately save the firms (and the Commission) significant time and money by automating the current manual process for filing out and submitting Form 102 information. Implicit in the Working Group proposal and the related cost estimates is the assumption that the weekly OCR change files would replace the manual process of submitting Form 102 by hard copy. As we previously noted, these forms currently are updated as requested by the Commission, generally, annually or upon request. With OCR automation, FCMs would be providing weekly feeds that would include updated information on each account meeting the threshold (*e.g.,* changes in the customer's address and e-mail address, as well as changes in the identity of the account controller).

Once implemented, the average cost savings associated with automating the Form 102 was estimated to be $33,300 per firm on an annual basis. This efficiency would also be realized by the Commission because of the decreased reliance on data entry, manual processing, recordkeeping, and document management in the current system of collecting and storing manual Forms 102.

Conclusion

For all of the above reasons, the OCR alternative described herein would achieve the essential regulatory purposes underlying the proposed OCR Rules and forms a basis for further discussion on the proper structure of an OCR report. As noted earlier, however, these discussions cannot take place in a vacuum. All of the pending recordkeeping and reporting requirements, and the estimated costs and benefits of each, must be analyzed and evaluated collectively, not individually. The OCR Working Group is anxious to work with the Commission and staff in developing and implementing an effective and efficient recordkeeping and reporting program.

FCMs' Industry Solution Cost Estimates [1]

	Affected Accounts	Start-up	Ongoing	Total Start-up and Ongoing/ First-Year Costs	First-Year Costs Per Account
Firm A	90,000	$7,500,000	$7,000,000	$14,500,000	$161
Firm B	75,300	$8,370,000	$225,000	$8,595,000	$114
Firm C	50,000	$2,935,000	$3,000,000	$5,935,000	$119
Firm D	39,979	$135,000	$600,000	$735,000	$18
Firm E	34,700	$2,000,000	$500,000	$2,500,000	$72
Firm F	30,000	$3,950,000	$1,080,000–$1,095,000	$5,037,500	$168
Firm G	19,473	$5,135,000	$2,550,000	$7,685,000	$395
Firm H	14,000	$5,050,000	$125,000	$5,175,000	$370
Firm I	250	$100,000	$300,000	$400,000	$1,600
Firm M*	10,000	$3,500,000–$4,000,000	$500,000	$4,250,000	$425
Firm N*	N/A	$650,000–$850,000	$50,000–$150,000	$850,000	N/A
Firm O*	50	$45,000	$60,000	$105,000	$2,100

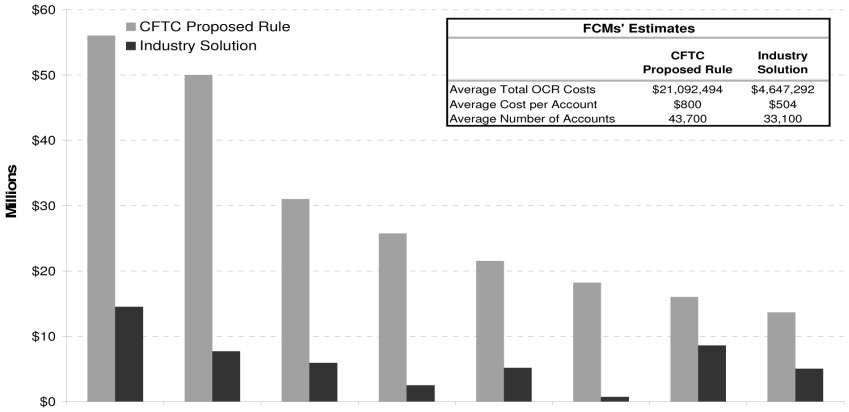
Notes:

[1] The 12 firms in the sample handle in excess of $96.4 billion, or nearly 71% of customers' segregated funds (as of July 31, 2010, according to monthly financial reports filed with the CFTC).

* Firm did not provide cost estimates for the CFTC Proposed Rule.

FCMs' OCR Implementation Cost Estimates

CFTC Proposed Rule vs. Industry Solution



Notes and Sources: Data from estimates provided to the FIA. Only FCMs that provided cost estimates for both the CFTC Proposed Rule and the Industry Solution are shown on the chart.

APPENDIX B

Proposed OCR File

Below is a summary of the fields in the proposed OCR File that would be sent weekly from the clearing FCM to the Commission and/or exchanges. The file includes information that exists in current systems and on the Form 102.

Field Name	Exists in Firm Back-Office Systems	Form 102	Description and Comments	Values	Format	Size
Trading Account Number	X		Account for which trade was executed	Alphanumeric ID that identifies the customer(s) on the associated trade record	AN	20
Special Account/Reportable Account	X		Large Trader reportable position account, if assigned.	Alphanumeric ID used to aggregate trading accounts for large trader position reporting.	AN	12
Short Code Short codes must be accompanied by a trading account number but may not have a special account number.			Account identifier used upon execution that is translated into a trading account number by back office systems.	Alphanumeric ID that identifies the customer(s) on the associated trade record	AN	20
Owner Last Name (Person)	X		Last name of account owner, if the owner is a natural person.	Smith	AN	30
Owner First Name (Person)	X		First name of the account owner, if the owner is a natural person.	James	AN	30
Owner Name (Organization)	X		Name of the business or organization that owns the account, if the owner is not a natural person.	Proprietary Trading Firm Inc.	AN	60
Owner Address 1	X		Primary address of the account owner	123 Main St.	AN	40
Owner Address 2	X		Primary address of the account owner	#500	AN	40
Owner Address 3	X		Primary address of the account owner		AN	40
Owner City	X		City of the owner's primary address	Chicago	AN	25
Owner State/Province	X		State or province abbreviation for the owner's primary address.	IL	AN	5
Owner ZIP/Postal Code	X		ZIP Code or postal code for the owner's primary address.	60601–9999	AN	10
Owner Country	X		Country code for the owner's primary address	U.S.	AN	2

