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OVERSIGHT HEARING: IMPLEMENTATION OF TITLE VII OF THE WALL STREET REFORM AND CONSUMER PROTECTION ACT

HEARING

BEFORE THE

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UNITED STATES SENATE

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Thursday, March 3, 2011

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

The Committee met, pursuant to notice, at 2:34 p.m., in room SR–328A, Russell Senate Office Building, Hon. Debbie Stabenow, Chairman of the Committee, presiding.

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

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

Chairwoman STABENOW. I am calling the meeting to order, and let me, before formally beginning—certainly welcome and good afternoon. We were just commenting upon the candy that is here. I have been looking for some dried cherries or blueberries to bring in for the Committee, and Senator Roberts beat me to it with—where is this candy from, Senator Roberts?

Senator ROBERTS. Madam Chairwoman, they are from Abilene, Kansas, home of Dwight David Eisenhower. It is just one to a member and one to the people who are testifying, and then the people who share my views get two.

Chairwoman STABENOW. Get two, okay.

[Laughter.]

Chairwoman STABENOW. Well, thank you. Thank you for the treats. Good afternoon, everyone, and we want to thank our two Chairmen for joining us today—we very much appreciate your time—and the other witnesses that will be with us, and we are here today, as we know, to discuss an extremely important part of the Committee's jurisdiction: oversight of derivative reforms and the Wall Street Reform and Consumer Protection Act.

Derivatives are a significant part of our financial markets and play an important role in our economy. More than 38 million Americans work at companies that use derivatives to manage their risk, and many more from pensions to municipalities use them to protect against market volatility.

Unfortunately, derivatives also played a very significant role in the failure that led to the financial crisis. Before regulatory reform, swaps were trading over the counter, off exchange, and in the dark. The result was that people who had saved money and played by the rules saw their 401(k)s plummet in value. Small businesses and farmers could not get the credit they needed to keep the lights on. Many had to close their doors permanently. Before it was over, 8 million Americans had lost their jobs.

Last year, Congress passed the Wall Street Reform and Consumer Protection Act to address the abuses in these markets and to give significant authority to our regulators to prevent future crises. During that debate I fought to ensure that the bill preserved the ability of American farmers, co-ops, manufacturers, utilities, and businesses to use derivatives for legitimate business purposes. They use derivatives to protect themselves from fluctuating currency exchange rates, interest rates, fuel prices, and commodity prices. This risk protection provides companies with the certainty to be able to grow and to be able to create jobs.

While Congress greatly expanded the authority of the SEC and the CFTC, that authority came with a warning: not to overreach. These agencies must follow congressional intent and protect end users from burdensome margin requirements which, if imposed, would divert much needed capital from investments in job creation.

Chairman Gensler, Chairman Schapiro, I hope you have considered how new rules with fit together in a way that makes sense for the markets, whether that is phasing in implementation or carefully sequencing the rules. We must make sure that market infrastructure is in place, the technology is ready, and that market participants are able to meet the requirements of this law.

The new accountability and transparency we have created is clearly in the public interest, and the most important thing is to get it right.

We also know there are serious budget constraints, and I am concerned that if our agencies do not have the tools that you need, we are asking for a repeat of the crisis that cost, as I mentioned, 8 million American jobs.

It is also critical that the system be able to adapt to the significant changes in the law. These are dynamic, diverse markets, and we need to provide as much certainty as possible.

I look forward to working with everyone involved to make sure that we are getting the implementation of these reforms right to protect our system from another crisis while maintaining the competitiveness of U.S. farmers, businesses, and financial markets.

I would now like to yield to my distinguished Ranking Member, Senator Roberts.

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

Senator ROBERTS. Thank you, Madam Chairwoman, and especially for holding what should be the first of several hearings regarding the implementation of the derivatives provisions included in the Dodd-Frank Wall Street Reform Act.

Now, you and I are new in this particular leadership position on this Committee. We have the privilege of doing that. But we are not new, Madam Chairwoman, to the very important issues surrounding derivatives regulation. We have both worked very hard, albeit from the different perspectives, on the Dodd-Frank bill as it went through the Senate last year, yet we share similar ultimate goals of properly reforming the derivatives markets while maintaining robust and liquid markets to allow our farmers and ranchers and commercial end users to manage risk and to discover market-driven prices.

I think it is fair to say that, as the Ranking Republican of this Committee, I would have preferred a more measured approach than what was passed, but I am optimistic that the regulators, specifically the Commodity Futures Trading Commission and the Securities and Exchange Commission have sufficient discretion in their newly granted authorities to ensure that we stay competitive and do no harm to our domestic markets, exchanges, or users. I sincerely hope that you use it.

That being said, I want to stress that the Dodd-Frank derivatives provisions reach far beyond financial firms. It will impact every segment of our economy from farmers and ranchers to manufacturers to energy companies to health care and to technology. Dodd-Frank gave the CFTC and the SEC nearly limitless authority with regard to the regulation of those derivatives, formerly known as over-the-counter swaps.

Now, proponents of the derivatives portion of Dodd-Frank surely believe it will prevent the next financial meltdown, and I hope that that is true. However, the regulation provisions of Dodd-Frank go well beyond dealing with credit default swaps, which, as far as I can tell, were the only derivatives ever mentioned as being part of the financial crisis, and completely regulate every aspect of every swap and every swap user, including a whole lot of people and businesses who had nothing to do with causing the financial crises.

So, the CFTC and the SEC have a lot of authority, and that does worry some folks. If our regulators stay focused, as indicated by the Chairwoman, on only writing regulations that truly reduce systemic risk and avoid actions that will unnecessarily raise risk management costs, then American farmers and businesses will be able to keep managing their business risk with derivatives in an economically sustainable manner.

Madam Chairwoman, with the fragile state of the economy today, we need to ensure that all new derivatives regulations and, for that matter, any regulation meets two tests: it must lower the systemic risk and, two, costs cannot outweigh any benefits. With the globalization of derivative markets, we need to ensure our regulators are exercising their authority in a manner that ensures we will continue to have thriving domestic derivatives markets.

I look forward to hearing from our witnesses today, and I thank them for their time.

Chairwoman STABENOW. Thank you very much, Senator Roberts. And let me stress what you said in your opening statement as well, that this is the first but not only oversight hearing, and I look forward to working with you on this.

In the interest of time, we will ask other members to submit their opening statements for the record, and we want to welcome our two distinguished Chairmen, Chairman Gensler and Chairman Schapiro, and we would ask, Chairman Gensler, if you would provide us with your comments.

Senator CHAMBLISS. Madam Chairwoman?

Chairwoman STABENOW. Yes, Senator Chambliss.

Senator CHAMBLISS. Before you turn to them, can I just make a quick statement? Since this is the first opportunity I have had to attend a hearing with you taking over the chairmanship and with my shotgun rider here for the last 6 years being the Ranking Member, I just want to tell you we are very proud of you. Congratulations to you for assuming the chairmanships, and it is going to be a fun time over the next couple of years. And I know under your leadership and with Pat's assistance, we are going to continue to work in a very strong and bipartisan way, and I want to commend and congratulate both of you.

Chairwoman STABENOW. Well, thank you. Thank you very much. It was a pleasure to work with you on the last farm bill in your position as Ranking Member, and we spent a lot of time working together to get that done, and I am looking forward to doing it again. So thank you very much.

Chairman GENSLER.

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

Mr. GENSLER. Good afternoon, Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee. I thank you for inviting me here to testify on the Dodd-Frank Act, and I am pleased to testify on behalf of the Commission. I also thank my fellow Commissioners and CFTC staff for all their hard work and commitment to implementing the legislation.

I am pleased to testify along with Chair Schapiro. I think it is probably the 10th or 12th time we have done this together over the 2 years, and the work between the staffs of the two agencies has been very close. We have formed a great partnership, and I think it is a great partnership as well.

Before I mention the testimony, I do want to congratulate the new Chair. I know it has been a difficult week. I read your statement and I express my condolences to you and your staff on your loss. It sounds like a wonderful individual.

I also congratulate Senator Roberts. I hope that from time to time I will get that second chocolate, that we will agree.

The CFTC is working very closely with the SEC and other regulators in the U.S. to implement Dodd-Frank. We also are coordinating and consulting with international regulators to harmonize the oversight of the market. And we have received thousands of comments from the public, both before the proposals were made and during public comment periods, that have helped inform the Commission.

At this point in the process, the CFTC has come to a natural pause. We have actually proposed rules in 28 of the 31 topic areas that the rule lays out. We do have three important topics to move forward on, and we anticipate at least on the two major ones to do that hopefully in the next month or 6 weeks.

As we receive comments from the public, we are looking at the whole mosaic, and hopefully the public is able to look at the whole mosaic as it is out there now.

Two components that we have asked the public specifically on is phasing of implementation, particularly with regard to the cumulative effect of these rules, and the cost/benefit analysis. The public comments will help inform the Commission as to what requirements can be met sooner and what requirements need to be phased over time.

Further, asking the public is one of the best ways to actually get a clearer picture on the cost and benefits of proposed rules as they bring those estimates and thoughts to us.

We will begin considering final rules only after the staff can analyze, summarize, and consider the comments, only after the Commission is actually able to discuss the comments and provide feedback from a wonderful five-person Commission to the staff and only after the Commission also consults with the SEC and the other Federal regulators and the international regulators. So this will take some time. We do not yet have any scheduled or planned final rule hearings. But as we bring this together, some of the, I will say, easier ones we will move on earlier, and others will certainly be over the course of the summer. And we are human. I will say it again. The July 15th deadline I do not think needs to change, but some of these rules will certainly be finalized after the July 15th date.

One proposed rule that I did want to comment on is with regard to margin. With the Dodd-Frank Act, Congress did recognize different levels of risk posed by different transactions in financial entities and the non-financial entities. This is what you took up in the clearing exemption.

Consistent with that, proposed rules on margin requirements—the CFTC I am speaking for—should focus only on transactions between financial entities rather than those transactions that involve non-financial end users. And as I mentioned, I think that we will probably take up that proposal towards the early part of April.

Before I conclude, I will briefly address the resource issue. We appreciate the difficult decisions that Congress and our great Nation face with regard to the budget deficit. Even in this context, the CFTC we believe is a good investment. Its mission is to promote transparent, open, and competitive markets, lowering the cost to end users and helping promote economic activity. The CFTC has a key role to play in overseeing derivatives markets for key commodities, including agricultural, energy, metal, and also financial products.

Now, the U.S. futures market is about $40 trillion notional size; the U.S. swaps market, about $300 trillion size. We will share some of that responsibility, but it is about 7 times the size of what we oversee now, and it is far more complex.

Last month, the President submitted a fiscal year 2012 budget—so for next year, not this year—of $308 million. That would be up from our current funding of $168 million. The CFTC, at about 675 people, is not that much different in size than we were 16, 18 years ago. In the early 1990s, we were 634. Unfortunately, we did shrink all the way down to the crisis when we were only 440 people in 2008.

So only last year with this Committee and all of Congress' help did we get back to our head count of where we were in the 1990s.

But staff is not enough. We will also need technology. Technology is the best way to be efficient as a regulator, and leveraged resources to the President's budget in 2012 would actually double our resources for technology, remarkably just from $31 million up to $66 million, far less than most of the large dealers spend in technology in a month—actually less than most of them spend in a week. But it does ask for about 45 percent more people.

I look forward to working with Congress to get these rules in place, and I look forward to your questions.

[The prepared statement of Mr. Gensler can be found on page 81 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Now, welcome, Chairman Schapiro.

STATEMENT OF HON. MARY SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Ms. SCHAPIRO. Chairwoman Stabenow, Ranking Member Roberts and members of the Committee, thank you for inviting me to testify today on behalf of the Securities and Exchange Commission regarding our implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. It is a pleasure to appear with my colleague Chairman Gensler.

Title VII of the Dodd-Frank Act creates an entirely new regulatory regime for the previously unregulated over-the-counter derivatives market. In particular, it calls upon the SEC and the CFTC to write a substantial number of rules designed to bring greater transparency and oversight to the market. While implementing these provisions and meeting these goals is a complex and challenging undertaking, we recognize the importance of this task, and we are committed to getting it right.

As part of that effort, we have engaged in a very open and transparent implementation process, seeking input from interested parties even before issuing formal rule proposals. In addition, our staff has sought meetings with a broad cross-section of market participants. We joined with the CFTC to hold public roundtables, and we have been meeting regularly with other domestic and international financial regulators to ensure consistent and comparable requirements across the rulemaking landscape.

Title VII is intended, among other things, to reduce counterparty risk by bringing transparency and centralized clearing to security-based swaps, reduce systemic risk, protect investors by increasing disclosure, and establish a regulatory framework that allows the OTC derivatives market to continue to develop in a transparent, efficient, accessible, and competitive manner.

To date, the SEC already has proposed ten swaps-related rules designed to achieve these goals. Among others, we have proposed rules that would address potential conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade or will trade security-based swaps; rules that would specify who must report security-based swap transactions; what information must be reported and where and when it must be reported; and then what information will be disseminated to the public; rules that would require security-based swap data repositories to register with the SEC; rules that would define security-based swap execution facilities and establish requirements for their registration and ongoing operations; and rules that would specify information that clearing agencies would provide to the SEC in order for us to determine if security-based swaps must be cleared and specify the steps that end users must follow to rely on their exemption from clearing requirements. And just yesterday, we proposed rules that would establish the standards for how clearing agencies should operate and be governed. In addition, with the CFTC, we have proposed rules regarding the definitions of many of the key terms within the Dodd-Frank Act.

In the coming months, we expect to propose rules to establish registration procedures for security-based swap dealers and major security-based swap participants and rules regarding business conduct, capital, margins, segregation, and recordkeeping requirements for dealers and participants. Finally, we will also propose joint rules with the CFTC governing the definitions of swaps, security-based swaps, and the regulation of mixed swaps.

We recognize the magnitude and the interconnectedness of the derivatives market, and so we intend to move forward at a deliberate pace, continuing to thoughtfully consider issues before proposing and certainly before adopting specific rules.

The Dodd-Frank Act provides the SEC with important tools to better meet the challenges of today's financial marketplace and fulfill our mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

As we proceed, we look forward to continuing to work closely with Congress, our fellow regulators and members of the financial community, affected end users, and the investing public.

Thank you for inviting me to share with you our progress on and plans for implementation, and I look forward to answering your questions.

[The prepared statement of Ms. Schapiro can be found on page 124 in the appendix.]

Chairwoman STABENOW. Well, thank you very much to both of you, and let me thank you for your service. We have given you major new responsibilities and tremendous amount of hard work that I know that you and your staffs are involved with. And issues around resources make it even more challenging, so thank you very much for your service.

The first question I would have is regarding the harmonization of the rules that you talked about. I have some concerns regarding coordination, both domestically and internationally. There are not only significant differences between the U.S. and Europe and Asia approaches to swap regulation, but also certain rules that are between agencies right now. For example, the SEC and the CFTC rules regarding swap execution facilities and the definitions, real-time trade reporting are different. Also, we are still waiting on the product definition rules. These are rules such as swap or mixed swap that require coordination between the agencies and have significant market and jurisdictional implications.

Having a different set of rules that governs similar transactions could have negative impacts on the markets. What can you do to assure us that the agencies are working together to iron out the differences on these rules, first? Second, could you expand on your efforts to ensure that global financial regulation is harmonized to the maximum extent possible? And where do you think international regulators might take a different approach than what we are talking about in the U.S.? Chairman Schapiro?

Ms. SCHAPIRO. We are having trouble coordinating who should speak first, so that maybe does not bode well for——

[Laughter.]

Ms. SCHAPIRO. I think to some extent there are differences, clearly, in the rules that have been proposed by the two agencies, and I think that that is perhaps to be expected, in part because we have two agencies in largely overlapping spaces; but I also think because to some extent we have products that, while they are over-the-counter derivatives, are actually quite different. And the narrow area that is under the regulatory auspices of the Securities and Exchange Commission's security-based swaps is a relatively small piece of the market and not a highly liquid piece of the market. So there may be some differences that arise just from the fact that we are, in fact, regulating different products.

But what I would say is that, first of all, we are still only at the proposing stage, so there is opportunity for us to come together and have very highly consistent rules. Also, where we have proposed something slightly different than the CFTC, we have asked for comment on CFTC's approach in our releases so that we can understand whether industry or other commenters think the CFTC has a better approach than the one that we have proposed. And so we are looking also at all the comment letters the CFTC receives in response to their proposals.

I think that we will continue to work together very, very closely. We meet on a consistent basis. Our staffs meet virtually continuously. We have held many meeting with industry in particular on a joint basis so we can hear the same comments at the same time, and we will continue to push forward to ensure that we have as consistent an approach as possible.

I would just add one thing in that I think that while differences in the products we regulate might dictate some differences, if I could use the example of swap execution facilities, we will both have rules requiring chief compliance officers. I think the obligations of those chief compliance officers must be the same. We cannot put an institution through very different rule proposals or final rules. But at the same time, because of the difference in the products we regulate, there might be some reason to have different rules about how orders have to intersect and interact in the marketplace because of the nature of the products being different.

So we are very focused on this issue, and I am happy to speak to international, but I will let Chairman Gensler go ahead, and then if you wish, I can come back to that.

Mr. GENSLER. I would just echo, I mean, I think that we are working very closely together. Maybe other than my fellow Commissioners, the four Commissioners at the CFTC that deserve any thanks that you have, it is for them as well. Chair Schapiro and I have spent an enormous amount of time, and I consider it a close working partnership. And I think I speak for probably a hundred plus other people at the agency who have similar partnerships with the SEC back and forth. We shared all our drafts with them. We shared our memos with them in September and August and continue to do that.

In terms of international coordination, it has been very positive. It is more than our two agencies. Of course, it is the Treasury and the Federal Reserve and the FDIC as well. I plan to be back over in Europe again in a couple of weeks in front a committee somewhat similar to this but in the European Parliament. They are currently considering and taking up rules that are very similar to what we have here on clearing, on data repositories—and, yes, they have an end user exception that is very similar to ours—and on dealer oversight. They are separately looking at something called MiFID reform, which is about trading, and that is a little later in timing.

We have shared with them directly many of the drafts with the European Commission, the folks in London, the FSA. We even shared with Tokyo and Canada some of our drafts and got comments from them, though we do have different cultures and politics so there will be some differences. But I feel good that we are trying our best and they are, too.

Chairwoman STABENOW. Well, thank you. In the interest of time here—my 5 minutes are almost up—let me just ask one thing about end users because you know how strongly I feel, and I hope the Ranking Member shares that as well. I am concerned about that there are differences—Chairman Gensler, you have said you will not impose margin on end users, but there is a difference with the Federal Reserve looking at a proposal for end users, and I am wondering if you are still committed to following congressional intent as it relates to this, not to apply this for end users and their affiliates. And how are you coordinating with the Federal Reserve?

Mr. GENSLER. To the first part of your question, yes, for the CFTC Congress gave both of our agencies oversight for capital margin for non-banks, for the various products we oversee. We are working very closely with the banking regulators. We have been since August on this topic and are very close. So I cannot speak for them. They can speak for themselves. But I think we are looking to try to take up rules, as I said, in that early part of April and maybe even try to do it all on the same day, if that was possible.

Chairwoman STABENOW. Thank you.

Senator Roberts?

Senator ROBERTS. Thank you, Madam Chairwoman.

For both of you, thank you again for coming. The President recently issued an Executive order—it got a lot of notice and made the press; very happy to see that—that intended to cut through the red tape and needless regulations all throughout Government, which I think all of us support. Unfortunately, his Executive order does not apply either to the SEC or the CFTC. I said “unfortunately.” Perhaps you believe fortunately.

I recently introduced legislation that would correct that oversight and I think would be a very good starting point for reviewing not only the regulations being proposed by the SEC and the CFTC in the implementation of Dodd-Frank, which is why we are here today, but also to all of the economically significant regulations being pushed out by Cabinet agencies across the board and across the country.

During a CFTC public meeting last week, Commissioner Sommers noted that all of the CFTC's proposed rulemakings for Dodd-Frank contain what we might call boilerplate language stating—and I am stating here—the CFTC has not attempted to quantify the cost of the proposal because Section 15(a) of the Commodity Exchange Act does not require the Commission to quantify the cost—we talked about this a little bit when you had the courtesy to come to my office, and we had a nice visit—and that the CFTC is merely obligated to consider costs and benefits without determining whether the benefits outweigh the costs.

I agree with Commissioner Sommers that the CFTC should quantify the costs of its proposal, especially when the original goal of the legislation was to reduce systemic financial risk.

Chairman Gensler, given the importance of getting these rules right, will you commit to voluntarily included a meaningful cost/benefit analysis prior to issuing any final rules? And that question would also apply to Chairwoman Schapiro.

Mr. GENSLER. We at the agency are committed to do that, and it is also in our statute. Congress took this up, I do not know, probably more than a decade ago and included it directly in our statute, as you said, Section 15(a). And more broadly, with regard to the President's Executive order, we actually are following the key principles in there about public involvement. We have also said that we will take up within 120 days is that it asks to have a plan to look at our entire rulebook, not just related to Dodd-Frank, but to have the plan to look at the whole rulebook. That might be later this year. And one of the best ways to actually learn about costs and benefits is also to ask the public.

And so what we have asked each of our teams to do is to take all of the public comments, these thousands of comments, and summarize it and that we as Commissioners will consider each of those detailed comments from the public on the costs and, as I said, the benefits, quantities as well as qualitative issues that the public raises with us.

Ms. SCHAPIRO. Senator, we actually consider economic data to really be core and central to all of our rulemaking proposals, and so we do include a cost/benefit analysis in our proposals, and we ask for comment on that and we will evaluate before we go final. I think specifically the language we look to is the economic implications of proposed rules under our statute.

We also consider the impact of our rules on competition under the Securities Exchange Act. We have to do a Paperwork Reduction Act analysis so we can understand the burdens of information collection because, as you can imagine, we have lots of reporting rules. We do a regulatory flexibility analysis to understand the impact of our rules on small businesses. And as with the CFTC, we routinely ask people to provide us with economic analysis and data that we can incorporate into our rulemaking process.

We are also following a very public notice and comment process for all our rules, which is suggested under the President's Executive order. And we have made a determination that we would on a voluntary basis look at our existing rules, particularly with respect to their impacts on small businesses, to see if there are things we can do to facilitate small business capital formation going forward.

Senator ROBERTS. So I take it from both of your answers that the answer is yes.

Ms. SCHAPIRO. Yes. A very long way.

Senator ROBERTS. I have just a few seconds here, but, Chairman Gensler, I have a CFTC-specific question about the current budget situation. Your testimony states that you operate on $169 million per year. The President requested $308 million. As you have indicated, the other body is contemplating—i.e., the House budget—about $112 million.

My question is: You have 680 employees apparently transferring from the information technology budget to avoid some layoffs. This concerns me given the fact that these new regs will require significant technological investments—we have talked about that—to administer. There is already a self-regulating body. The National Futures Association looks like it will be quite capable of shouldering some of the burden, if not a lot of the burden, of these implementation issues.

Question: How will you handle Dodd-Frank implementation if the Commission stays at or below its current funding level? How will you prioritize the regulatory enforcement? Shouldn't we at least define swap first and know what we are regulating? And what role do you see, if any, for the National Futures Association in implementation?

I apologize for being over time to my colleagues and the Chairwoman.

Chairwoman STABENOW. That is perfectly fine. It is an important question, but I would ask you both to be brief.

Mr. GENSLER. If we were actually rolled back to the 2008 levels, we could not ensure the public that we can fulfill our mission on the futures market let alone take on swaps. We only had 440 people in 2008. Particularly if it came in the middle of the year, we would have to have reductions in force far more significant to smaller than that.

On technology, I agree with the Senator very much. It is a very hard choice. It was not one that I wished to make, but to put it—we only spent $31 million on technology last year out of $168 or $169 million, only 18 percent. We think we need to spend significantly more. The President has proposed $66 million in technology. I think that is the right thing, spend more on technology, obviously some more on people, and, yes, we are working closely with the NFA and Dan Roth as to how they can take up registration and possibly examination of swap dealers.

Ms. SCHAPIRO. Senator, I think that our ability to operationalize these many rules under Dodd-Frank under the current continuing resolution or a cutback is very much in question, and we will obviously need to be very transparent about what we are able to do and what we are not able to do.

We are a little bit more disadvantaged in the sense that we cannot rely on a self-regulatory organization on the securities side the way the CFTC can rely on the NFA under the statute as it was drafted. So we will not have the option to push off hedge fund examination or swap dealer examination unless they are also dually regulated and registered as broker-dealers on the securities side. So that will create some additional stress for us.

We have made no decisions at this point about how to make the trade-offs between human resources and technology resources without knowing yet what the budget numbers really will look like.

Chairwoman STABENOW. Okay. Thank you very much.

We will now go to members' questions for 5-minute rounds. If we finish and there is someone who wants to ask a question after we have done this once, then we can offer that. But right now I would like to ask for 5 minutes, and we will start with Senator Bennet.

Senator BENNET. Thank you, Madam Chair. Thank you for holding the hearing.

Thank you for your testimony. We get to see each other all the time on Agriculture and Banking.

I wanted to come back on the international question for a second that the Chairwoman had raised because it is incredibly important that our efforts here do not force trading in other places rather than here, especially in markets that are untransparent or have vastly different regulatory regimes. And I wonder whether that, first of all, is a risk in your view and what we are trying to do to mitigate that risk. And are there regions or countries that you worry about?

Mr. GENSLER. It is a risk because risk and money know no geographic boundaries or borders. And, in fact, it moves not just in minutes but it moves in microseconds and nanoseconds. So we are working very closely with international regulators. I think we have made great progress with Japan, with Canada, with Europe, but there are some regions that are not as engaged.

I would say this, that the statute is very clear. If an international bank is dealing with U.S. commerce, is entering into swaps with U.S. counterparties under Section 722 of the act, it is supposed to be transparent and supposed to have the benefits of the act. And so one of the things we are trying to ensure is, whether it is an international bank or a U.S. bank that is dealing with a U.S. counterparty, that it would be a level playing field. And we think that is very important, and we think that was Congress' intent to make sure that U.S. banks somehow, you know, did not have the same treatment.

Ms. SCHAPIRO. I would agree these are incredibly global markets, and there are many, many cross-border issues for us to resolve. But I do think that most other foreign jurisdictions are in the process of developing their own derivatives regulatory regimes. I would say they are, as a general matter, at earlier stages than we are, but I think also very much committed to having a reasonable regulatory approach.

It seems to me that we have to build a system in this country that makes people want to do business here because a race to the bottom will not serve anybody well, and as you know from the Banking Committee, after May 6th, when we had that extraordinary volatility in our equity and futures markets, we saw lots of people pull out because they were not sure about the basic integrity and quality of the U.S. markets. And a sound, rational regulatory system can do a lot to giving people basic confidence that this is someplace where they want to do business.

So we have to translate that desire, which I think all regulators share, into very consistent, concrete rules that make it possible for businesses to operate fluidly around the world but not engage in regulatory arbitrage and not have the regulators looking for a race to the bottom.

Senator BENNET. I think that is well put, and Senator Roberts said at the beginning that he hopes this is the first of several, and I agree with that. And I hope over time we can keep our eye on this question about what is really happening globally, whether we are pushing people away, and also away to places that create systemic risk, which brings me to my last question.

There was a lot of discussion that we had when we were legislating Dodd-Frank about the risk of the clearinghouses themselves becoming systemically risky. I used the word "risk" twice in one sentence—appropriate given what we have just been through. Could you tell us a little bit about that, what you are doing to mitigate that danger?

Ms. SCHAPIRO. I would be happy to. In fact, it is a little fresh in my mind because yesterday the SEC proposed clearing agency standards that will now go out for comment, and the goal there is to ensure that clearing agencies do not marshal risk together and then not have the risk management capabilities to manage it so that they—the proposals we set out yesterday is quite a large number of requirements, but the basic goal is to create fair and open access so we have competition, promote prompt and accurate clearances and settlement, finality of payments, safeguarding of securities and funds, and good risk management practices, including testing of margin models, limiting exposure to individual counterparties, maintaining financial resources so that transactions—so that the institution can withstand the default by, in the case of the rules we propose, the two largest exposures in a security-based swap clearing agency.

And so I think we will be very anxious to get comment on this set of proposals, but I think it does a lot to really bolster the risk management and integrity of clearing agencies because what you have said is exactly right. We have to get this right, or all of this effort to move transactions into clearing agencies to reduce counterparty risk will really come to naught.

Mr. GENSLER. I would just say what we are doing is following international standards, so it is good news on the international front. IOSCO, which Chair Schapiro plays a big role in, but we have a lesser role at the CFTC, has international standards. They are still updating those, but our clearing rules are meant to be consistent also so that our U.S. clearinghouses will be accepted by Europe. Europe has a provision in there, what they are considering in front of the European Parliament, that there has to be an equivalency. So for European banks and European end users to use the clearinghouses, they want them up to international standards. So that is a harmonization and clearing question together.

Senator BENNET. Thank you.

Chairwoman STABENOW. Thank you.

Senator Johanns?

Senator JOHANNS. Thank you, Madam Chair, and I thank both of you for being here today. I really appreciate it.

I am listening to the testimony of both of you, and I know you both to be people of enormously good faith, and I think you deal with this straight. But there is such a different story between the world you see from where you are at and those who are regulated.

In fact, I would go so far as to say that I really do think that we are going to look back in 5 years and ask ourselves what happened to this market. I do think we are forcing it out of the United States to areas where it will be in the shadows and it will be less regulated. This is a big business. Any country would want this business, and they will do everything they can, I believe, to take it away from us. So I think we are just subjecting our economy to enormous risk here by overregulation.

Let me ask you a couple of specific questions, though. By any measure, I think both of you would have to agree that because of the act, not because of something new invented, there has been a massive amount of regulations and paper. I mean, we must be clearing forests to keep the paper going into your office.

Just speaking honestly, there cannot have possibly been any kind of decent economic analysis or cost/benefit analysis of these rules and regulations, especially the interrelationship between your two areas. Is that a safe assumption?

Ms. SCHAPIRO. Senator, I think our staff—we have about 30 economists on our staff, and as I say, we do cost/benefit analysis for all of our rule proposals and our final rules, and I think they have worked very hard to do the best quality economic analysis possible. And as I said, we seek economic data and information from the industry, which has lots of access to good data because it is their data and lots of access to high-powered economists to help generate it and we try to incorporate that in our rulemaking process.

There is no question that the pace of rulemaking has been a challenge, and we will undoubtedly miss a number of the deadlines because we are trying to take the time we need, even if it was not necessarily time that was offered under the statute. Part of that time is to enable us to try to do high-quality cost/benefit analysis.

I understand your concern. I clearly hear it. I think we have to be highly sensitive to the regulatory regimes that develop around the world. But we also, I think, have to be leaders in bringing people to rational, high-quality regulation of this market in a way that allows businesses to continue to function effectively.

Senator JOHANNS. Chairman, here is my concern. You know, everything I read about the financial crisis is that there were a handful of enormously greedy people who created a system that darn near brought our economy down. And I am not talking about millions of people, although millions got caught up in it. I am talking about a handful of very, very powerful people in key positions who made very dumb decisions over time.

And I look at this, and I find it heart-breaking. I mean, I hear about the little gas and oil company somewhere out there that is trying to hedge risk, or the farmer, and all of a sudden they are caught up in this massive rewrite, and they just do not have the economic power to deal with you.

Ms. SCHAPIRO. I agree with that, and that is why I think end user exemption from the clearing requirement is so important, and

Congress was very wise to include that. The clear congressional intent we have heard with respect to margin on end users, with respect to rules that are not really the subject for today but hedge fund reporting, for example, on the SEC side. We have tried to tier the market so that we can have lesser burden on smaller hedge funds. We have proposed a small bank exemption as well from the clearing requirements on the SEC side. So we are trying to be very sensitive to those issues, and there is no desire to make it harder for any institution to mitigate the risks that it faces in running its business.

Senator JOHANNS. Chairman Gensler, I am out of time, and I do not want to abuse the privilege of being here, and others want to ask questions. Here is what I would ask of the two of you, just to wrap up. You have been very, very accommodating in stopping by all of our offices. I would hope that you would set aside some time to do that again. I have got some very serious concerns, and I do not want to be Chicken Little running around, "The sky is falling, the sky is falling." But I think we are overregulating in a massive sort of way, and I just want to try to come to grips with what we are headed toward here.

Mr. GENSLER. I would like to do that. I think it is a marketplace that is enormously consequential to those farmers, those oil producers, the gas stations. It is to make sure it is transparent and it does not pose risks to those folks. They are not going to be in the clearing. They are not going to be in the margin at the CFTC. They are not going to be major swap participants and so forth. But they benefit from transparency and they benefit that the folks that are the big actors do not force millions of people out of work because of the calamities like we had in 2008.

Chairwoman STABENOW. Thank you very much, and I would just echo what Senator Johanns has said in terms of continuing to be available. We appreciate that very much. But it is very important to members of the Committee given the impact on the economy and the fact that we need to make sure that this is being done correctly and we have the opportunity to continue to have dialogue. So I would echo Senator Johanns' request.

Senator Gillibrand?

Senator GILLIBRAND. Thank you, Madam Chairwoman.

Thank you both for being here. I respect you both immensely and appreciate your dedication and service at this time.

I would like to drill down on two of the questions that the Chairwoman started with, compliance costs and competitiveness and international harmonization, and then ask a question about fiduciary duty if we can get to it.

But on compliance costs, many people are concerned that because, you know, you are making this effort to work together to make sure your rules are compatible, there are still a number of significant differences in implementation that may result in higher compliance costs. For example, under current proposed real-time reporting rules, the SEC has put forward 12 categories of data it requires while the CFTC has between 29 and 37 varying requirements for block trades and other specific inconsistencies.

What are you actually going to do to iron out the differences for these technical differences to make it straightforward and simple to report this essential information? And, you know, do you have a plan to do that? And how will you do that?

Ms. SCHAPIRO. Well, I would say that as the comment letters come in and we read both the CFTC's comment letters on their proposals and our own, we will sit down together and try to hammer all of these differences out. I think there are some differences that will perhaps continue to exist for very good reason because the nature of the markets is so different. As you know, the Securities-based swaps, we are talking about under the SEC's jurisdiction are only about 5 percent of the notional value of this marketplace. So it is a pretty small piece, and these are products that do not trade anywhere near the way interest rate swaps trade, with anywhere near that kind of liquidity. So there may be some reasons for us to approach something like block quite differently than the CFTC has chosen to do it. We have actually not put out our block proposal yet. We have asked for comment on how should we think about block trading in the context of our markets, and then we will come out with some standards, objective standards on block trading at a later time.

Mr. GENSLER. I know we have about 75 comment letters on the real-time reporting rule. It closed about 3–1/2 weeks ago, so the staff is still summarizing it. But we will be looking very closely at the SEC's comments, our comments, and as Chair Schapiro said, some of the product differences because we cover oil swaps, interest rate swaps, agricultural swaps. So some of those fields may be relevant for, for instance, agricultural swaps that are not relevant for interest rate swaps.

Senator GILLIBRAND. Okay. In terms of international harmonization, one of the concerns that I have is in timing and making sure we have a timetable because obviously we do not want to create the opportunity for regulatory arbitrage, and we want to avoid incentives for market participants to go abroad. So are you seeking a memorandum of understanding with other countries? What are you actually going to do to prevent this kind of reaction?

Mr. GENSLER. We have actually initiated dialogue with a number of other countries. We think that the CFTC will probably have between a dozen and 20 memorandums of understanding, principal amongst them the European Union and the new ESMA, which is their joint regulator for this in Europe, the FSA, and elsewhere.

We have been an agency for long that has mutual recognition agreements. Maybe it is just partly that we are small. We need to leverage off of international regulators.

Ms. SCHAPIRO. I would say that I think the European markets are a bit behind us, and I understand that timing is a concern. But I think that we do not yet really know the timing in the United States just because we are going to have to be very thoughtful about how we sequence the implementation of the rules that we ultimately adopt, allowing the industry sufficient time to develop the technology that they need, allowing us some time to develop the technology that we need to have oversight of this market.

So I think I am not worried yet about the fact that we are on different timetables, but it is something for us to keep a very close watch on.

Senator GILLIBRAND. Okay. The last issue is, you know, during Dodd-Frank we worked very hard to ensure that municipalities and other entities that had little experience in the swap markets would be protected while continuing to provide market access to entities that need to address their risk. And, additionally, we expanded fiduciary responsibilities for investment advisers to similarly protect investors.

But in recent weeks, we have seen that the Department of Labor has issued a new proposal that would expand the scope of fiduciary duty requirements for many of these same market participants. What are you doing to work with the Department of Labor to coordinate the proposals and the new rules that you are developing to avoid conflicting requirements?

Ms. SCHAPIRO. Well, we have delivered to Congress—on time, in fact—our fiduciary duty study, but we were very careful there to say that we were not implicating fiduciary duty under the ERISA statute, which is solely the responsibility of the Department of Labor.

There are some issues with respect to how the Department of Labor is contemplating—and they have just closed their comment period, and I think they actually had 2 days of hearings this week that our staff attended, and I believe CFTC staff attended as well—and where they are considering expanding the definition of "fiduciary," and the concern being whether fulfillment of any of the business conduct obligations of Dodd-Frank will turn dealers or others into fiduciaries under ERISA bringing in all the prohibited transaction language.

We have been talking with DOL about this. We stand ready to provide expertise and assistance to them in any way they choose going forward.

Mr. GENSLER. We, too, are in dialogue directly with the Department of Labor. I believe that we can harmonize the business conduct standards as Congress anticipated with what the Department of Labor is doing.

Senator GILLIBRAND. Okay. Thank you.

Thank you, Madam Chair.

Chairwoman STABENOW. You are welcome.

Senator Boozman?

Senator BOOZMAN. Thank you, Madam Chair.

I was with an individual the other day, and he was telling me about a hearing over in the House, and they were questioning one of the other agencies, one of the other regulators, and the House Member said something to the effect of, "Every place I go, people are so angry," at, you know, this and that. "What have you done to upset so many people?" And I hope that, you know, in a matter of months you are not back over here and we are asking you the same question as you go forward with this. This is really very, very serious, and I just want to reiterate the importance.

All of us agree that, you know, so many of the—while the end users themselves were not in a position to cause any of the problems that we had, and we need to protect them. It is so important, not only in fairness but also because of the economy. There is so much uncertainty out there right now, you know, it is so difficult to plan, so difficult to look forward as you go forward with your agricultural venture, whatever, if you do not know the certainty of things.

So I would just encourage you. I think that I would just want to echo, you know, what you are hearing at the Committee, how important that is, and we really do expect you to do that as you go forward. But it is important not only, like I say, a fairness issue, doing things right, but also the importance of the economy that we try and get some stability so that people can plan, so that they can make decisions, so that we can get things moving forward.

Mr. GENSLER. I deeply appreciate that. I think this market fundamentally is helping end users, investors, and municipalities to plan for risk. It is really a market that helps them shift risk to somebody else, whether it be a speculator or somebody else to hold that risk. And at the core of Dodd-Frank is to lower risk to those systemically important folks, but also to create transparency for whether it is the agricultural user in Arkansas or elsewhere to use these products. And we have proposed rules. We look forward to comment on agricultural swaps as well.

Senator BOOZMAN. Thank you, Madam Chair.

Chairwoman STABENOW. You are welcome.

Senator Klobuchar?

Senator KLOBUCHAR. Thank you very much. Thank you, both of you, for being here today.

I am the co-chair with Senator Thune of the bipartisan Congressional Farmer Co-op Caucus. I bet you did not know there was such a thing, but there is. Minnesota boasts the largest number of agricultural co-ops, and these co-ops use the future and swap markets to lock in prices for fuel and fertilizer, and also to guarantee that their farmer members receive a certain price for their crop. There is concern that these farmer co-ops will face additional regulations because of your work, which I know is done for all the good reasons, but they are concerned that they are going to be facing these additional regulations intended for swap dealers which will increase costs.

So my question is this: Assuming that farmer co-ops are using the market to hedge the risk of their members, how do farmer co-ops fit into the new transparency and regulatory requirements? And will the CFTC classify farmer co-ops as a swap dealer or a major swap participant?

Mr. GENSLER. We have been working very closely with farmer cooperatives—Dairy Farmers of America, Land O'Lakes, others, some in the non-dairy area as well. The comment period on that proposed rule just closed last week, but I think that much of what they do, in fact, will not be a swap at all. Often they use documents called ISDA documents to do what is called forwards or options embedded in forwards, and though I know we have not proposed it yet, this product definition rule we anticipate will extend the forward exclusion from futures to being a forward exclusion from swaps. And that has clearly been the congressional intent, and there were a lot of colloquies and letters on that.

Senator KLOBUCHAR. Right, yes.

Mr. GENSLER. We plan to extend that.

Senator KLOBUCHAR. I am so glad you read them.

Mr. GENSLER. I have read as many as I can, but, yes, I have read them and the staff has, and we plan to follow that congressional intent. But we are looking closely and working and meeting with them because many of them are quite small, also, and might fall as they sense—even that which they do might be de minimis, but working with them closely on these matters.

Senator KLOBUCHAR. Okay. Thank you.

I think you remember that during our work on the Agriculture Committee I worked to include language that would authorize the CFTC to regulate companies that act as both swap dealers and end users according to the actual activity that they are engaged in. Could you comment on the progress you have made to ensure that diversified businesses will have the segments of their business that use the market to hedge risk qualify for that end user exemption?

Mr. GENSLER. Well, if somebody is a non-financial entity, they are an end user as long as they are hedging a commercial risk, and we put a proposal out that has a very wide definition of commercial risk.

Secondly, on the language to which you refer, we have been talking to a number of companies directly, just as they think that they might want to be a swap dealer. And there are not many in the commercial space that want to be, but some of them provide risk management services. We are talking to them already about how they might work with us to comply with the statute, as you say, that some activities are a swap dealer and then something over here is not. But it is usually then—and this is partly why we need resources, to have that give and take, to meet with companies and make sure that we get it exactly as Congress has laid out.

Senator KLOBUCHAR. Okay. And just the last question would be that I know you spoke earlier before I got here about the resources and the staffing level needs, and it was only, I think, this year that these staffing levels returned to the levels that they were in the 1990s. We could see what happened when we did not have enough staff with some of the problems we have incurred in this country. But if you could explain a little more to the Committee about the need for the modern technology, why that is needed, how the size and the complexity of today's marketplace requires having more regulators overseeing the marketplace.

Mr. GENSLER. Well, I thank you for that. The marketplace that we oversee and the futures marketplace is about 40 trillion notional, but it is also all on exchanges. By statute, since the 1930s it has all been on exchanges. This swaps marketplace is about 7 times the size. A lot of it will still be bilateral and off-exchange.

And so in terms of technology, our needs for technology—it is only $30 million or $31 million we spent last year—is less than even one week's budget of the major swap dealers that they spend on technology. It might only be a few days' budget. We need the technology to actually take the information in, aggregate it, and make sure that we check for trade practices, whether those be trade practices that we all could lock arms and say we should not have wash sales and things like that. But if you do not have technology to bring it in—there are 12 million transactions a day in the futures marketplace. There are not as many in the swaps marketplace. It is low volume transactions but high risk and so forth. So it is aggregating data. And May 6th, it took us months, really, between our two agencies to aggregate data and actually do a really thoughtful report on that, and that makes it difficult.

Senator KLOBUCHAR. Well, thank you. I think I have always believed, in my old job as a prosecutor, that you have to be as sophisticated as the people you are trying to in this case regulate. I think the added piece of that is we want this market to function, and we want you to be able to work with some of these companies that should not come under the regulations, and that is why I have supported your added staff, so thank you.

Chairwoman STABENOW. Thank you very much.

We have a second panel that we certainly want to hear from, but because of this important discussion, we are going to give one more opportunity for a question from any members in terms of doing a second round.

I would just simply, first of all, ask a follow-up to Senator Klobuchar's question in terms of farmers and co-ops being an important part of the end user exemption that we talked about. And I just want to make sure that you are saying—or that you are going to guarantee that the relationship between farmers and co-ops will be preserved and that farmers will continue to have affordable access to risk management tools.

Mr. GENSLER. That is a broad question. Farmers are end users—I have not found any farmer that is not an end user. At most, thousands of co-ops are end users. There is a short handful of co-ops who have been very gracious to come in, give us their comments, because they are providing some risk management services to farmers. And so we are sorting through that, you know, these six or eight co-ops that are sort of the Federal co-ops, where we are helping— they are helping us and we are sorting it through with them.

Chairwoman STABENOW. Thank you. One other question on transparency, because increased transparency is one of the most important aspects, as we know, of the reform efforts. We wanted to give you and the markets more access to trade information in order to increase market efficiency and identify market manipulation and, of course, price discovery. There will be a lot of sensitive data moving back and forth and a lot of analysis that is going to need to be done. And so my question would be: Will your agencies—the technology and the market infrastructure be ready to handle the information load by this summer? And then what are you doing to deal with information security breaches? And can you guarantee that data confidentiality and protections for proprietary information will be there?

Mr. GENSLER. Two excellent questions. I think in terms of timing we have asked the public on the phasing of this. I think that it will take longer than this summer. The data repositories in some fields, like interest rate swaps and credit default swaps, are earlier. There is not yet a data repository for agricultural swaps, for instance, and that will take longer. Under the statute, there is strict confidentiality about individuals' positions, but we have also included in the real-time reporting questions for the public to help us that the confidentiality has to be protected about who the counterparty is. And in some cases, that means there will be less information to the public.

Ms. SCHAPIRO. I would just add that we would not register a swap data repository if it could not prove to our satisfaction that it had the capacity to protect the confidentiality of the data in its possession.

Chairwoman STABENOW. Thank you.

Senator Roberts?

Senator ROBERTS. Thank you, Madam Chairwoman. And thank you for your testimony. It is very pertinent to the concerns that we all have. Let me identify and associate myself with the remarks by the Senator from Colorado, Senator Bennet, and Senator Johanns—if Senator Johanns is Chicken Little, I am Rooster Big—and Senator Gillibrand.

Let me ask just a couple of real quick ones and then get to the main question, and then I will submit the last one for the record.

Chairman Schapiro, you said you only had 30 economists. How many do you need? I cannot imagine 30 economists in one room.

[Laughter.]

Senator ROBERTS. What you need is an economist with one arm so he cannot say, "On the other hand."

Ms. SCHAPIRO. That is exactly right.

[Laughter.]

Ms. SCHAPIRO. Well, we are actually recruiting right now for a new chief economist, although we have a very fine acting——

Senator ROBERTS. Well, if you get the chief and you have got 30, how many more do you need? Thirty, 40, 50, 60? I mean, for economists? Come on.

Ms. SCHAPIRO. I guess given—our economists work not just on rule writing at the SEC and on our cost/benefit analysis, but we also use them, for example, after the May 6th events, to help us reconstruct data and do trading analyses, but also to assist us in our enforcement efforts. So I would love to come back to you with a specific number because I do not have one off the top of my head, but we would like——

Senator ROBERTS. Okay. That is fine. I just think that numbers of economists sort of boggle my mind. But at any rate, you said you had a small bank exemption. Can you tell me where you are on that? What are we talking about?

Ms. SCHAPIRO. That is out for proposal. The statute directed us to contemplate whether it would be appropriate to——

Senator ROBERTS. What, 100 million and less?

Ms. SCHAPIRO. It is 10 billion.

Senator ROBERTS. Oh, I am for you. All right.

Ms. SCHAPIRO. Yes, small banks, credit unions——

Senator ROBERTS. No, wait a minute. I am not for you. I need to raise it up. I am sorry.

Okay, go ahead. I am sorry.

Ms. SCHAPIRO. It is out for comment right now, and I am not sure exactly when that comment period ends.

Senator ROBERTS. All right. I appreciate that very much.

The European proposal on position limits—I am being repetitive here—which is you have to go through the numerous legislative steps before it is close to final, and it is going to be significantly less prescriptive than the CFTC proposal. Won't this timing gap alone create arbitrage opportunities? Moreover, if the EU adopts a less restrictive regime, won't that be an obvious invitation to move business away from the U.S. A very similar comment and question by Senator Gillibrand and others.

Ms. SCHAPIRO. I am sorry, Senator. I did not hear the first part. Was this about position limits?

Senator ROBERTS. No. We are talking—yes, about the position limits on the European proposal and the timing in regards to the steps before it is close to final, significantly less prescriptive than the CFTC proposal. Won't this timing gap alone create arbitrage opportunities? Moreover, if the EU adopts a less restrictive regime, won't that be an obvious invitation to move the business away from the United States overseas?

Mr. GENSLER. Once again, we are working very closely with the Europeans on position limits as well as many other perspectives. I think what Congress did in terms of position limits is ask for agricultural, metals, and oil, energy commodities that we shall put a proposal forward. We have done that. I would suspect this is one we will get thousands of comments on. We put a proposal forward last January to reinstate energy position limits. We got 8,200 comments. And they were helpful. We withdrew that and re-proposed based on those 8,000 comments, based upon the Dodd-Frank Act, and I think it is very important to get this right. And as you say, it has not been over in Europe, and that is part of the considerations as well.

Senator ROBERTS. I appreciate that. The 15 largest dealers will spend about $1.8 billion, an estimate, to implement the derivatives portion of the Dodd-Frank bill over 3 years. Question: Who do you think will end up paying that bill? Answer, my answer: Consumers. Divided by three, that is $700 million, that is more than you are asking for your budget. Any comment?

Mr. GENSLER. Well, I think that it does put in light a small agency budget of $168 million. The $1.8 billion, which was an estimate by the Tabb Group, is in the context that the U.S. financial industry, that same Tabb Group, spends $20 to $25 billion a year on technology. So while $600 or $700 million a year sounds large—and it is—it is in the context of an industry that is spending $20 to $25 billion a year.

Senator ROBERTS. Yes, but they are not going pay for it. The consumer is going to pay for it, with all due respect.

I have another question about the rules for swap execution facilities and for security-based swaps is different than the CFTC, but I am going to submit it for the record in the interest of time.

[The question of Senator Roberts can be found on page 205 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Senator Gillibrand, did you have another question.

Senator GILLIBRAND. One more.

Chairwoman STABENOW. Yes.

Senator GILLIBRAND. Chairman Gensler, the CFTC proposed rules require requests [inaudible] the SEC says many customers want. Many people are concerned about low trades where they are the only possible counterparties whether it will make it hard to trade these kinds of products. Why doesn't CFTC feel it is needed?

Mr. GENSLER. Well, this was a proposal whose comment period still runs for another week, and we look forward to the comments. But as we looked at the swap execution facility rules, Congress had said that they had to have multiple participants have the ability to execute with multiple participants, so what some people call "many to many." And we have a history, a 70-plus-year history, in the futures market and a statute that says that all futures have to come to an exchange.

That is not the case with swaps. There are bilateral swaps and customized swaps. But it is in that context that we also took up this rule, and we are very focused on how the SEC and we work to harmonize and try to be as consistent as possible, but at the same time not undercut a futures regime in some way and have some regulatory arbitrage between futures and swaps. So there is that trade-off. But we look forward to the public comment. We look forward to working consistently with the SEC.

Senator GILLIBRAND. Thank you.

Chairwoman STABENOW. Well, thank you very much. We appreciate your time today. You have a very big job, both of you, the Commissions, and the work that you are doing, again, we appreciate the hard work. We look forward to working with you as we go forward. We are very anxious to see this be done correctly, as I know that you are, and that the time that is necessary to do it right is taken to sequence and to phase this in in a way that is going to be good for our economy and good for consumers and provide the light of day that we know is very important on these markets.

So thank you very much again.

Mr. GENSLER. Thank you.

Ms. SCHAPIRO. Thank you.

Chairwoman STABENOW. We will welcome our second panel. We have a very distinguished second panel that is going to join us.

Welcome. We very much appreciate all of you being here and your patience, and I do want to reiterate, as members are moving to other meetings, that as you know, we will be both reviewing all of your comments. They are in the record and are a very important part of the record, and so Senator Roberts and I, while we are the only two here at the moment, you are providing a very, very important part of our discussion on oversight, and it will be part of our effort moving forward. You are providing us very important insight, and so we thank you very, very much for being here. Let me just briefly introduce everyone.

Ms. Jill Harlan is the corporate risk manager at Caterpillar, and we appreciate your being here this afternoon.

Terry Duffy, it is good to see you, the executive chairman of CME Group. Welcome.

And Steven Bunkin, who is the managing director and associate general counsel at Goldman Sachs, where he is the global co-head of commodities legal coverage.

And Larry Thompson, who is with us, general counsel for the Depository Trust and Clearing Corporation.

And last, certainly not least, Professor Michael Greenberger, who is with us as a professor at the University of Maryland School of Law and former director of Division of Trading and Marketing at the CFTC under Chairperson Brooksley Born.

So we welcome all of you. We appreciate having this level of expertise and input as we move forward on our oversight. Ms. Harlan, we would ask you to go first.

STATEMENT OF JILL HARLAN, CORPORATE RISK MANAGER, CATERPILLAR, ON BEHALF OF THE COALITION FOR DERIVATIVES END USERS, PEORIA, ILLINOIS

Ms. HARLAN. Good afternoon, Chairwoman and members of the Committee. Thank you very much for the opportunity to be with you today. My name is Jill Harlan, and I am the corporate risk manager for Caterpillar, Inc. I am also testifying on behalf of the Coalition for Derivatives End Users, of which Caterpillar is a member. The coalition represents thousands of companies across the country that use derivatives to manage their day-to-day business risk.

For more than 85 years, Caterpillar, Inc. has been a global leader in making sustainable progress possible. We directly employ 47,000 people in the U.S., and our dealer network employs an additional 34,000. We have manufacturing facilities across the U.S. and successfully compete globally from that significant U.S. production base, with approximately 70 percent of our sales outside of the U.S. in 2010.

We support this Committee's efforts to ensure that the derivative markets operate efficiently and are well regulated and appreciate the opportunity to share with you some of our concerns related to derivatives regulations impacting the end user community.

Understanding and managing risk is key to successfully operating our business and thousands of others in virtually every sector of the U.S. economy. The best-run companies identify risks associated with external and internal factors and seek to mitigate both.

At Cat, for example, we can control many internal risk factors. We cannot, however, control many external factors like the global price of copper, fluctuation in value of the Japanese yen, or the movement of interest rates in key economies. We do mitigate these risks by hedging our net exposures with derivative contracts.

In my written statement, I describe an FX forward transaction that illustrates how we use derivatives to mitigate currency risk. While I find FX derivative transactions very exciting, I will not bore the Committee by describing it again here this afternoon.

[Laughter.]

Ms. HARLAN. It is important to understand that Cat does not use derivative contracts for speculative purposes. Cat's derivative policies are specifically written to ensure we only focus on the management of risks associated with our business operations.

Cat and our coalition partners have many concerns about the impact of potential rulemaking on our end user derivative activities. I will focus today on four primary areas. My written statement goes into these concerns in some detail, so I will just summarize them this afternoon.

First, we are very concerned about the costs associated with direct or indirect imposition of margin costs on end users. Such regulatory action appears contrary to congressional intent and would harm our ability the ability of end user companies generally to manage our risks. It would also divert capital from more productive uses such as growing the economy and creating jobs.

Second, we are concerned about uncertainty surrounding foreign exchange forwards. We hope that the Treasury Secretary will exercise his statutory authority to exempt foreign exchange swaps and forwards from the regulations that will be applied to other derivatives contracts.

The third area of concern I describe in my written statement is the need for clarity concerning the impact of regulations on captive finance affiliates such as Caterpillar Financial Services, which bring an important source of liquidity to small and medium customers. The Dodd-Frank Act contains language exempting certain captive finance companies from the mandatory clearing requirement and the major swap participant definition. The standard, though, needs greater regulatory clarity in order to ensure that the captive's function of facilitating sales of the parent organization is able to be fulfilled.

A lot is at stake in the regulatory rulemaking process, and our final concern is the amount of time that has been allocated to draft and implement these critically important rules. We would like Congress to provide regulators and affected parties with more time for rulemaking and for regulators to allow market participants sufficient time for implementation.

The end user market for over-the-counter derivatives functioned well both before, during, and after the crisis. The responsible and effective use of these products by Cat and other end users helped reduce risk at both the individual company and the systemic level. We hope that active oversight from the Committee will help avoid a situation where implementation of rules increases costs for Main Street businesses and drives behavior that inhibits economic growth.

On behalf of Caterpillar and the coalition, I would like to thank you very much for your time this afternoon and the opportunity to share our thoughts on these important issues. I am happy to answer questions.

Thank you.

[The prepared statement of Ms. Harlan can be found on page 120 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Duffy, welcome.

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

Mr. DUFFY. Thank you, Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee. I want to thank you for the opportunity to testify on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am Terry Duffy, executive chairman of CME Group, which includes our clearinghouse, our four exchanges—CME, CBOT, New York Mercantile Exchange, and COMEX.

In 2000, Congress adopted the Commodity Futures Modernization Act. This leveled the playing field with our foreign competitors. It gave us the opportunity to grow and put us in a position to become the world's most innovative and successful regulated exchange and clearinghouse. As a result, we are now an economic engine of growth in Chicago, New York, and the Nation.

The 2008 financial crisis focused attention on the lack of regulation of OTC financial markets. The Nation learned painful lessons about unregulated derivatives trading. But we also demonstrated that regulated futures markets and futures clearinghouses operated flawlessly before, during, and after the crisis. Futures customers were protected.

Congress responded to the financial crisis by reining in the OTC market to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discover, and to prevent fraud and market manipulation. We support these goals, but we are concerned that the CFTC has launched its own initiative to turn back the clock on regulation of futures exchanges and clearinghouses. This will impose unwarranted costs and stifle innovation.

We are not alone. Most careful observers, and even some of the Commission, have concluded that many of the proposed regulations unnecessarily expand the Commission's mandate under Dodd-Frank.

Much of the problem results from the CFTC's efforts to expand its authority, and it is changing its role from an oversight agency whose purpose has been to assure compliance with sound principles to a front-line decisionmaker that imposes its business judgments on every operational aspect of derivative trading and clearing. This role reversal, which is inconsistent with Dodd-Frank, will require doubling the Commission staff and budget. It will also impose astronomical costs on the industry and the end users of derivatives. There is no evidence that any of this is necessary or even likely to be useful. This is the classic solution in search of a problem.

The crisis of 2008 did not arise from a failure of the regulated transparent futures markets. My written testimony includes numerous examples of rulemaking that will have costly adverse consequences on customers, end users, exchanges, and the economy.

We are strong proponents of an adequate budget for our regulator. However, we object to expanding the Commission's staff and budget to enforce regulations that are uncalled for by Dodd-Frank or that duplicate the duties that are now being performed by SROs, which are self-regulatory organizations, at no cost to the taxpayer.

The Commission justifies its budget demands by focusing on a couple of points: one, the growth in the notional value of the contracts it oversees on regulated futures markets; and, two, the notional value of the swap markets that it will be responsible for under Dodd-Frank. But there is no valid relationship between notional value of contracts traded and the regulatory burden associated with them.

The swap market today that the CFTC will regulate involves only 4,000 to 5,000 transactions per day. The futures market, on the other hand, has grown to millions of transactions per day. It has become a global electronic marketplace with a sophisticated audit trail and high-tech enforcement tools.

The CFTC's budget should reflect the positive impact of technology and other enforcement tools that SROs already have in place which meet the regulatory obligations imposed by Dodd-Frank. This Congress can mitigate some of the problems that have burdened the CFTC's rulemaking process. It can do this by demanding a full and fair cost-and-benefit analysis on every proposal.

It also can extend Dodd-Frank's effective date in 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 costs imposed by its new regulations. Otherwise, we believe that the well-regulated futures industry will be burdened by overly prescriptive regulations. These regulations would be inconsistent with the sound industry practices and make it more difficult to reach Dodd-Frank's goal of increasing transparency and limiting risk.

I thank you very much for your time and attention this afternoon, and I look forward to answering your questions.

[The prepared statement of Mr. Duffy can be found on page 60 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Mr. Bunkin, welcome.

STATEMENT OF STEVEN M. BUNKIN, MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, GOLDMAN SACHS, NEW YORK, NEW YORK

Mr. BUNKIN. Thank you. Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee, my name is Steve Bunkin. I am a managing director at Goldman Sachs. Thank you for inviting me to testify at today's hearing.

The over-the-counter derivatives market plays an essential role in the capital markets and the economy generally. Various entities, including corporate end users and investment funds, use these instruments as risk management and investment tools.

In debating Title VII of the Dodd-Frank Act, Congress considered the possibility of requiring that all derivatives be traded on exchanges and centrally cleared. Congress recognized the importance of OTC products and determined that they should continue to be available to the broad range of market participants that rely on them. As a firm, Goldman Sachs has supported many of the policies reflected in Title VII.

Since Congress enacted the Dodd-Frank Act last summer, the CFTC, SEC, and other regulators have been working with great dedication to propose various rules contemplated by the act. We appreciate the remarkable effort that the agency's staff and Commissioners have made to develop the rules.

It is critically important that the implementation of these complicated reforms be done in a manner that avoids disruption and allows continuing access to derivative instruments. To protect market liquidity, the final rules must be developed with great care. With that in mind, we offer the following recommendations to support the Committee in its Title VII oversight responsibilities.

First, we recommend that Title VII rules be phased in on a sequence that will best enhance financial stability. We propose a three-part process. Phase 1 would involve the creation of swap data repositories and the application of requirements to provide transactional information to them. Phase 2 would involve the application of clearing requirements. Phase 3 would involve the application of requirements to execute relevant swaps on exchanges or swap execution facilities and have information regarding all swaps be reported to the public.

Second, we recommend that the regulators establish a strong foundation to promote an evolution of markets to achieve the overarching goals of Dodd-Frank.

Third, we recommend promoting liquidity as a central means of reducing systemic risk by, A, closely following the statutory definition of swap execution facility; B, defining a block transaction as a trade that is larger than customary social size and designing appropriate alternative public reporting requirements for such transactions; and, C, adopting position limits only if the statutorily required determination that such a rule is appropriate has been made and then ensuring that such a rule adheres to the four-part mandate articulated in Title VII.

Fourth, and finally, we recommend that the CFTC reconsider the proposed business conduct rules. In particular, these proposed rules would severely restrict access to derivatives for pensions, endowments, and governmental entities because of the fiduciary-like standards contained in them, notwithstanding the specific decision by Congress not to include a fiduciary standard in the statute itself.

Goldman Sachs is committed to working with Congress, the regulators, industry participants, and, of course, our clients to achieve a successful transition to the reforms adopted in Title VII of the Dodd-Frank Act.

I appreciate the opportunity to testify before this Committee and look forward to any questions you may have.

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

Chairwoman STABENOW. Thank you very much.

Mr. Thompson, welcome.

STATEMENT OF LARRY THOMPSON, GENERAL COUNSEL, DEPOSITORY TRUST AND CLEARING CORPORATION (DTCC), NEW YORK, NEW YORK

Mr. THOMPSON. Thank you, Chairwoman Stabenow, Ranking Member Roberts, and members of the Committee. I am the general counsel of the Depository Trust and Clearing Corporation, a noncommercial utility that in 2010 settled approximately 1.7 quadrillion in securities transactions.

Since 2006, DTCC has also developed and operated the Trade Information Warehouse, a global electronic database that now has virtually all position data on credit default swaps. The TIW currently represents about 98 percent of all credit derivatives transactions in the global marketplace, constituting approximately 2.3 million contracts with a notional value of $29 trillion.

DTCC shares Congress' goals of ensuring more transparent markets for global regulatory oversight and systemic risk mitigation. Today I would like to make two central points: one, transparency is a key pillar of any attempt to mitigate systemic risk in the swaps markets; and, two, providing transparency is a cooperative effort.

The Dodd-Frank Act requires that all swaps, cleared and uncleared, must be reported to swap data repositories. To the extent that OTC derivatives contributed to the 2008 crisis, we believe it was due to a lack of a comprehensive view of who held what exposures in the swaps markets. That uncertainty, that lack of transparency, contributed to the hesitancy about the creditworthiness of institutions at just the wrong time.

The basic safety net needed to address these sorts of situations has since been put in place for the credit default swaps market on a global basis in cooperation with the OTC derivatives regulators form, which comprises over 40 regulators and other authorities worldwide, including all of the major regulators and central banks in the U.S. and Europe.

In response to the 2008 crisis, DTCC used the warehouse to provide standard position reports to appropriate regulatory authorities worldwide, and since then DTCC has responded to over 100 ad hoc requests from such authorities. We also began publishing comprehensive market information to ensure public transparency.

Just 2 weeks ago, we launched a web-based regulator portal through which regulators and other authorities can directly access and query detailed position risk data relating to their regulatory purviews. At present, 20 regulators worldwide have used our portal.

Providing transparency is a cooperative effort. Transparency has been achieved because of the substantial degree of global regulatory cooperation and support. One factor that made this possible was that DTCC is now a traditional commercial entity and does not use the data for commercial purposes. This removes commercial concerns from what is and what must remain a market utility, base regulatory, and supervisory support function. This structure works because all market participants, all clearers, all trading platforms are cooperating.

If cooperation fails, if the reporting of data becomes fragmented, the inevitable result will be misleading public reporting of exposures and regulatory errors. What would follow is a very expensive if not politically impossible task for regulators to build complex data aggregation and reporting mechanisms that the industry and the regulators themselves have brought to fruition in a single place within DTCC. Both of those results would be undesirable.

The challenge is to bring similar regulatory and public transparency to other asset classes of the swaps markets, as we have done in the CDS market. As an industry-governed utility, it is our sense that market participants are poised to undertake the significant cooperative effort necessary to achieve complete transparency across all asset classes and derivatives markets as contemplated by Dodd-Frank.

I urge the Committee in exercising its oversight function to focus on removing obstacles to this process and to continue to use proven infrastructure while avoiding the injection of commercial considerations that would hinder the cooperative attitude that has so far made progress possible.

Thank you, and I welcome your questions.

[The prepared statement of Mr. Thompson can be found on page 133 in the appendix.]

Chairwoman STABENOW. Thank you very much.

Now Professor Michael Greenberger, welcome.

STATEMENT OF MICHAEL GREENBERGER, LAW SCHOOL PROFESSOR AND DIRECTOR, CENTER FOR HEALTH AND HOMELAND SECURITY, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MARYLAND

Mr. GREENBERGER. Thank you, Chairwoman Stabenow and Ranking Member Roberts and other members of the Committee. I have submitted testimony that has an introduction that I think hits my major themes and has a lot more information in it. I am fully prepared to answer substantive questions, but I think process questions need to be addressed in the few minutes I have.

I have worked as a volunteer adviser to Americans for Financial Reform and the Commodity Market Oversight Coalition. The latter is an end user group that represents petroleum marketers, heating oil dealers, many farm groups, airlines, truckers, car manufacturers in some sense, and it is reflective certainly of a bipartisan, at a minimum, philosophical ideology. I also work with Americans for Financial Reform, which is a coalition of 250 consumer groups, unions, environmental groups, public interest groups, the AARP, and others.

Those two groups that represent the broadest bipartisan spectrum have come together, I would say, while they have not had time to review my testimony, I believe that they represent the rank-and-file people who are exposed to—were exposed to the worst financial crisis since the end of the Great Depression, and if we think we are sitting here today with the war being over and now we can cut against the edges of Title VII—which, by the way, this Committee should take a lot of credit for. Were it not for the Senate Agriculture Committee, Title VII would not be in the excellent shape it is in. The war is not over.

First of all, all the derivatives that are executed up until the point that the CFTC and the SEC put their regulations into place are unregulated. I pointed out how Mr. Paulson, who did a perfectly legal, shrewd thing, represents the investors who, without having any exposure to subprime mortgages, got insurance at a 2-percent minimum and insured themselves trillions of dollars if those subprime mortgages, which they did not own, failed. The hole that was blown into the economy was not the defaults. It was the fact that those mortgages were bet on often 9 times by people who did not own them that they would fail.

Now, Senator Johanns said there are 15 people who made some terrible mistakes. The people who made those terrible mistakes essentially insured the subprime market at 100 percent on the dollar.

Now, some people say that is a zero sum game. If the American taxpayer had not intervened to trillions of dollars, it would have been a lose-lose game. Your end users, who are saying, oh, we are just doing perfectly business-like kind of things, ask them how they would feel if Lehman Brothers was their swap dealer. They would now be in a bankruptcy hoping to get 10 cents on the dollar.

We cannot cut back on this process. If municipalities start failing—and Jamie Dimon, who is the CEO of JPMorgan Chase, gave a speech a month ago worried about the stability of municipalities—municipal bonds will fail, and Republicans, Democrats, Tea Party members, and Independents will lose pension money because of that.

If sovereign defaults occur in Europe, there are credit default swaps up the gazoo on people who do not own the debt but are betting that Ireland, Italy, Portugal, and the euro will fail.

Everybody is asking questions about what could go wrong with Title VII. If AIG had had to post capital as a swap dealer, they would have never gotten to the $75 billion business of insuring that the cherrypicker in California who earns $14,000 a year got a $729,000 mortgage. They insured that mortgage because it was AAA rated, and it was so confusing because it had been manipulated so many times, they did not understand what they were insuring.

If AIG had to post capital to get in the business of being a swap dealer, they would have had to go to their holding company, and the holding company would have said, "We are not going to put billions of dollars of capital into insuring the cherrypicker in California."

The transaction would have been transparent, and you would have CNBC and Fox business analysts talking all day about the stupidity of people who are trying to insure the subprime market. Now, the subprime market, you have got the same instruments for the prime market, commercial real estate, credit cards, student loans. This market is still out there, and I spend half my time worrying about al Qaeda, and if I had to bet who is a greater threat to the United States within the next 2 years, it is the next round of commitments that are undercapitalized to insure somebody who does not own municipal bonds or does not own sovereign debt will fail, and there will not be capital to make that payment. And the American taxpayer—that is what too big to fail means—will be looked to again to bail these people out.

The reason the American taxpayer is furious about the budget crisis is trillions of dollars have been spent to put Wall Street back in the saddle again, and it has not meant anything for jobs, pensions, or anything else.

So the Commissioners who work on this, this Committee, this Congress have got to keep in mind when your end users come to you and say, "We do not want to post collateral, and we do not want the bank to post collateral," what happens if that bank becomes the next Lehman, Bear Stearns, AIG? Their shrewd business hedging will collapse in the absence of clearing, transparency, and pricing.

You have got in my assessment the most important job of any Committee in this Congress, and if there are municipalities failures or sovereign debt failures, or if oil and food, which are related to betting through swaps, start going through the roof, you will be back here not voluntarily, but you will be back here. Chairwoman

Stabenow, you remember July 2008 when we met and had a debate in front of the Democratic leadership about whether supply-demand or speculation and swaps caused $4-a-gallon gasoline.

My final point would be to say, Senator Roberts, talk to YRC in Overland Park, Kansas. They almost went bankrupt because the holders of credit default swaps did not want them to work out a bankruptcy. I volunteered as a lawyer to the Teamsters and the 90,000 employees who would have lost their jobs but for the fact that the Teamsters and the State Attorneys General went to the holders of those credit default swaps and said, "You cannot drive the largest truck manufacturer in the United States into bankruptcy."

Thank you.

[The prepared statement of Mr. Greenberger can be found on page 92 in the appendix.]

Chairwoman STABENOW. Well, thank you very much, and let me just indicate that, of course, there is a concern, I would just say, Professor Greenberger. That is why we passed the law, and that is why, as you talk about the impacts on families, on farmers, on businesses, on consumers, the need to bring things into the light of day, to have transparency, to have accountability, that is what this is all about.

I guess from my perspective I think it is important to also look at the role of hedging risks in the marketplace and the capital that it has made available for businesses that are hedging their own risk. And I do think we have got to make sure we are addressing everything you are talking about, but also making sure that we are allowing businesses and farmers and co-ops to continue to function in terms of their activities in the marketplace as well.

And so I guess that would lead me, Ms. Harlan, to ask you a question, to talk a little bit more about why it is important from your standpoint to be able to have the end user exemption. And could you talk more specifically about how Caterpillar uses its finance arm and why it is critical in your judgment to your competitiveness that margin requirements are not applied to the swap transactions?

Ms. HARLAN. As far as our financing arm goes, Caterpillar Financial Services, it does exist solely to provide financing for Caterpillar equipment. Now, we need the definition to be a little bit broader than that because that is their purpose. But certainly there are times when they provide financing for an attachment, for example, to a Caterpillar unit, or another example might be to provide financing for an entire vessel to support the sale of a Caterpillar engine. But they use the derivatives products in the same way as the Cat Inc. parent does from a standpoint of we only enter into a derivative product if we are trying to protect a risk. So we are hedging or mitigating our risks. In their case either it could be a foreign exchange movement or it could be an interest rate movement. So as a captive finance, they are there to support the parent and in the sale of the parent product, and that is their main purpose.

As far as the margin issue—I believe that was your other question—today we do not post margin, so that would be an additional cost and additional expense to us in the future. So it appears that as an end user, the way the regulation is going, we would not post margin. We are still concerned that our bank counterparty would be in a situation—it appears some of the regulators may be thinking along the lines that they would post margin. If that happens, we think those costs would still end up coming in our direction, coming towards us. So that is our concern from the other side of the transaction with our counterparty.

Chairwoman STABENOW. And could you speak a little bit more about what that means in the real world to you in terms of the business and jobs?

Ms. HARLAN. It means an additional cost. We would not treat that cost any differently than any other cost. So, for example, if we have an additional cost in our product, we would have to consider numerous things. One would be, you know, do we move the price of our product? Does it impact that? Caterpillar has not specifically considered the cost and how we would manage it at this juncture, but that probably would not be a popular choice. So we would look at do we hedge or do we stop hedging. If we do not hedge to try to avoid that cost, that obviously means we would be taking on more risk, which in the end could, in fact, be a lot more costly.

We also would consider if there is a cheaper way to still be able to enter into that derivatives contract, and one of those options may be to utilize our regional treasury centers that are located in other places if we did not need to post a margin in those locations.

Chairwoman STABENOW. Thank you. When looking at the important changes that were made in the Dodd-Frank legislation and looking at the important transparency measures, the real-time reporting, the mandatory clearing and trading provisions, the reliance on swap execution facilities and swap data repositories, I wonder if each of you might speak about the timelines in terms of from your perspective how long you think the markets need to adapt to the new requirements, and just speak from your perspective from where you sit in terms of timelines.

Mr. Duffy, I will start with you.

Mr. DUFFY. You know, I think it is kind of hard to predict the timeline as these things get rolled out. There are still, as Chairman Gensler said, many comment letters that are still yet to even be read by the staff of the CFTC, yet to be analyzed and how they are going to write the rules.

As I said in my testimony, Madam Chairwoman, I do believe that the Congress needs to extend the rulemaking process so everybody can have an adequate amount of time to assess the different rules that are being proposed, and then we can decide how they should come out and in what sequence, because sequencing, as everybody has said, is very important.

Chairwoman STABENOW. Mr. Bunkin?

Mr. BUNKIN. Senator, the question on timing and implementation is very important. I think as you said in your opening remarks, the most important thing is that we get this right. And in terms of how we would view this, it is no different than building a house. You really have to survey the land, get the plans drafted, build the foundation, build the walls and so forth. And we are talking about a very significant build across swap data repositories, enhancement to clearinghouses, the creation really for the first time of swap execution facilities, of a magnitude that we have not seen probably since the 1933 and 1934 act.

In terms of the total time that that will take, it will probably be dependent to a large extent on the existing infrastructure that we have for particular asset classes. So as you heard from Mr. Thompson, in the context of the credit markets the existence of DTCC gives us a great head start in having a swap data repository that will be ready, willing, and able to begin its mission.

In other asset classes, such interest rates, currencies, and commodities, we do not have the benefit of having that much of a head start. So it will be asset class dependent, and I think the important thing, as you had indicated, is that we get it right, we do it thoughtfully and based on the data that we collect so that we have a good, informed understanding of how we are going about the process as it moves forward.

Chairwoman STABENOW. Mr. Thompson?

Mr. THOMPSON. Madam Chairwoman, I think Mr. Bunkin stated it very well. It depends on how well you use the present infrastructure that is already in place, which has already been built at great expense. The credit default swaps market through DTCC is in pretty good shape. There obviously will be some things that we will have to add.

What I said in my testimony, written as well as spoken here today, is that that should be used as well for other asset classes. So there are some extensions. The communication lines to some of those members in the interest rate swaps and the equity swaps area already exist, and those things should be utilized in order to save money and to speed implementation.

I also stated that transparency should be the number one goal. With transparency, you could prevent some of the things that Professor Greenberger was concerned about. What is going to happen? It would give the supervisors and the regulators the tools that they need in order to oversee the market while the market is phasing in at a deliberate rate, the rest of the regime in a pace and a time that works for them.

As to DTCC, we are committed, once the regulations are clear as to what needs to be built, to build that as quickly as we can possibly do it. But as Mr. Bunkin said, this has to be an industry build, and the industry is made up of both large and very small participants. And each one of those will have to spend a great deal of funds in order to build some of this infrastructure in order for it to work.

Thank you.

Chairwoman STABENOW. I see I am over my time, but, Mr. Greenberger, would you want to respond to that as well?

Mr. GREENBERGER. Yes. I would say [inaudible] dealing with rulemakings, and those statutory deadlines are very hard to enforce, and the Commission Chairmen, Chairman Schapiro and Chairman Gensler, already said they will not be able to meet them.

The second thing is the rules contemplate phase-in periods. Gary Gensler did not just fall off a hay wagon yesterday. He was the youngest partner in the history of Goldman Sachs. He has been on the other side of these things. He knows how these things run, and I believe from meetings I have had with him and other staff members, they are very sensitive to phasing these things in in a realistic way. Obviously, there is some infrastructure available. A lot is not. That will be taken into account, I have no doubt in my mind. In other words, if there is a final rule, that does not mean right away everything is going to happen.

Chairwoman STABENOW. I think that became clear from the Chairmen today, so thank you.

At this point I am going to turn this over to our Ranking Member, Senator Roberts.

Senator ROBERTS. Thank you, Madam Chairwoman.

Some very quick questions, Ms. Harlan. What are the biggest potential deterrents to hedging in the Dodd-Frank bill and the proposed implementation rules? I am sorry. Did you hear me?

Ms. HARLAN. No, I am sorry. Could you repeat that?

Senator ROBERTS. What are the biggest potential deterrents to hedging in the Dodd-Frank bill and the implementation rules that are being proposed?

Ms. HARLAN. I would say if we are required to post margin, that is by far our biggest concern because of the additional costs it would impose upon us to hedge.

Senator ROBERTS. I appreciate that.

Moving right along, a lot of questions for the record. Mr. Duffy, tell me what you think about the effects of Dodd-Frank implementation will be on U.S. derivatives markets' competitiveness?

Mr. DUFFY. To be quick, sir, I am very concerned about the competitiveness of the Dodd-Frank Act. If the Dodd-Frank Act overextends itself, these over-the-counter products, which are important derivative products. They are also very complementary towards regulated futures markets. If they were to migrate to different jurisdictions, you could absolutely take the futures business along with it, and that is the last thing in the world that you would want to see happen, is to have regulated futures markets migrate out of the United States. So I am concerned about some of the overreaching on the over-the-counter markets because it is an integral part of the regulated market.

Senator ROBERTS. Mr. Thompson, comment briefly on any areas of your operations that will be affected by the lack of harmonization between the SEC and CFTC proposals. Some of them, as you know, are quite different. How would this lack of harmonization impact your businesses and customers?

Mr. THOMPSON. Well, thank you, Ranking Member Roberts. There is a significant difference in terms of how some of the reporting is going to be done. In the SEC proposal on reporting, swap data repositories have to report the data to the SEC; whereas, in the CFTC proposal, there is no requirement, similar requirement for that. So you could have a non-commercial entity which is not regulated, which does not come under the swap data repositories, registration requirements, being required to give the same data. We think that is something that should be very carefully considered.

But there is equally a more important issue from our mind, and it concerns the international harmonization. There is a requirement right now in Dodd-Frank that swap data repositories receive an indemnification from foreign regulators in order to receive certain information. In our talks with foreign regulators, that has been a very sore point. They believe that this is data that they are entitled to, and, in fact, it is data that they are presently receiving in the credit default swaps market from our Trade Information Warehouse. And just as our regulators would be upset if they had to indemnify a foreign company, they see no need to have to indemnify us. And, quite frankly, we do not see it either. And we think that could be a source of fragmentation going forward into the future.

Thank you.

Senator ROBERTS. I thank you for that.

Mr. Bunkin, many folks have been complaining about the al dente approach of the CFTC, Dodge City language, throw all the rules on the wall at once and see which one sticks. Some of us have suggested, as you did in your testimony, that a more rational approach would be to phase in the rules in a tiered manner basically by order of importance and necessity. If the CFTC were to do this, either voluntarily or with some encouragement by Congress, how much time do you think each phase needs in terms of the implementation period? And what should come first? I would suggest perhaps definition might be a consideration.

Mr. BUNKIN. Thank you, Senator. That is an important question. And I think that it has—the answer has two aspects to it.

The first is I think a lot of the rules that are going to be finalized would benefit from having better data with regard to the market. That would include: How do you establish the right block transaction size? How do you determine which products should be cleared? How do you determine whether to apply position limits and, if so, how to size the position limits?

So from our point of view, all of the rules would benefit from having good data on the market, and from that perspective what makes sense is to first create the data repositories so that the information can be collected to ensure that we have rules that are done on an informed basis.

Senator ROBERTS. I appreciate that. I am down to one second.

Professor or Mr. Greenberger, whatever title you wish, we will meet in Kansas City at the Gates Barbecue and talk over the saving of YRC. Thank you, sir.

[Laughter.]

Senator ROBERTS. Thank you, Madam Chairwoman.

Chairwoman STABENOW. Thank you, Senator Roberts.

Senator HOEVEN.

Senator HOEVEN. Thank you, Madam Chairwoman.

My question essentially is, I guess, for each one of you, if you would address it. What is the best way to make the commodities market—and I am talking about futures options, certainly derivatives. What is the best way to achieve transparency, to understand it in terms of systemic risk so the regulators can some way and the public can some way determine what is the systemic risk? Who in terms of an end user should get an exemption in terms of their hedging their product for business purposes, not speculate, not creating premiums, if you will, in times of scarcity or great uncertainty or, you know, some of the issues that we face now in the oil markets, for example? Other commodity markets, too.

So I would ask each panel member, transparency, what do we do to make it transparent in terms of derivatives, commodities market, futures options, transparent, understandable in terms of the systemic risk in the market from a regulatory standpoint, and for end users, who should have that hedging exemption? So if you would just respond to that.

Mr. THOMPSON. Well, perhaps I should go first because I made transparency the highlight of my particular talk, both in my written as well as my oral testimony.

I agree with Mr. Bunkin that swap data repositories need to be built, and along the lines that we have already built the Trade Information Warehouse. That will lead to more transparency into the marketplace. That information should be made available to all regulators, and it should be made available to the public as the regulators see fit so that the public understands exactly what is going on and sees transparency. And, therefore, we have already done that. We already make available information to the public about the CDS marketplace. We are building an equity repository. We intend to do the same thing with that information that we have done with the credit default swap.

I think the answer to some of your other questions really sort of depends on what does the information inform the regulators of, which is what Mr. Bunkin had said earlier. They need to understand what the position limits are, and you will not have a full understanding of that unless you have all of the positions in one place. And the thing I think we have to remember is that this is a global marketplace. And even though the U.S. is a large part of that marketplace, in some of the asset classes we are not as much as 50 percent. Those are in Europe and in Asia. And in order to encourage that, we have got to be certain that those markets are also participating on a global basis in a cooperative fashion in order to get the information that they need as well.

Senator HOEVEN. And do you feel the systems you are building are transparent and understandable and that the regulators will be able to both understand them and assess risk?

Mr. THOMPSON. At this particular point, we do believe that with the credit default swaps information that we built because we built it in cooperation with the regulators. There are 40 regulators in the OTC Regulators Forum. They come up with the guidelines that we have adopted. They are the ones who go into our portal to retrieve the information that they are looking for. They are the ones who are giving us the ad hoc requests for the information so that we can give back the information to them. And so we have worked cooperatively with them over the course of the last 2 years to build a system that they are comfortable with.

Senator HOEVEN. My next question would be to whoever wants to go next. Then if that system is being built and if it is transparent and accountable, then how should it be managed in terms of capital, in terms of margin requirement, and who should get end user exemptions on the basis of hedging versus speculating? Mr. Duffy?

Mr. DUFFY. If I may, since I think I am the only one that runs an exchange and owns a clearinghouse, we are a transparent institution. The central limit order book is the first way to figure out transparency on price. The second way to get the transparency is through central clearing. On trade data repositories, clearinghouses have the ability today without going through a third party to go directly to the regulator. So we already have that transparency.

As far as end user exemptions go, I think the CME—and I have been very consistent in this. We never believed that anything should be mandated from an end user perspective. We believe that there should have been capital incentives for people that want to clear and not clear.

So I think that is the best way to get the transparency, and as far as the costs go and who should manage it right now, exchanges like ours and others throughout the U.S. are already incurring these costs today. And to get the duplication, as we talked about earlier, through the regulator does not make any sense at all.

Senator HOEVEN. Mr. Bunkin?

Mr. BUNKIN. Yes, Senator, I think there are a couple of different kinds of transparency. Mr. Thompson talked about transparency of having complete information about all transactions which would reside in a data repository and be completely accessible to the regulators. They would understand the full composition of positions at any given moment in time.

Another type of transparency is what the market sees, what the public sees. That is a type of transparency that comes perhaps through closing settlement prices on an exchange or through reporting requirements that are made available publicly. And the concern that requires attention with respect to that type of transparency is its potential impact to liquidity and the continuing availability of products.

As it relates to end users, I think the question is: When can an end user be exempt from clearing requirements, execution requirements, margin requirements? But also when do they get an exemption from position limits? It is a very critical aspect of their ability to enter the market and hedge risk. And one of the concerns that exists with respect to the CFTC's proposal on position limits is, notwithstanding the fact that there is a specific exemption for end users, the way that the rule is otherwise defined, it will severely impact the ability of the intermediaries to provide liquidity to the end users. And I think that is a subject that would appropriately deserve the attention of the Committee.

Senator HOEVEN. I do have another question or two, but I would certainly wait until the next round.

Chairwoman STABENOW. Senator Roberts and I said we would like to give you a little bit more time because you were joining us a little bit late in the meeting, so we would like to have you have an opportunity for another question. I think once you are finished we will be wrapping up.

Senator HOEVEN. Thank you, Madam Chairman.

Mr. Bunkin, does Goldman Sachs understand and do you feel have accurately quantified its risk under all derivative transactions it is currently engaged in? And would you say that is true for other not only investment bankers but hedge funds? Do they understand their full risk involved in their derivatives that they have outstanding at this point?

Mr. BUNKIN. I cannot speak for other organizations, Senator, but I can——

Senator HOEVEN. I am just asking for your opinion.

Mr. BUNKIN. I can tell you with respect to our firm we spend a tremendous amount of resources and effort to understand and manage risk. That is a critical function of what we do. It applies across all types of instruments and markets in which we are involved, and derivatives would be a key focus for those efforts.

With regard to other organizations, I think it really is dependent on the extent of their involvement in the markets and their resources that they dedicate to that activity.

Senator HOEVEN. So you feel that you have a good handle as an organization on your risk involved in all your derivatives and option and futures activity? You assess that, you have models that quantify it, you feel you understand it, and that if there is some type of event—Mr. Greenberger referred to, you know, something happening either in one of our markets or, as Mr. Thompson said, in a market overseas—you feel that you would understand how your derivative products would react in that situation, that you have adequate capital margin and so forth to make sure that you do not have a financial problem for the firm should something like that occur?

Mr. BUNKIN. We do a number of different things to address our risk. We value it every day, both at the level of the individuals who are responsible for putting on positions and then independently through a separate control function that verifies prices independent of the traders.

But we also do other things such as run scenario analyses and shock tests and various types of reviews to imagine different market scenarios and the potential effects that they would have on our liquidity position and so forth. So that is a very important part of what we do at Goldman Sachs.

Mr. GREENBERGER. Senator, if I might have a chance just to address some of your questions?

Senator HOEVEN. Just a second. Madam Chairwoman, I want to be respectful of my time and the Committee's time, so I——

Chairwoman STABENOW. Yes, well, we do need to wrap up in the next couple of minutes, but, Mr. Greenberger, if you would like to respond to that.

Senator HOEVEN. Specifically, Mr. Greenberger, my question to you would be: Should there be any end user exemption? And if so, for whom? Remember, certainly Senator Roberts and myself will tell you about our farmers and others who are out there trying to hedge and already have many cost constraints that they face. But as you can tell, I also am very concerned about systemic risk and whether or not we have handled that.

So should there be end user exemptions? And what should they look like?

Mr. GREENBERGER. Yes. As I said, the Commodity Market Oversight Coalition, which I do a lot of work with, has a lot of—the farmers are not unified in this, and it tends to be on what their size is. And Caterpillar may have a different view than the family farmer. But I will say Dodd-Frank has an end user exemption. The Commodity Market Oversight Coalition supported it. But it is limited to commercial hedging by people who physical handle the farm product, the oil, and everything else.

I think it is now beyond peradventure, pursuant to what Mr. Gensler said and Chairman Schapiro, that they will not be charged margin for that. Now, as is evidenced, I think that is risky, but my political judgment is they are doing the right thing.

So the end user has a great exemption. What worries us all is that the Goldmans of this world—the position limits, end users have never since 1936, when position limits were created by that Congress, they are not applied to farmers or people who handle the product. The position limits keep speculators—speculators are needed to make the market liquid, so we do need speculators. But if you have too many speculators, the markets go haywire. So the farmers in your region have given up trying to hedge on the CME because speculators have taken over those markets because there are not adequate position limits.

Farmers should not be subject to position limits. They should hedge for every dollar of risk they feel they have.

Senator HOEVEN. A last question——

Chairwoman STABENOW. I would say this will have to be the last question. Thank you.

Senator HOEVEN. You have got to be quick, because I wanted to ask Ms. Harlan to respond to what Mr. Greenberger just said. But it sounds like, Mr. Duffy, you would like to as well.

Mr. DUFFY. I certainly would.

Chairwoman STABENOW. I would ask 2 minutes each because we really do have to wrap up.

Mr. DUFFY. If you do not mind, Madam Chairwoman, I really appreciate it, because we were not in a discussion around speculators in the marketplace, which there has been absolutely no evidence that they have anything to do with the effective price, whether it comes from an academic, whether it comes from a Government study or anything else. So just to put that clear. So the farmers that are in your State and the farmers in Kansas are hedging quite a bit on the CME today, and they do have position limits to put in place.

Secondly, your other question, sir, where you talked about risk, Mr. Thompson talked about a quadrillion. I do not know if anybody heard that number but me. We did 1.2 quadrillion value of contracts cleared in CME in 2008. We did 900 trillion of value cleared, notional value of contracts in 2010. We did not come to the taxpayer for any monies. We settled those products completely each and every night, and I think that is how you risk manage the product.

So when you are talking about risk, I think that we are talking about oversight and we are talking about overreaching of rules that are being written on regulated exchanges. I think it is important to highlight the record that no customer has ever lost a penny in 156 years at the CME Group due to one of our clearing member defaults. And I think that is a record that we could put up against anybody in the financial services industry.

I just wanted to get that on the record. I appreciate it very much.

Senator HOEVEN. Thank you.

Chairwoman STABENOW. And we have the 2-minute warning.

Ms. HARLAN. Our position, Caterpillar's position and the coalition's position, is that there should be a strong end user exemption, and I will wrap up. I know we are close for time. But that is our position, that there should be a strong end user exemption. When we put on a derivatives contract, we are taking risk off the table. We are not putting risk on the table. We are taking risk off the table because of our business operations, and we are mitigating that risk.

Chairwoman STABENOW. Thank you very much to everyone.

Let me say this is a very important discussion that we need to continue as we move forward to implementation, and from my perspective, as somebody who was very involved in creating a narrow end user exemption for the purposes of people being—entities being able to hedge their own risk, we certainly want to maintain that narrow focus, but at the same time have that available for those that are involved in managing their own risks as a tool.

But there is a very important set of issues that we want to continue to work with all of you on as this is implemented. We want to get this right. There was a reason we passed the law. There was obviously an incredibly serious crisis that affected millions and millions of Americans, and there was a reason to put in place this new law. But there is also a reason to spend the time to get this right and to make sure that it works and maintains liquidity in the marketplace and allows us to continue to create jobs and growth. And so that is why very much appreciate all of your time and attention and look forward to continuing to work with you.

Thank you.

[Whereupon, at 4:47 p.m., the Committee was adjourned.]

A P P E N D I X

MARCH 3, 2011

Senator Brown
Statement for the Record
Agriculture Committee Hearing on Dodd-Frank Law Implementation
March 3, 2011

I want to thank you both for all of your hard work during the Wall Street reform process.

Passing Dodd-Frank last July was only the beginning of our effort to impose transparency and accountability in the opaque over-the-counter derivatives market.

Even though opponents of transparency and oversight lost the first fight, they are back trying to starve these agencies to stop new rules from being written.

Your agencies need increased resources so that we never have another financial crisis.

That's why the SEC needs the increased resources in 2011 and 2012. And the CFTC should be able to fund itself through industry user fees like the other financial watchdogs—it's wrong for an agency to have to squeeze blood from a stone to regulate a nearly $25 trillion international derivatives market.

Let's remember that our current fiscal situation was started by Wall Street gambling, and we could easily find ourselves in another crisis if we don't get these rules right.

Chairman Gensler, I want to acknowledge the statements that you've made before this Committee and the Banking Committee about the importance of protecting the interests of commercial end users like the many manufacturers, beer distributors, and other companies in my state.

You told the Banking Committee back in September that you understand that the derivatives rules should focus on Wall Street gambling, not investments by companies trying to control their costs.

You reiterated the point last week, and have repeated it again today. And I am confident that you will carry out the intent of those provisions.

Senator Brown
Written Questions for the Record
Agriculture Committee Hearing on Dodd-Frank Law Implementation
March 3, 2011

Question 1
We know that derivatives helped inflate the housing bubble, and now I'm concerned about their effects on other markets.

Chairman Gensler, I sent you a letter back in January about gas price speculation, and the importance of the CFTC's position limits rules in curbing excessive speculation.

Tire makers and auto manufacturers in states like Ohio and Michigan are being squeezed by the rising price of rubber and steel, respectively.

New Commerce Department data suggests that last month's rises in gas and commodity prices wiped out any potential boost in consumer spending from the new payroll tax holiday.

A group of commercial end users, the Commodity Markets Oversight Coalition, points to 57 studies conducted in the last five years which demonstrate the influence that speculation has on asset and commodity prices.

How does financial speculation affect prices for businesses and consumers?

How does Dodd-Frank and other regulations help the SEC and CFTC police these markets?

Question 2
One proposal that did not make it into the Dodd-Frank Act, but which I supported, was the Dorgan Amendment banning naked credit default swaps (CDS), or bets that someone else will default on their debt.

My former colleague from North Dakota pointed out that naked CDS are basically gambling—the parties don't own the bonds that they're betting against.

The *Wall Street Journal* reported that investment banks are trading about $750 million worth of naked CDS on GM bonds—*but GM doesn't have any debt*! It was cancelled in bankruptcy.

The *Financial Times* recently reported on the development of a market in synthetic junk bonds. The article notes that, "[s]imilar investments, called collateralised bond obligations, blew up after corporate defaults unexpectedly soared when the telecoms bubble burst in the early 2000s."

This is exactly the kind of speculation that helped bring down AIG and Lehman Brothers.

What are the benefits and risks of these sorts of speculative trading instruments?

What will you do with the authorities granted to you in the Wall Street Reform Act to curb this kind of speculation and ensure that history doesn't repeat itself?

Opening Statement
Senator Saxby Chambliss
Senate Committee on Agriculture, Nutrition and Forestry
Hearing
March 3, 2011
Regulatory Reform and the Derivatives Markets

Chairwoman Stabenow, thank you for providing this Committee the opportunity to review and discuss the implementation of the Dodd – Frank Act, particularly Title VII, also known as the Derivatives Title of which this Committee has oversight. I would also like to thank the Senator from Kansas for his leadership as Ranking Minority Member. I appreciate the witnesses for being here and providing their testimonies, which I hope will be helpful as we move forward.

A few years ago, it became obvious that Congress would need to examine how large Wall Street firms were using derivatives. Unfortunately, the opportunity to regulate businesses that had nothing to do with the financial meltdown was just too tempting for Congress, and now we find ourselves with a law that potentially regulates American businesses as if they were <u>all</u> large risky financial institutions. These businesses, which use derivatives to responsibly manage risks, should not be treated the same as large financial institutions.

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

As we explored the evolution of the financial crisis, we found that many financial dealers and entities, such as AIG, were holding large uncleared derivative positions, which increased their vulnerability during unfavorable conditions. Congress properly determined that moving more of the derivatives held by these systemically risky institutions into a clearinghouse would relieve pressure on the financial system.

However, forcing businesses that are not contributing to systemic risk to move their derivatives through a clearinghouse has several negative economic effects: Companies that are required to cover these margin costs will pass them along to consumers; companies in capital-intensive industries will be forced to raise and tie up additional capital that would otherwise be available to hire workers; and some businesses that cannot pass on their costs or raise additional capital will simply quit using derivatives to hedge business risk or go offshore to do the same transaction.

There are real-life examples of these negative effects of clearing requirements everywhere: The Municipal Gas Authority of Georgia estimated that a clearing requirement would increase costs by approximately 25 cents on every Million British Thermal Units delivered – a 10 percent increase in distribution rates – to its 243,000 customers in Georgia, Alabama, Florida, Pennsylvania and Tennessee. Numerous practical examples can be given and they all translate into one thing – job losses.

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

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

Let's be clear: Risk does not disappear in a clearinghouse. It is simply transferred from the individual counterparties of the derivatives transaction to the clearinghouse. Clearing mandates designed to address the systemic risk should be applied only to those businesses that are systemically relevant; businesses that do not contribute to this type of risk should not be required to comply with regulations designed to provide relief from a crisis they did not create.

Mandatory clearing of derivatives could drain the economy of approximately $700 billion in capital. The key to job creation and economic recovery starts with strong businesses with capital resources, not economically harmful limits on capital availability and risk-management options.

In addition to the impact these regulations may have on end users, we must also ensure that new authorities within Dodd – Frank do not result in overly burdensome regulations being applied to already regulated exchanges. The Commodity Exchange Act and its principled-based approach have served the commodities market well and as a result the exchanges performed well during the recent crisis.

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

Statement of Senator Thad Cochran
Senate Agriculture Committee
March 3, 2011

Chairwoman Stabenow, thank you for holding this hearing to review the implementation of the derivatives title of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I would also like to thank Chairman Gensler and Chairwoman Shapiro for providing testimony today on behalf of their respective agencies, and I welcome them to the Senate Agriculture Committee.

The financial regulatory bill that Congress was able to enact last year provides more financial reform than any legislation since the Great Depression. The Dodd-Frank Act was crafted to improve transparency in futures markets while maintaining their functionality and efficiency for the benefit of farmers and business operations. Improving transparency without hampering a company's ability to hedge its risk and reduce costs to its customers is vital to a healthy economy.

While more transparency in the futures market was undoubtedly needed, it is imperative that the CFTC and SEC not overreach and overregulate beyond Congressional intent during implementation of the derivatives title. Production agriculture utilizes these markets to maximize profitability, and overly burdensome regulations would cause further strain on a sector that already deals with a great deal of uncertainty. With the current state of the economy, we must ensure that the proposed regulations will not hinder the country's desperate need for economic growth and job creation.

Chairwoman Stabenow, thank you again for holding this hearing today. I look forward to hearing everyone's testimony.

Statement of Senator Tom Harkin
Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act
Thursday, March 3, 2011

Thank you, Chairwoman Stabenow and Ranking Member Roberts, for holding this important oversight hearing on Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). We all spent a great deal of time working on the reforms included in Title VII of the Act last year, and it is critically important that we ensure the implementation of the Act goes smoothly and complies with the statute.

In the months since President Obama signed the Act into law, I am pleased to see that the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) are making good progress on writing the rules needed for implementation of the Act. The commissioners and the staff at those agencies are doing an immense amount of complicated work, and you have our thanks for it. I am quite pleased that the Agencies recognize the need to coordinate these rulemakings among U.S. regulators and with their counterparts internationally.

Although I am not universally pleased with every aspect of the proposed rules, in general, these proposals comply with the provisions of the Act and will help to restore much-needed transparency and integrity to the derivatives markets.

It is worth our taking a moment to step back and remember exactly why these reforms were so critical. In the run-up to the financial crisis, largely through the use of over-the-counter derivatives, the largest institutions in the global financial system became dangerously interconnected and accumulated too much risk relative to their capital. As mortgage securities began to go bad, the highly leveraged positions taken by financial institutions and other market participants through these OTC derivatives led to what can best be described as a run on the shadow banking system. As counterparties across the system were forced to offer more and more collateral and otherwise meet obligations under these derivative contracts, major firms were sold off, forced into bankruptcy, or bailed out by taxpayers.

Title VII of the Dodd-Frank Act confronts that problem head-on. To reduce the dangers of the interconnectedness of the system and counterparty credit risk, the Act requires all derivatives that a clearinghouse will accept to be cleared and executed on a transparent platform. It requires regulators to put in place strong capital standards on swap dealers and major swap participants so that they will have sufficient capital to cover their risks. It regulates the governance arrangements of clearinghouses, exchanges, and swap execution facilities so that large dealers won't be able to manipulate these entities to their benefit. It directs the Commissions to put in place firm speculative position limits and promotes transparency by greatly increasing the public reporting requirements of swap dealers. And, it prohibits commercial banks from taking certain types of dangerous speculative positions in these markets.

These are all beneficial changes that will increase the long-run stability of the financial system, and that is why I voted for and continue to support the Act. Nevertheless, throughout consideration of the Act, I also expressed concern that these reforms may not go far enough in reducing the outsized role of the largest swap dealers and reforming the financial system. In particular, I continue to worry that there may be some derivatives that are perfectly capable of being cleared that market participants may be able to avoid clearing by convincing a clearinghouse that those contracts cannot be cleared or by contriving unnecessarily complex contract terms. In addition, I am worried that swap dealers and major swap participants may not be required to hold sufficient capital to cover their risks. Those problems will need to be addressed in order for these reforms to be successful.

In addition, it will be imperative for the rules to require collecting data accurately and in real-time with the specificity needed to enforce the reforms in Title VII and elsewhere in the Act, including the Volcker Rule. It is critically important for the Commissions to put these rules in place as soon as possible for the benefit of both market participants and regulators.

In closing, I believe strongly that the reforms made by the Dodd-Frank Act in this area will help restore integrity to the derivatives markets that were at the center of the global financial crisis. Strong but fair implementation and enforcement of these provisions is essential, and I look forward to working with my colleagues on this Committee and in the Senate, as well as with regulators, to accomplish this objective.

Testimony on Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

By

Steven M. Bunkin

Goldman, Sachs & Co.

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

March 3, 2011

Chairman Stabenow, Ranking Member Roberts, and members of the Committee:

My name is Steven Bunkin and I am a Managing Director and Associate General Counsel at Goldman, Sachs & Co. Thank you for inviting me to testify at today's hearing.

OTC Derivatives and the Dodd-Frank Act

The over-the-counter ("OTC") derivatives markets play an essential role in capital markets and in the economy generally. These instruments are used by a range of entities, including corporate end-users and investment funds, as risk management and investment tools.

The Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank") imposes fundamental reforms on the financial markets. In debating Title VII of Dodd-Frank, Congress considered the possibility of requiring that all derivatives be traded on exchanges and centrally cleared. Congress recognized the importance of OTC products and determined that they should continue to be available to the broad range of market participants that use them.

Goldman Sachs has supported many of the policies reflected in Title VII. For several years, we and other members of the industry have worked with regulators to improve the infrastructure for these markets and to develop clearing of various products.

Since the enactment of Dodd-Frank, the regulators have worked with great dedication to develop the rule proposals contemplated by the Act. We appreciate the remarkable efforts that the staffs and Commissioners of the Commodity Futures Trading Commission and Securities and Exchange Commission (the "CFTC" and "SEC", respectively and, together, the "Commissions") have made to implement Title VII. It is critically important that the implementation of these complicated reforms be done in a manner that avoids disruptions and allows continuing access to OTC derivative instruments, and we are confident that this Committee agrees. To protect market liquidity, the rules must be developed with great care.

With that in mind, we offer the following recommendations to support the Committee in the discharge of its Title VII oversight responsibilities:

- We recommend that Title VII regulations be implemented in a deliberate, informed and sequenced manner;

- We request that market participants, particularly end-users, be given the opportunity to review and comment on the totality of the rule set before it is implemented, as well as the time to adjust their activities to achieve efficient and effective compliance with new requirements;
- We recommend the regulators study the effect on market liquidity of the proposed rules, adjusting them as appropriate; and
- We recommend that the CFTC revise its proposed business conduct rules to, among other things, ensure that swaps remain accessible to pensions, endowments and governmental entities who rely on them to conduct their activities.

We detail our specific recommendations below.

Phased In Implementation

It is essential that the Commissions phase in the Title VII in a manner that promotes the stability of the financial system. We propose a three-phase process to achieve this:

- In Phase I, create swap data repositories ("SDRs") and impose requirements on market participants to provide transactional information to them.
- In Phase II, impose clearing requirements.
- In Phase III, after successfully completing the first two phases, regulators and market participants will have the tools and information necessary to create effective public trade-reporting mechanisms and swap execution facilities ("SEFs").

Having SDRs established early will allow the regulators to collect the information they need to develop other rules, such as the definition of "block transactions" and appropriate position limits based on actual market information. In addition, the regulators will benefit from having data that will allow them to monitor systemic risk. Other requirements, such as the business conduct standards would be implemented during the course of the three phases.

The foregoing approach is necessary in light of the scope of the Title VII reforms. Dodd-Frank represents the most comprehensive reordering of markets since the Securities Act of 1933 and the Securities Exchange Act of 1934. To implement Title VII it will be necessary to create new structures and substantially revise existing ones. Fundamental issues with respect to how participants will access the markets remain unresolved. SDRs, clearinghouses, SEFs, and market participants themselves will all need to build or supplement systems, and develop, negotiate and implement various agreements to comply with new requirements. The system enhancements necessary for clearinghouses simply to handle broader participation presents a great challenge.

Market participants will need to make a number of strategic decisions about how to conduct activities to comply with the new rules. To do so, they will need resolution on a number of key questions that remain unanswered. These include issues as basic as which transactions will constitute "swaps" and what the impact of the Title VII requirements will be on activities conducted outside the United States. Providing businesses that are subject to new requirements with clarity on rules before they are imposed is both sound policy and essential to satisfy the requirements of the Administrative Procedures Act.

The Dodd-Frank rules should be considered in the context of existing regulation applicable to key participants, such as capital and prudential requirements. To avoid overlapping or inconsistent rules, the agencies will need to leverage these well-developed rules. Of course, Title VII rules will inter-relate with standards currently being developed at a more measured pace in Europe and elsewhere. Imposing Dodd-Frank rules before other international standards have been established will create the potential for regulatory arbitrage and a migration of liquidity to non-US markets.

We appreciate the willingness of the agencies to discuss with industry participants the important question of implementation and look forward to continuing to work with the regulators on these issues.

Market Evolution

We believe that as a result of the fundamental reforms mandated by Title VII the OTC derivatives markets will evolve in significant ways, the specific characteristics of which are difficult to predict at this point. Our firm has had the opportunity to observe and participate in a variety of market structure developments, including those resulting from

- The advent of the euro,
- Decimalization in equities, and
- The implementation of the TRACE reporting system in bond markets.

Our experience suggests that it is difficult to predict the manner in which changes will occur, and that evolution should be encouraged so that the market finds a new equilibrium. We recommend that the regulators adopt an approach that creates a robust foundation and framework for the new market structure, and fosters an environment in which the market naturally evolves.

Transparency/Liquidity

We recommend that the Commissions evaluate certain proposed rules in light of the Congressional intent to promote liquidity and preserve access to OTC derivatives. Liquidity is essential for the proper operation of capital markets. Liquidity enables a market participant to transfer risk or establish an investment position efficiently and promotes confidence in markets. Correspondingly, the absence of liquidity, particularly during times of market stress, exacerbates systemic risk. The proposed rules relating to execution of swaps on SEFs and real-time public reporting of transactions raise concerns with respect to liquidity and the ability of market participants to choose how they will transfer risk or establish an investment position.

SEFs are a key component of ensuring that OTC derivatives continue to remain available and liquid in the post-Dodd-Frank world. In drafting the definition of and provisions applicable to SEFs, Congress took care to ensure that the standards governing SEFs would be distinct from those governing exchanges by providing greater flexibility in the manner of execution.

The market broadly expected that systems that provide a "request for quote" or "RFQ" functionality would be the principal means through which parties would be able to satisfy the Title VII execution requirement while having flexibility in execution. However, the CFTC SEF proposal requires participants to broadcast solicitations to at least five quoting parties. This is significantly more quoting parties than clients currently choose to solicit in the existing market structure. This requirement will hurt many investors by forcing them to reveal their expected positions more widely than necessary in order to find the best price. It also appears to go beyond the standard set out in Title VII, which simply requires that multiple participants "have the ability to execute swaps by accepting bids/offers made available by multiple participants." The SEF rule proposed by the SEC more closely adheres to the statutory text by requiring SEFs to afford market participants the ability to request quotes from all members of the SEF while allowing the requesting party to solicit a quote from as few as one participant. We strongly encourage the CFTC to adopt a consistent approach.

With respect to "real-time" reporting, Title VII provides a means to calibrate transparency objectives against liquidity considerations. The lever for achieving this calibration is the block transaction definition. A "block" trade is one of a size larger than that customarily transacted in the relevant market. Transactions that qualify as blocks are eligible for an alternative reporting cycle to protect liquidity.[1] We believe that the CFTC proposal on the block transaction definition will fail to capture many trades that should qualify to serve the purpose of the definition.

Specifically, under the proposal trades will qualify as blocks only if they are of a size that is larger than the greater of (a) the top five percent of trades in a particular category or (b) five times the highest of the mean, median or mode of trades of the relevant category during the preceding year. Moreover, the reporting period afforded to trades that do qualify as blocks, 15 minutes in most cases, lacks an analytical foundation and is unlikely to be sufficient for the intended purpose. Unfortunately, the CFTC is not in a position to know whether the reporting period or the metrics for determining a block trade are an appropriate means for satisfying the purposes of the statute because the Commission does not yet have the market data that would be needed to make these determinations based on actual market dynamics. In analyzing the proposed rule, we applied the block metrics to our own positions and found these tests would make block treatment available on an extremely limited basis for many products, constraining the liquidity that would be available to investors.

<u>Business Conduct Standards</u>

We strongly support promoting integrity in the market and in dealings involving swap dealers or major swap participants and their clients. We are concerned, however, that the CFTC's proposed business conduct standards go beyond the Dodd-Frank mandate in ways that are both inconsistent with the nature of the counterparty relationship in a derivative transaction and that create uncertainty for market participants while providing little appreciable benefit. In particular, the proposed business conduct rules would impose a host of duties on dealers that do not have a basis in Title VII, including for example, the requirement to use reasonable due diligence to obtain facts necessary to "effectively service the counterparty" or "implement any special instructions" from the counterparty. Such vague, extra-contractual duties may cause dealers to retreat from providing swaps in a variety of situations. Another example of the breadth of the proposed rules is the provision that would transform breaches of bi-lateral confidentiality agreements into federal offenses.

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[1] In addition, block trades may be executed bi-laterally even if otherwise subject to an execution requirement.

The provisions applicable to transactions involving pensions, endowments and certain governmental entities (referred to as "special entities") present particular concerns. The special entity provisions impose what is tantamount to a fiduciary duty in situations when dealers/MSPs provide information specific to transactions. This fiduciary-like standard may apply in a number of situations because other provisions of the rules require dealers/MSPs to provide transaction specific information to counterparties. Congress specifically decided to eliminate a fiduciary standard from draft legislation to continue to allow special entities to access risk management and investment products; it recognized that the role of a fiduciary is not compatible with that of a counterparty and may, under certain laws, be illegal.

Position Limits

The Commission's proposed rule on position limits for listed and OTC commodity contracts merits this Committee's focus.

Dodd-Frank directs the Commission to adopt specific position limits to the extent that such limits are appropriate to address excessive speculation. In its rule, however, the Commission proposes to impose limits "prophylactically" without finding that such limits are appropriate. The Commission has taken this approach notwithstanding the fact that its staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets or that position limits will prevent excessive speculation.

But even beyond whether such limits are appropriate, we are particularly concerned about the specific content of the proposed rule. In this regard we note that to the extent limits are appropriate, Dodd-Frank directs the Commission to establish them in accordance with a four-part mandate:

- Preventing excessive speculation,
- Preventing manipulation,
- Preserving liquidity for hedging, and
- Protecting the price discovery function.

In our view, the CFTC proposed rule addresses an objective not contained in this mandate: position concentration. Under the proposed rule, position concentration is deemed to exist when an entity has a large holding of a particular contract, even if that holding is non-speculative by virtue of it being a hedge or an offset for other positions. Under the proposed rule, an intermediary would not be permitted to offset positions in different contract types (e.g., swaps vs. futures) on the same or similar underlying commodity for purposes of determining limit compliance even though the two positions are, because of their offsetting nature, manifestly not speculative.

For example, assume a dealer sold a fuel swap to an airline and then bought futures on the same product. Those transactions, viewed together, are not speculative and, therefore, should be eligible to be considered against the applicable limit on a netted basis. However, CFTC rule would still apply separate contract specific limits (i.e., a limit on fuel swaps and a limit on fuel futures). In addition to not being contemplated by the Title VII mandate, it actually undermines the ability of dealers to provide liquidity to hedgers, which is something that is specifically part of that mandate.

As a financial intermediary, Goldman Sachs has a deep interest in the stability, transparency and efficiency of the OTC derivatives markets. We believe that balance in the implementation of Title VII of the Dodd-Frank Act is vital -- liquidity and transparency are both equally important and we committed to working with Congress, the regulators, industry participants and, of course, our clients to achieve a successful and effective transition to reforms that promote greater market stability, healthy competition and prudent risk management.

I appreciate the opportunity to testify before this Committee and look forward to responding to any questions you may have.

TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN
CME GROUP INC.
BEFORE THE

SENATE COMMITTEE ON
AGRICULTURE, NUTRITION AND FORESTRY

MARCH 3, 2011

Chairman Stabenow, Ranking Member Roberts, members of the committee, thank you for the opportunity to testify on the 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 ("CME Group" or "CME"), which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc. the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, Inc. and the Commodity Exchange, Inc. (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 executed in compliance with the applicable Exchange rules and cleared by CME's clearing house. 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 aggressive schedule imposed by DFA, the Commodity Futures Trading Commission ("CFTC" or "Commission") has proposed hundreds of pages of new or expanded regulations.

The invitation from Chairman Stabenow and ranking member Roberts to Chairman Gensler echoes a number of themes of our testimony here today. We agree that the Commission must temper its use of its added rule-making authority and "closely adhere to Congressional intent, especially in situations involving potential significant economic impacts to derivatives users." It is vitally important that, "the rules promulgated by the CFTC . . . target systemic risk, " and that, "any increased costs due to new regulations can be justified as an appropriate way to reduce systemic risk, rather than simply raising the costs of risk management generally."

We are in complete agreement with the following important principle set out in that invitation:

"It is critical that you continue to coordinate with international regulators and examine the ability and the readiness of the industry and markets to absorb the changes in Dodd-Frank in a timely manner. Given the significant changes to our financial markets that will occur as a result of Dodd-Frank, it is imperative that businesses have regulatory certainty. You have said that it is important to write the rules quickly, but we would also remind you that it is more important to do so correctly, in a manner that keeps our domestic businesses competitive."

In our view, many of the Commission's 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. I will highlight some of the most egregious examples below, but first want to elaborate on the Commission's refusal to be governed by the Congressionally mandated cost benefit process. Elimination or reformation of these overreaching regulations will allow the Commission to fulfill all of its mandates with a budget well below its current ask.

The Commission's rulemaking has been skewed by its refusal to be guided by the plain language of Section 15 of the Commodity Exchange Act ("CEA"), as amended by DFA, which requires the Commission to consider the costs and benefits of its action before it promulgates a regulation. In addition to weighing the traditional direct costs and benefits, Section 15 directs the Commission to include in its evaluation of the benefits of a proposed regulation the following intangibles: "protection of market participants and the public," "the efficiency, competitiveness, and financial integrity of futures markets," "price discovery," "considerations of sound risk management practices," and "other public interest considerations." The Commission has construed this grant of permission to consider intangibles as a license to ignore the real costs.

It is obvious from the explicit cost benefit analysis included in the more than thirty rulemakings to date and from the Commission's testimony in a number of congressional hearings, that those responsible for drafting the rule proposals are operating under the mistaken interpretation that Section 15(a) of the CEA excuses the Commission from performing any analysis of the direct, financial costs and benefits of the proposed regulation. Instead, the Commission contends that Congress permitted it to justify its rule making based entirely on speculation about unquantifiable benefits to some segment of the market. The drafters of the proposed rules have consistently ignored the Commission's obligation to fully analyze the costs imposed on third parties and on the agency by its regulations.

Commissioner Sommers forcefully called this failure to the Commission's attention as recently as February 24, 2011, at the start of the CFTC's Meeting on the Thirteenth Series of Proposed Rulemakings under the Dodd-Frank Act.

> "Before I address the specific proposals, I would like to talk about an issue that has become an increasing concern of mine – that is, our failure to conduct a thorough and meaningful cost-benefit analysis when we issue a proposed rule. The proposals we are voting on today, and the proposals we have voted on over the last several months, contain very short, boilerplate "Cost-Benefit Analysis" sections. The "Cost-Benefit Analysis" section of each proposal states that we have not attempted to quantify the cost of the proposal because Section 15(a) of the Commodity Exchange Act does not require the Commission to quantify the cost. Moreover, the "Cost Benefit Analysis" section of each proposal points out that all the Commission must do is "consider" the costs and benefits, and that we need not determine whether the benefits outweigh the costs."

In the view of many experienced derivative industry professionals, the CFTC has been selectively reading DFA to permit it to implement a policy that is likely to defeat the real goals of DFA. We realize that the Commission is under pressure to complete many rulemakings within an unrealistic time period. And even more problematically, many of the rulemakings required by DFA are interrelated. That is, DFA requires many intertwined rulemakings with varying deadlines. Market participants, including CME cannot fully understand the implications or costs 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.

For example, rules addressing the definitions of "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant" are absolutely fundamental to the Commission's regulatory scheme under DFA. As such, they must be established before interested parties can meaningfully address other proposed rules. Nonetheless, the Commission just proposed rules regarding these definitions on

December 21, 2010, and the comment period for those proposed rules recently closed on February 22, 2011. See 75 Fed. Reg. 80174. Meanwhile, the Commission has proposed many other rules, and many comment periods have closed without commentators having the benefit of clarity on these essential definitions.

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 the innovative, effective risk management that regulated exchanges have provided through the recent financial crisis and stifle the intended effects of financial reform, including the clearing of OTC transactions.

Several Commissioners clearly recognize the potential unintended consequences and have been forthright in suggesting that the CFTC temper its ambitions. 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."[1] Commissioner 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

[1] 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

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?" [2]

Additionally, concern has been expressed regarding unduly stringent regulation driving major customers overseas; indeed, we have already seen this beginning to happen with only the threat of regulation. For example, Commissioner Sommers recognized this concern in her recent statement opposing proposed rules in the area of position limits when she noted 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.[3]

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[2] 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

[3] 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

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Many of the Commission's rulemakings to date unnecessarily convert the regulatory system for the futures markets from the highly successful principles-based regime to a restrictive, rules-based regime that will unnecessarily stifle growth and innovation. We are concerned that many of the Commission's proposed rulemakings go beyond the specific mandates of DFA, and are not legitimately grounded in evidence and 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]

A prime example of a refusal to regulate in strict conformance with DFA, 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 CEA, 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

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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

[4] 76 Fed. Reg. 4752 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. 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.

> 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. (emphasis supplied)

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 recordkeeping 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 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.

It is important not to lose sight of the real economic cost of imposing unnecessary and unwarranted position limits. 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 restrictive position limits adversely impact legitimate trading and impair the ability of producers to hedge. They may also drive certain classes of speculators into physical markets and consequently distort the physical supply chain and prices.

Similarly troubling is the fact that the CFTC's proposed rules in this and other areas affecting market participants are not in harmony with international regulators. International regulators, such as the EU, are far from adopting such a prescriptive approach with respect to position limits. Ultimately, this could create an incentive for market participants to move their business to international exchanges negatively impacting the global leadership of the U.S. financial market. Furthermore, exporting the price discovery process to overseas exchanges will likely result in both a loss of jobs in the U.S. and less cost-efficient hedging for persons in business in the U.S. As an example, consider the two major price discovery indexes in crude oil: West Texas Intermediate, which trades on NYMEX, and Brent Oil, which trades overseas. If the Commission places heavy restrictions in areas such as position limits on traders in the U.S., traders in crude oil, and with them the price discovery process, are likely to move to overseas markets.

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

Another example of a rule proposal that 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 significant 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

[6] 75 Fed. Reg. 667277 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pts. 1, 150, 151)

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 time-consuming process to determine whether mandatory clearing is required. Regulation Section 39.5(b)(5) starkly illustrates this outcome. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. Completion is determined in the sole discretion of the Commission. Only then does the 90 day period begin to run. This process to enable an exchange to list a swap for clearing is clearly contrary to the purposes of DFA.

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 the principles-based regulation, which was the foundation of the Commodity Futures Modernization Act of 2000 ("CFMA"). In accordance with CFMA, the CFTC set forth "[g]uidance on, and Acceptable Practices in, Compliance with Core Principles" that operated as safe harbors for compliance. This approach has proven effective and efficient in terms of appropriately allocating responsibilities between regulated DCMs and DCOs and the CFTC.

We recognize that the changes instituted by DFA give the Commission discretion, where necessary, to step back from this principles-based regime. Congress amended 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. But the language clearly assumes that the principles-based regime will remain in effect 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-

[7] *See*, 75 Fed. Reg. 80747 (proposed Dec. 22, 2010) (to be codified at 17 C.F.R. pts. 1, 16, 38)

based regime that has fostered success in CFTC-regulated entities for the past decade.

The Commission's almost complete reversion to a prescriptive regulatory approach converts its role from an oversight agency, responsible for assuring self regulatory organizations comply with sound principles, to a front line decision maker that imposes its business judgments on the operational aspects of derivatives trading and clearing. This reinstitution of rule-based regulation will require a substantial increase in the Commission's staff and budget and impose indeterminable costs on the industry and the end users of derivatives. Yet there is no evidence that this will be beneficial to the public or to the functioning of the markets. 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 the goal of performing those functions that are mandated by DFA.

Further, 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. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been 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. 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

A specific 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").

The Commission justifies the 85% requirement only with its observations as to percentages of various contracts traded on various exchanges. It provides no support evidencing that the requirement will provide 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 imposition of the proposed 85% exchange trading requirement will have extremely negative effects on the industry. It 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 suite of very popular and very liquid foreign exchange products developed and offered by CME would not have met the 85% requirement for four years after it was initially offered. The suite of products' on-exchange trading continued to increase over ten years, and it now trades only 2% off exchange. Under the proposed rule, CME would have had to delist this suite of products.[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

[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.

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.

4. 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 the generation of substantial unnecessary paperwork by exchanges and by the CFTC's staff. It slowed innovation without a demonstrable public benefit.

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 underlying rationale for the self-certification process which has been 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.

Self-certification has been in effect for ten years and nothing has occurred to suggest 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.

[9] 75 Fed. Reg. 67282 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. 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)." DFA does not direct the Commission to require the submission of all documents supporting the 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 proposed by the CFTC will require exchanges to prematurely disclose new product innovations and consequently enable foreign competitors to introduce those innovations while the exchange awaits CFTC approval. Moreover, given the volume of filings required by the Notice of proposed rulemaking, the Commission will require significant increases in staffing and other resources. Alternatively, the result will be that these filings will not be reviewed in a timely manner, further disadvantaging U.S. exchanges. Again, we would suggest that the Commission's limited resources should be better aligned with the implementation of the goals of DFA rather than "correcting" a well-functioning and efficient process.

First, the proposed rules require a registered entity to submit "all documentation" relied upon to determine whether a new product, rule or rule amendment complies with applicable Core Principles. This requirement is so vague as to create uncertainty as to what is actually required to be filed. 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. It is clear that the benefits, if any, of 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 that material intellectual property issues may arise. This requirement would force registered entities to undertake extensive intellectual property analysis, including patent, copyright and trademark searches in order to satisfy the regulatory mandates, with no assurances that any intellectual property claim is discoverable through that process at a particular point in time. Again, this would greatly increase the cost and timing of listing products without providing any 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, which is routinely criticized and 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.

5. 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 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*

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

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 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.

6. Prohibition on Market Manipulation[11]

The Commission's proposed rules on Market Manipulation, although arguably within the authority granted by 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, however, 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

[11] 75 Fed.Reg. 67657-62 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pt. 180)

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, we believe 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.

7. Antidisruptive 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 an advance notice of proposed rulemaking ("ANPR") on this issue and informed the market that it will publish a, "Proposed Interpretive Order [which] provides guidance regarding the three statutory disruptive practices set forth in section 4c(a)(5) of the Commodity Exchange Act (CEA) as amended in by Dodd-Frank Act section 747." The contents of the Interpretive Order have not yet been made public.

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

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. If the Interpretive Order does not clearly define "disruptive trade practices," it will discourage legitimate 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.

8. Effects on OTC Swap Contracts

DFA's overhaul of the regulatory framework for swaps creates uncertainty about the status and validity of existing and new swap contracts. Today, under provisions enacted in 2000, swaps are excluded or exempt from the CEA under Sections 2(d), 2(g) and 2(h) of the CEA. These provisions allow parties to enter into swap transactions without worrying about whether the swaps are illegal futures contracts under CEA Section 4(a). DFA repeals those exclusions and exemptions effective July 16, 2011. At this time, it is unclear what if any action the CFTC plans to take or legally could take to allow both swaps entered into on or before July 16, and those swaps entered into after July 16 from being challenged as illegal futures contracts. To address this concern, Congress and the CFTC should consider some combination of deferral of the effective dates of the repeal of Sections 2(d), 2(g) and 2(h), exercise of CFTC exemptive power under Section 4(c) or other appropriate action. Otherwise swap markets may be hit by a wave of legal uncertainty which the statutory exclusions and exemptions were designed in 2000 to prevent. This uncertainty may, again, chill participation in the swap market and impair the ability of market participants, including hedgers, to manage their risks.

These examples represent a few examples where 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.

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

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

WASHINGTON, DC

March 3, 2011

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

Before I move into the testimony, I want to congratulate Senator Stabenow for becoming Chairwoman of the Committee and Senator Roberts for becoming Ranking Member. I look forward to working with you and all Members of the Committee.

The Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Act. The Act amended the Commodity Exchange Act (CEA) to establish a comprehensive new regulatory framework for swaps. Title VII of the Act, which relates to swaps, 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 recordkeeping 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.

Implementation

The Dodd-Frank 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 the 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 had our first meeting with the 30 team leads the day before the President signed the law.

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.

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. We have thus far proposed rulemakings or interpretive orders in 28 of the 31 areas. 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 an advanced notice of proposed rulemaking with regard to segregation of funds for cleared swaps.

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 Controller of the Currency and other prudential regulators, which includes sharing many of our memos, term sheets and draft work products. We also are working closely with the Treasury Department and the new Office of Financial Research. As of Tuesday, CFTC staff has had 470 meetings with other regulators on implementation of the Act.

In addition to working with our American counterparts, we have reached out to and are actively consulting and coordinating 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.

Specifically, we have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority and the new European Securities and Markets Authority. We also have shared documents with the Japanese Financial Services Authority and consulted with Members of the European Parliament and regulators in Canada, France, Germany and Switzerland.

Through this consultation, we are working to bring consistency to regulation of the swaps markets. In September of last year, the European Commission released its swaps proposal. As we had in the Dodd-Frank Act, the E.C.'s proposal covers the entire derivatives marketplace – both bilateral and cleared – and the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. The proposal includes requirements for central clearing of swaps, robust oversight of central counterparties and reporting of all swaps to a trade repository. The E.C. also is considering revisions to its existing Markets in Financial Instruments Directive (MiFID), which includes a trade execution requirement, the creation of a report with aggregate data on the markets similar to the CFTC's

Commitments of Traders reports and accountability levels or position limits on various commodity markets.

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. As of Tuesday, we have received 2,873submissions from the public through the email inboxes as well as 4,323 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 and have joined with other regulators on several of them as well. These meetings have allowed us to hear directly from investors, market participants, end-users, academics, exchanges, clearinghouses and other concerned members of the public on key topics including governance and conflicts of interest, real time reporting, swap data recordkeeping 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. As of Tuesday, we have had more than 564 such meetings. We are now posting on our website a list of all of the meetings CFTC staff 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 12 public meetings thus far.

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 some occasions, the public comment period lasted 30 days.

At this point in the process, the CFTC has come to a natural pause as we have now promulgated proposals in most of the areas. As we receive comments from the public, we are looking at the whole mosaic of rules and how they interrelate. We will begin considering final rules only after staff can analyze, summarize and consider comments, after the Commissioners are able to discuss the comments and provide feedback to staff, and after the Commission consults with fellow regulators on the rules. Consistent with the Dodd-Frank Act, we hope to move forward in the spring and summer with final rules.

One component that we have asked the public about is phasing of implementation. Within many of the proposed rulemakings, we have asked a question 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. Phasing implementation will benefit market participants as they come into compliance with the Dodd-Frank Act's requirements.

End-User Margin

One of the rules on which the CFTC is working closely with the SEC, the Federal Reserve and other prudential regulators will address margin requirements for swap dealers and major swap participants.

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.

Existing Derivatives Contracts

Congress provided for the legal certainty for swaps entered into prior to the date of enactment of the Dodd-Frank Act. Questions also have been raised regarding the clearing mandate and margin requirements. With respect to the clearing requirement and margin, I believe that the new rules should apply on a prospective basis only as to transactions entered into after the rules take effect.

Position Limits

In January, the CFTC issued a proposed rule to establish position limits on futures contracts and some swaps in agriculture, energy and metals markets. The proposed rule covers 28 commodities and includes one position limits regime for the spot month and another for single-month and all-months combined. Under the proposal, spot month limits would be set based on deliverable supply. Single-month and all-months-combined limits would be set using a formula based on data to be collected on the total size of the swaps and futures market. The proposed rule also includes provisions to implement the Dodd-Frank Act's directions defining the conditions under which bona fide hedging exemptions to position limits may be exercised. We look forward to reviewing the public's comments on this proposal.

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 OCC, 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 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 equivalent employees for pre–reform authorities and $45 million to provide half of the staff estimated at that time needed to implement the Act. Under the continuing resolution, the Commission has operated in FY 2011 at its FY 2010 level. In the budget released on Monday, the President requested $308 million for the CFTC for FY 2012 that would provide for 983 full-time equivalent employees.

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.

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

Testimony
of
Michael Greenberger
Law School Professor
University of Maryland School of Law

United States Senate Committee on Agriculture, Nutrition and Forestry
Dirksen Senate Office Building, Room 328A
Washington DC
Thursday, March 3, 2011, 2:30 PM EST

MICHAEL GREENBERGER
BRIEF BIOGRAPHY

After 25 years in private legal practice, Michael Greenberger served under Chairperson Brooksley Born as the Director of the Division of Trading and Markets ("T&M") at the Commodity Futures Trading Commission ("CFTC") from September 1997 to September 1999. In that capacity, he supervised approximately 135 CFTC personnel in CFTC offices in DC, New York, Chicago, and Minneapolis. During his tenure at the CFTC, he worked extensively on, *inter alia*, regulatory issues concerning exchange traded energy derivatives, the legal status of over-the-counter ("OTC") energy derivatives, and the CFTC's authorization of trading foreign exchange derivative products on computer terminals in the United States.

Professor Greenberger was also actively involved in the drafting of the May 7, 1998 CFTC "Concept Release on OTC Derivatives," which, before being blocked by Congress with the support of the remaining members of the President's Working Group on Financial Markets ("PWG"), was designed to encourage a public discussion on whether these multi-trillion dollar unregulated instruments should be subject to the kind of market regulation which has long governed – and continues to govern – the Nation's equity and futures markets and which is embodied in Title VII of the Dodd-Frank Act.

While at the CFTC, Professor Greenberger also served on the Steering Committee of the PWG. In that capacity, he drafted portions of the April 1999 PWG Report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." The report enumerated regulatory recommendations to Congress in the wake of the near collapse of the Long Term Capital Management ("LTCM") hedge fund. Further, as a member of the International Organization of Securities Commissions' ("IOSCO") Hedge Fund Task Force, he participated in the drafting of the November 1999 report of IOSCO's Technical Committee relating to the LTCM episode: "Hedge Funds and Other Highly Leveraged Institutions."

After a two-year stint between 1999 and 2001 as the Principal Deputy Associate Attorney General in the U.S. Department of Justice, Greenberger began his service as a Professor at the University of Maryland School of Law. At the law school, he has continued to focus on OTC derivatives. He currently teaches a course entitled "Futures, Options, and Derivatives."

Professor Greenberger served in 2009 as the Technical Advisor to the United Nations Commission of Experts on Reforms of the International Monetary and Financial System and in 2009-2010 as a member of the International Energy Forum's Independent Expert Group on reducing worldwide energy price volatility.

During Congress' consideration of the Dodd-Frank legislation, Professor Greenberger served as a volunteer technical advisor to Americans for Financial Reform and the Commodities Market Oversight Coalition, and he is now working with those groups on the implementation of the Dodd-Frank Act. To date, he has filed comments on 15 Dodd-Frank proposed rules.

Professor Greenberger is also the Founder and Director of the University of Maryland Center for Health and Homeland Security, an academic consulting center of nearly 65 professionals working at the local, state, federal, and international level providing legal and operational guidance on crisis management.

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Introduction

The Relationship of Unregulated OTC Derivatives to the Meltdown. It is now accepted wisdom that it was the non-transparent, poorly capitalized, and almost wholly unregulated over-the-counter ("OTC") derivatives market that lit the fuse that exploded the highly vulnerable worldwide economy in the fall of 2008.[1] Because tens of trillions of dollars of these financial products were pegged to the economic performance of an overheated and highly inflated housing market, the sudden collapse of that market triggered under-capitalized or non-capitalized OTC derivative guarantees of the subprime housing investments. Moreover, the many undercapitalized insurers of that collapsing market had other multi-trillion dollar OTC derivatives obligations with thousands of financial counterparties (through unregulated interest rate, currency, foreign exchange, and energy derivatives). If a financial institution failed because it could not pay off some of these obligations, trillions of dollars of interconnected transactions would have also failed, causing a cascade of collapsing banks throughout the world. It was this potential of systemic failure that required the United States taxpayer to plug the huge capital hole that a daisy chain of nonpayments by the world's largest financial institutions would have caused, thereby heading off the cratering of the world's economy.[2]

An Example of the Multi-Trillion Dollar Derivative "Bets" That Had to Be Paid by the U.S. Taxpayer. The then perfectly lawful "bets" that hedge fund manager John Paulson placed through this unregulated OTC derivatives market provide but a single example of how that market collectively misfired and – but for taxpayer bailouts – nearly imploded the world economy.[3] From 2006 to 2007, Mr. Paulson with, *inter alia*, the assistance of swaps dealers,

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[1] *See* Ben Moshinsky, *Stiglitz says Banks Should Be Banned From CDS Trading*, BLOOMBERG.COM (Oct. 12, 2009), http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=a65VXsI.90hs; Paul Krugman, Op-Ed, *Looters in Loafers*, N.Y. TIMES, Apr. 18, 2010, *available at* http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk. *See generally* Alan S. Blinder, *The Two Issues to Watch on Financial Reform — We Need an Independent Consumer Watchdog and Strong Derivatives Regulation. Industry Lobbyists are Trying to Water Them Down*, WALL ST. J., Apr. 22, 2010, *available at* http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html; Henry T. C. Hu, *"Empty Creditors and the Crisis*, WALL ST. J., Apr. 10, 2009, at A13; MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010) [hereinafter THE BIG SHORT]; SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2011) [hereinafter 13 BANKERS]; MICHAEL HIRSH, CAPITAL OFFENSE: HOW WASHINGTON'S WISE MEN TURNED AMERICA'S FUTURE OVER TO WALL STREET (2010) [hereinafter CAPITAL OFFENSE]; BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS (2010) [hereinafter ALL THE DEVILS ARE HERE]; INSIDE JOB (Sony Pictures Classics & Representational Pictures 2010); *Frontline: The Warning* (PBS television broadcast Oct. 20, 2009) [hereinafter The Warning]; FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xxiv (Jan. 2011), *available at* http://www.fcic.gov/report [hereinafter FCIC REPORT].

[2] *See* Moshinsky, *supra* note 1; Krugman, *supra* note 1; Blinder, *supra* note 1; Hu, *supra* note 1; THE BIG SHORT, *supra* note 1.

[3] Complaint at 2, Securities and Exchange Commission v. Goldman Sachs & Co. and Fabrice Tourre, 2010 U.S. Dist. Ct. 3229 (S.D.N.Y. Apr. 16, 2010) ("Undisclosed in the marketing materials and unbeknownst to investors, a large hedge fund, Paulson & Co. Inc. ('Paulson'), with economic interests directly adverse to investors in the ABACUS 2007-AC1 CDO, played a significant role in the portfolio selection process. After participating in the selection of the reference portfolio, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps ('CDS') with [Goldman] to buy protection on specific layers of the ABACUS 2007-AC1 capital structure. Given its financial short interest, Paulson had an economic incentive to choose RMBS that it expected to experience credit events in the near future.") (On July 15, 2010, Goldman Sachs entered into a settlement without admitting or denying the SEC's allegations for the amount of $550 million.)

purchased synthetic collateralized debt obligations ("CDOs"), which were nothing more than the purchase of insurance on his selection of weak tranches of subprime residential mortgage-backed securities that Mr. Paulson himself did not own.[4] In other words, through so-called "naked credit default swaps ('CDS')," Mr. Paulson effectively bought insurance on his own selection of subprime investments in which he had no ownership and for which he had no risk, but which he believed would fail. Since the dawn of the 19th century, it has not been legal to buy insurance on someone else's risk. However, because these "bets" were categorized as OTC derivatives, they were expressly deregulated as "swaps" by Congressional enactment, and insurance laws were not applied.

When subprime mortgage borrowers (*i.e.*, those with various degrees of non-creditworthiness) defaulted and could not, as common sense would have suggested, sustain their mortgages, the tranches that Mr. Paulson insured (but did not own) failed, thereby triggering highly lucrative payment obligations to Mr. Paulson pursuant to his synthetic CDOs and naked CDS. Paulson ultimately made about $15 billion on these bets.[5]

Even though the purchasers of synthetic CDOs, such as Mr. Paulson, "profited spectacularly from the housing crisis . . . they were not purchasing insurance against anything they owned. Instead, they merely made side bets on the risks undertaken by others."[6] In fact, because synthetic CDOs mimicked insurance, those who were "insured" through synthetic CDOs were only required to sustain their multi- trillion dollar bets with insurance-like "premiums," *i.e.*, they were only required to pay about two percent of the total amount insured.[7]

Moreover, as has been widely demonstrated, investors "creating" their synthetic bets that the subprime market would fail often repeatedly insured against the *same* weak subprime tranches, *i.e.*, many weak subprime tranches were "bet" to fail multiple times.[8] In essence, therefore, once a borrower defaulted on a mortgage, the loss in the real economy was exponentially multiplied by the many side bets placed on whether that borrower would default.

Mr. Paulson's investments are reflective of trillions of dollars bet on the subprime market, and the astronomical amounts owed to the holders of this unregulated "insurance" of the subprime market serve as a microcosm of the worldwide financial crisis.[9]

Most importantly, the "insurers" of the subprime market (some of the most prominent financial institutions in the world) were not required to have capital to sustain their insurance or to post collateral to ensure their payments. (Had these investments been governed by insurance or gaming laws, those betting that subprime mortgages would be paid would have been required to have adequate capital to ensure payments if the bet were lost.) And, when the "insurers" were "surprised" to find that those without creditworthiness could not pay their mortgages, they did not have the ability to pay off their indebtedness to the holders of synthetic CDOs. However,

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[4] *Id.*

[5] Svea Herbst-Bayliss and Kevin Lim, *Paulson reassures on Goldman role*, REUTERS (April 21, 2010), *available at* http://www.reuters.com/article/2010/04/21/us-goldman-paulson-redemptions-idUSTRE63K0C620100421?pageNumber=1.

[6] FCIC REPORT, *supra* note 1, at 195.

[7] *See* THE BIG SHORT, *supra* note 1, at 51.

[8] *See id.*

[9] *See generally* THE BIG SHORT, *supra* note 1; *see also* INSIDE JOB, *supra* note 1.

what should have been a zero-sum game was converted from a lose-lose game into a win-win situation, *i.e.*, the Mr. Paulsons of this world only got paid because "insurers" were subsidized by the taxpayer so that the "casinos" could make payment on the bets. Unlike regular gambling, no gambler lost – except the perfectly innocent bystanders: the U.S. taxpayer.[10]

As it now stands, the world is attempting to dig itself out of the worst financial crisis since the Great Depression of the 1930's – a task now aggravated, *inter alia*, by the burden of escalating energy and food commodity prices. As will be shown below, dozens of studies suggest that even those escalating commodity prices may very well be aided by betting on the upward direction of those prices through passive investments originated by U.S. financial institutions using unregulated OTC derivatives.[11]

Dodd-Frank Provides the Tools to Protect the U.S. Taxpayer. As will be shown below, Title VII of the Dodd-Frank Act, thanks to the major contribution of this Committee, would make it very difficult to repeat the kind of undercapitalized, non-transparent, and economy-busting "betting" mentioned above. That statute, *if properly implemented*, (1) requires all major players to have adequate capital to enter the market to sustain their potentially huge obligations; (2) requires that almost all of these kinds of investments be collateralized by counterparties; (3) requires almost all of these investments to be guaranteed and properly margined by clearing facilities, which, in turn, are subject to strict federal regulation and oversight; (4) requires all of these transactions to be publicly recorded and, in many instances, traded on public exchanges or exchange-like environments; and (5) collectively places the CFTC, the SEC, and the members of the Financial Stability Oversight Council in a position to have full transparency of these kinds of investments with an eye to preventing the kind of systemic risk that threatened the world economy in the fall of 2008.

We Are Not Home Free Yet. As will be shown below, there is now a substantial question whether Title VII of Dodd-Frank will be properly implemented because of resistance by big banks and other financial institutions. According to the Comptroller of the Currency, five big Wall Street banks have controlled 98% of the existing (pre-Dodd-Frank) OTC derivatives market, thereby necessitating, for example, the Antitrust Division of the Department of Justice to intervene in one of the critically important CFTC and SEC proposed rulemakings concerning ownership of the major new financial institutions created by Dodd-Frank. The big banks want to keep these institutions within their control. Needless to say, if properly implemented, the huge profits of these and other banks will be diminished by the competition that a transparent market brings, in the words of Dodd-Frank, "free and open access" to what would be highly competitive derivatives markets.

While each argument advanced by swaps dealers must be analyzed on its own merits, there can be no mistake that a fundamental underlying tenet of minimizing the impact of Dodd-Frank, either implicitly or explicitly, is that we are now out of the financial crisis and there is no need for change. Therefore, it is suggested that as much of the status quo ante as can be

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[10] *See* THE BIG SHORT, *supra* note at 1, at 256.

[11] Commodity Markets Oversight Coalition, EVIDENCE OF THE IMPACT OF COMMODITY SPECULATION BY ACADEMICS, ANALYSTS AND PUBLIC INSTITUTIONS (2011), http://www.nefiactioncenter.com/PDF/evidenceonimpactofcommodityspeculation.pdf.

preserved should now be left in place. A subsidiary argument is that if Dodd-Frank is fully enforced, it will be a job killer.

As shown above, the undercapitalized casino that unregulated derivatives fostered in the subprime housing market was the ultimate job and pension killer. The misery created by that unregulated market often gets lost in Wall Street talking points. Moreover, the economic infrastructure built before Dodd-Frank around subprime mortgages exists, *e.g.*, for prime mortgages, commercial mortgages, student loans, auto and credit card debt.

We are presently in a jobless "recovery." Moreover, the shock of rapidly escalating energy and food prices, as well as threatened defaults by municipalities and European Union sovereign states, can either individually or collectively create economic dislocations akin to that experienced in the fall of 2008. For example, there is almost certainly an untold number of grossly undercapitalized naked CDS on municipal and sovereign obligations. If there are widespread defaults in those areas, an untold number of "insurance" guarantees will be triggered.

The loss of profits of "too big to fail" financial institutions, which have fully recovered and may be stronger now than before the meltdown, must be balanced against the well being of the American consumer, worker and taxpayer. Rejecting Dodd-Frank on the assumption that all is now well is a dangerous strategy to follow legislatively or at the regulatory level.

Whatever new costs Dodd-Frank imposes (and those costs are greatly exaggerated by those seeking to deflate regulation) are minimal compared to the dire economic havoc that might be caused by under-regulation, especially when Congress is now almost devoid of "stimulus bullets" to repair future economic ills.

Funding for the CFTC and SEC. Severely hampering the CFTC's and SEC's ability to implement Title VII of Dodd-Frank are their challenging financial and staffing conditions. I recognize that this Committee can only serve an authorization – not appropriation – role. It also only has jurisdiction over the CFTC. Nevertheless, the voice of this Committee on funding by appropriators for the CFTC can doubtless play an important role in ensuring proper implementation of Dodd-Frank.

With regard to the CFTC, that agency's gross underfunding makes performing its new and complex functions under Dodd-Frank "a herculean task."[12] Under the new regulations, the CFTC must examine a voluminous amount of data and information encompassing transactions that number in the millions.[13] An $11 million slash in the technology budget has forced the agency to cease developing a new program that would scan the overwhelming number of trades to detect suspicious trading. Moreover, the potential long-term effects of insufficient funding is severe; operating under its current budget will mean that applications, findings, and enforcement required by the new law would languish.[14] As Commissioner Bart Chilton aptly warns, "Without

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[12] Ben Protess, *Regulators Decry Proposed Cuts in C.F.T.C. Budget*, N.Y. TIMES (February 24, 2011) (quoting CFTC Commissioner Michael Dunn), *available at* http://dealbook.nytimes.com/2011/02/24/regulators-decry-proposed-c-f-t-c-budget-cuts/?ref=todayspaper.

[13] Jean Eaglesham and Victoria McGrane, *Budget Rift Hinders CFTC*, WALL ST. J. (Feb. 25, 2011).

[14] *See* Transcript of the Congressional Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act before the H. Comm. on Agriculture (Feb. 15, 2011) (statement of Terry Duffy, Executive Chairman, CEM Group).

the funding, we could once again risk another calamitous disintegration."[15] Lack of funds not only shortchanges the Commission, but it also risks another widespread financial crisis.

In this regard, the CFTC lacks an adequate number of personnel to perform its increased regulatory duties. From 1999 to 2007, the agency shrunk from 567 full-time equivalents ("FTEs") to 437. By 2010, the number of FTEs had risen to 650, only a 30% increase in the number of personnel since the agency's establishment in 1975. Chairman Gary Gensler estimates that he needs an additional 400 people to meet the challenges of regulating the multi-trillion dollar derivatives markets.[16] As Barbara Roper of the Consumer Federation of America has noted, for example, the "draconian cuts" of the House of Representatives' proposed budget would "decimate that tiny agency without making any meaningful inroads in the federal deficit."[17] Even the relatively fiscally conservative *Financial Times* has within this last week editorialized that the SEC and CFTC deserve the funding levels that were promised to prevent a future meltdown through proper implementation of Dodd-Frank.

It is one thing to attack Dodd-Frank frontally by seeking deregulatory action either through legislation or weakened rules. There can be little doubt, however, that starving financial regulatory agencies dependent upon appropriations is a *de facto* rescission of Dodd-Frank. It asks Americans to face yet another crisis under the guise of budget cuts – a crisis that may "the next time" drag the United States and the world into the next Great Depression.

In making this point, I also want to commend the CFTC for its heroic work in meeting the necessarily rigorous deadlines imposed by Dodd-Frank for well over 60 new rules. I spent 25 years in a private law practice heavily devoted to rulemaking advocacy, and then involvement in the judicial review of those rules in virtually every federal circuit court of appeals in the country and in the United States Supreme Court. I was also very proud of the many rules that were promulgated by the CFTC while I was the Director of the Division of Trading and Markets. However, the hard and productive work performed by the CFTC in implementing Dodd-Frank, especially with its small staff, is extraordinary. The quality of that work also meets the highest standards of public service. This Committee should be very proud of this effort. The agency has more than demonstrated that it will be a vigilant protector of the important markets it now oversees if it receives the financial support it needs from this Congress.

This testimony will highlight the manner in which the lack of regulation of the OTC derivatives market was a principal cause of the 2008 credit crisis and the resulting onset of the Great Recession and how Title VII of the Dodd-Frank Act, *if properly implemented*, can avoid similar crises in the future. The remainder of this testimony is based principally on my soon to be published article in the University of Maryland School of Law's *Journal of Business and*

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[15] *See* Statement of Bart Chilton, Commissioner, Commodity Futures Trading Commission, Risky Business (February 24, 2011), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement022411.html.

[16] Ben Protess and Mac William Bishop, *At Center of Derivatives Debate, a Gung-Ho Regulator*, N.Y. TIMES (Feb. 10, 2011), *available at* http://dealbook.nytimes.com/2011/02/10/at-center-of-debate-over-derivatives-a-gung-ho-regulator/.

[17] *See* Statement of Barbara Roper, Director of Investment Protection, Consumer Federation of America, Feb. 14, 2011.

Technology Law, as well as on a series of my previously published articles and testimony delivered to Congress and to the Financial Crisis Inquiry Commission.[18]

The Commodity Futures Modernization Act of 2000's Deregulation of Swaps

On December 15, 2000, Congress passed the Commodity Futures Modernization Act of 2000 ("CFMA"), which President Clinton signed into law on December 21, 2000.[19] The CFMA removed OTC derivatives transactions, including energy futures transactions, from all requirements of exchange trading and clearing under the CEA so long as the counterparties to the swap were "eligible contract participants."[20] Generally speaking, a counterparty to be an "eligible contract participant" had to have in excess of $10 million in total assets with some limited exceptions allowing lesser amounts in the case of an individual using the swap for risk management purposes.[21]

Thus, the OTC derivatives market (at that time according to then-Treasury Secretary Summers amounting to $80 trillion notional value) was exempt from the traditional and time-tested regulatory controls of the securities and futures markets: capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self regulation; any bars on fraud, manipulation[22] and excessive speculation; and requirements for clearing. The SEC was similarly

[18] This testimony article draws significantly from *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by An Unregulated Multi-Trillion Dollar Derivatives Market,* 6 J. Bus. & Tech. L. 127 (forthcoming 2011), *available at* http://works.bepress.com/michael_greenberger/41/, as well as the following previous publications and written testimony: *Derivatives in the Crisis and Financial Reform, in* THE POLITICAL ECONOMY OF FINANCIAL CRISES, OXFORD UNIVERSITY PRESS HANDBOOK (Gerald Epstein & Martin Wolfson eds., forthcoming 2011); *Is Our Economy Safe? A Proposal for Assessing the Success of Swaps Regulation under the Dodd-Frank Act, in* THE FUTURE OF FINANCIAL REFORM: WILL IT WORK? HOW WILL WE KNOW? (Roosevelt Institute 2010), *available at* http://works.bepress.com/michael_greenberger/34; *Out of the Black Hole: Regulatory Reform of the Over-the-Counter Derivatives Market, in* MAKE MARKETS BE MARKETS 99 (Roosevelt Institute 2010), *available at* http://works.bepress.com/michael_greenberger/35/; *Out of the Black Hole: Reining in the Reckless Market in Over-the-Counter Derivatives,* AMERICAN PROSPECT (2010), *available at* http://works.bepress.com/michael_greenberger/37; and Written Testimony of Michael Greenberger, *Hearing Before the Financial Crisis Inquiry Commission Regarding The Role of Derivatives in the Financial Crisis* (June 30, 2010), *available at* http://www.fcic.gov/hearings/pdfs/2010-0630-Greenberger.pdf [hereinafter FCIC Testimony].

[19] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763.

[20] *See* FCIC Testimony, *supra* note 18, at 9.

[21] PHILLIP MC BRIDE JOHNSON AND THOMAS LEE HAZEN, DERIVATIVES REGULATION §1.02[3] 328-29 (Aspen 2004) [hereinafter DERIVATIVES REGULATION].

[22] Unlike financial swaps, which were "*excluded*" from the exchange trading requirement, including fraud and manipulation prohibitions, energy and metals swaps, while relieved of the exchange trading, continued to be subject to fraud and manipulation prohibitions; they were therefore labeled by the CFMA as "*exempt*" transactions. *Id.* *Compare* § 2(g) (relating to financial swaps) with § 2(h) relating to energy and metals swaps. *Id. See also* CHARLES W. EDWARDS ET. AL., COMMODITY FUTURES MODERNIZATION ACT OF 2000: LAW AND EXPLANATION 28 (2001) (quoting remarks of Sen. Tom Harkin, 146 Cong. