Testimony

Before the Senate Agriculture Committee

On

Regulatory Reform and Derivatives Markets

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My name is David Dines, President of Cargill Risk Management. I am testifying on behalf of Cargill, Incorporated and have been in the hedging and risk management services industry for 15 years.

I want to thank you for the opportunity to testify today.

Cargill is an international provider of food, agricultural, and risk management products and services. As a merchandiser and processor of commodities, the company relies heavily upon efficient, competitive, and well-functioning futures markets and over-the-counter (OTC) markets.

Cargill is an extensive end-user of derivatives products, and is also active in offering risk management products and services to commercial customers and producers in the agriculture and energy markets.

One of the major challenges for policymakers and regulators is that the term "over-the-counter market" covers a vast array of products across a number of markets.

This broad definition highlights why it is extremely difficult to seek a one size fits all regulatory or legislative solution that still allows all interested parties to manage their genuine economic risks.

- **One major concern with the recent proposal by the US Treasury Department is that it appears to seek a regulatory solution for *all* OTC products in response to systemic risk posed by one particular market: credit default swaps.**

It is important to note that while we have witnessed the greatest economic crisis in 80 years, and perhaps the most volatile commodity market Cargill has ever seen, OTC contracts in the agriculture, energy, and foreign exchange markets performed well, did not create systemic risks, and in fact helped many end-users manage and hedge their risks during this very difficult time.

For the purposes of our testimony today relative to the US Treasury proposal, we will focus our comments on two categories of OTC products where Cargill is an active market participant:

- Agriculture and energy products
- Foreign exchange products

The Treasury proposal seeks to achieve four broad objectives:

1. Prevent Activities Within the OTC Markets from Posing Risk to the Financial System
2. Promoting Efficiency and Transparency Within the OTC Markets
3. Preventing Market Manipulation, Fraud, and Other Market Abuses
4. Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties

We support these stated objectives and believe that steps can be taken to meet these goals, without denying end-users' access to an effective and competitive market. While we have not seen the specific details of the Treasury Department's proposal, we offer these observations based on the information available under each of the specific objectives.

Objective 1: Prevent Activities Within the OTC Markets from Posing Risk to the Financial System

The Treasury Department's outline seeks to apply mandatory clearing of all standardized contracts, impose robust margin requirements, including initial margin requirements for both standardized and customized contracts.

- The imposition of mandatory clearing and mandatory margining of tailored hedges will have a significant drain on working capital at a time when capital is highly constrained and credit is in short supply. There will be a liquidity drain on those companies who have taken conservative business approaches and choose to prudently hedge their economic risks. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital requirements.

- The potential magnitude of this drain on working capital should be carefully weighed by all policymakers. Cargill is a member of the National Association of Manufacturers (NAM) and has worked closely with a coalition of NAM members concerned about the ability of end-users to efficiently access the OTC market.

  I would like to submit for the record a letter from the NAM on this issue, as well as a recent letter from Chesapeake Energy, an Oklahoma-based end user of OTC derivatives and the largest independent producer of US natural gas.

  The Chesapeake Energy letter provides an excellent example of how restricting access to credit by imposing mandatory margining could severely drain capital that could otherwise be invested to grow a business. In the one example provided here, over $6 billion would have been taken away from running and expanding a job-creating business, and instead be left idle in a margin account until the maturation of the OTC contract. While not posting cash, Chesapeake had pledged collateral valued at more than $11 billion to secure their derivative counterparties.

  Expand this example across all of the businesses that use OTC products and the amount of capital diverted from growing the US economy would be severe, unless companies reduced their hedging and risk management.

- There is a misconception that OTC products do not have credit provisions, and are never collateralized or margined. A significant number of OTC transactions are collateralized or margined with collateral being moved daily to adjust for the change in market value. With futures, margining terms are standardized across all participants, while in the OTC markets credit and collateral terms vary and are set according to the credit quality of the hedger.

- With regard to mandatory clearing of standardized products, defining which products are "standard" and which products are "customized" is a complex issue that must be thoroughly examined by the appropriate federal regulator to avoid disrupting market segments that continue to perform well.

- The loss of tailored hedging tools will greatly impact the ability of companies to comply with current accounting standards (Financial Accounting Standard 133). This accounting policy requires hedges to precisely match the underlying risk in order to reduce income volatility.

The Treasury Department outline also indicates that substantial capital requirements could be placed on all OTC dealers.

- While some level of capital requirements might be appropriate, there is a concern that the new regulatory framework could be developed such that only financial institutions could remain active dealers. The agriculture and energy hedging sectors both have active non-financial institution OTC dealers who offer healthy competition in the market. No non-financial institution dealers have required any taxpayer-based financial assistance from the Federal government. It would be inappropriate to eliminate these competitors from the OTC market through legislative or regulatory action.

***Recommendation*: Regulatory requirements should be based on risk to the financial system and not one-size-fits-all.**

Additional monitoring and transparency in the OTC markets (agriculture, energy, foreign exchange, and interest rates) is warranted and Cargill supports these efforts, but restricting working capital through major increases in mandatory margining in these markets is counterproductive.

Improved monitoring and transparency accomplishes the goals for the objective, without the increased expense and capital demands of clearing.

Objective 2: Promoting Efficiency and Transparency Within the OTC Markets

The Treasury Department's outline seeks to impose more recordkeeping and force trades on to regulated exchanges.

***Recommendation*: More record keeping and better disclosure would be helpful, although the regulator should be directed to focus on areas with the greatest risks.**

As previously mentioned, mandatory movement of activities from the OTC market to an exchange-traded market does not seem warranted in those markets that have not created systemic risks to the financial system.

Objective 3: Preventing Market Manipulation, Fraud, and Other Market Abuses

The Treasury Department's outline seeks clear authority to police fraud, market manipulation, and other market abuses and the authority to set position limits on OTC derivatives that affect a significant price discovery function with respect to futures markets.

***Recommendation*: We support the CFTC having clear authority to police fraud, manipulation and other abuses.**

The Commodity Futures Trading Commission is already using its existing authority and is receiving public comment on an Advance Notice of Proposed Rulemaking to address the enforcement of position

limits, address concerns about excess speculation, and help maintain the integrity of price discovery in the futures markets.

Cargill filed public comments with the CFTC on this proposal. In our comments, we support:

- Position limits for non-commercials
- Much greater transparency and reporting for over-the-counter markets.

A graphical summary, including the highlights of the comments, is included at the end of today's testimony as Appendix A. The entire comments are on file with the CFTC, and we would be happy to distribute them to members of the Senate Agriculture Committee.

Objective 4: Ensuring That OTC Derivatives Are Not Marketed Inappropriately To Unsophisticated Parties

Recommendation: Products should be marketed and continue to be available to those parties who meet the current regulatory parameters as eligible market participants.

Summary:

1. Derivatives play an important role in helping companies manage risks. Exchange-traded derivatives are essential in price discovery and help facilitate basic risk management, while over-the-counter derivatives are essential to hedgers because they can be customized to fit a company's specific risk management needs.

2. Additional legislative and regulatory actions in the OTC market should:
   a. Be risk-based, and not treat all products identically
   b. Improve transparency and reporting
   c. Seek to add minimal costs and disruptions to those products that have not posed systemic risks to the financial system

3. Mandatory clearing and margining:
   a. Would severely reduce hedging activity
   b. Would greatly restrict working capital at a time when it is in very short supply
   c. Is not warranted for OTC products that have not created systemic risk

4. The CFTC, through its existing rule-making, is proposing much-needed steps and should continue to work on:
   a. Ensuring the enforcement of position limits in related exchange-traded markets, principally agriculture and energy products
   b. Improving the transparency and reporting of OTC products

We appreciate the opportunity to testify today and look forward to working with the Members of the Senate Agriculture Committee and other policymakers as this issue develops.

Appendix A:

CFTC Advance Notice of Proposed Rulemaking:
Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits

Highlights of Cargill's Suggested Changes as Outlined in Comments on CFTC Concept Release:

1. OTC dealer reporting to the CFTC once clients reach a significant size
   - Ensures compliance with exchange-related position limits

2. End user reporting to the CFTC once their activity reaches a significant size
   - Greater transparency
   - Ensures that if multiple dealers are used, the regulator knows the activity
   - Similar to Large Trader Position Reporting requirement

3. *Bona Fide* hedge definition limited to those physically involved with underlying commodity

4. OTC exemption that allows OTC dealers to facilitate customer transactions. A speculative position limit would apply if a dealer is trading on its own behalf, and not addressing client risk.

Graphical Summary of Recommended Changes:

Bold (Blue) Lines Indicate New Reporting/Compliance