Field Name	Exists in Firm Back-Office Systems	Form 102	Description and Comments	Values	Format	Size
Owner E-mail Address (Person)			E-mail address of the account owner, if the account is owned by a natural person.	*James.Smith@tradingfirm.com*	AN	100
Controller Last Name (Person)		X	Last name of account controller, if the controller is a natural person.	Smith	AN	30
Controller First Name (Person)		X	First name of the account controller, if the controller is a natural person.	James	AN	30
Controller Name (Organization)		X	Name of the business or organization that controls the account, if the controller is not a natural person.	Proprietary Trading Firm Inc.	AN	60
Controller Address 1		X	Primary address of the account controller	123 Main St.	AN	40
Controller Address 2		X	Primary address of the account controller	#500	AN	40
Controller Address 3		X	Primary address of the account controller		AN	40
Controller City		X	City of the owner's primary controller	Chicago	AN	25
Controller State		X	State or province abbreviation for the controller's primary address.	IL	AN	5
Controller ZIP Code		X	ZIP Code or postal code for the controller's primary address.	60601–9999	AN	10
Controller Country		X	Country code for the controller's primary address	U.S.	AN	2
Controller E-mail Address (Person)		X	E-mail address of the account controller, if the account is controlled by a natural person.	*James.Smith@tradingfirm.com*	AN	100
Controller Type		X	Describes the type of controller(s) listed on the respective account.	F—Fund C—CTA/CPO	AN	1
CFTC Firm ID	X		CFTC provided firm identifier assigned to the firm.	AN	3	
Omnibus Account Flag	X		Yes or No indicator to denote the type of account	Y—Omnibus N—Not Omnibus	AN	1
Trading Account Effective Date	X	X	The day account was established in the firm's back office system.	YYYYMMDD—Date on which the trading account is effective	N	8
Trading Account Expiration Date			Expiration date/end date of the trading account. Could have a default of 99991231, denoting no expiration.	YYYYMMDD—Date on which the trading account has expired	N	8
EFS Owner Exchange			For member accounts, the exchange at which the account owner holds a membership.	CME—Could optionally use ISO MIC.	AN	5
EFS Non-Member Owned Indicator			Indicator to denote if the account is fully member owned or if non-members are joint owners on the account.	Y—Indicates account is a joint account between a member and nonmember N—Non-members do not exist on the account	AN	1
EFS Main Account Description			Description of the group of accounts which often includes the legal name of the 100% owned subsidiary. This is often referred to as "Account Title".	Contains company name, trading group, partnership, *etc.*	AN	40
EFS Main Account Number			Grouping/roll up account that associates all trading accounts with the same account owners(s) and controller(s)	Alphanumeric ID that identifies the Fees grouping account.	AN	20
EFS Owner Type			Describes the type of owner(s) listed on the respective account.	I—Individual N—Non-Member F—Firm J—Joint Account	AN	1
EFS Owner Middle Name (Person) if available	X		Middle name or middle initial of the account owner, if the owner is a natural person.	R	AN	15
EFS Controller Middle Name (Person) if available		X	Middle name or middle initial of the account controller, if the controller is a natural person.	R	AN	15
EFS Exchange	X		Exchange Acronym CBT—Could optionally use ISO MIC.	AN	5	
EFS Clearing Firm Number	X		Clearinghouse assigned clearing firm number/firm number	999—Existing 3–5 character firm code.	AN	5
EFS Clearing Firm Name	X		Clearing Firm Name	Name of the clearing firm	AN	60

Field Name	Exists in Firm Back-Office Systems	Form 102	Description and Comments	Values	Format	Size
EFS Main Account Effective Date			Effective date/start date of the main account. Could potentially be derived from the reporting of the change record.	YYYYMMDD—Date on which the main account is effective	N	8
EFS Main Account Expiration Date			Expiration date/end date of the main account. Could have a default of 99991231, denoting no expiration.	YYYYMMDD—Date on which the main account has expired	N	8
EFS Owner Effective Date			Effective date/start date of the owner relationship to the account. Could potentially be derived from the reporting of the change record.	YYYYMMDD—Date on which the owner was associated with the account	N	8
EFS Owner Expiration Date			Expiration date/end date of the owner relationship to the account.	YYYYMMDD—Date on which the owner relationship has expired.	N	8
EFS Controller Effective Date		X	Effective date/start date of the controller relationship to the account. Could potentially be derived from the reporting of the change record.	YYYYMMDD—Date on which the controller was associated with the account	N	8
EFS Controller Expiration Date			Expiration date/end date of the controller relationship to the account.	YYYYMMDD—Date on which the controller relationship has expired.	N	8

○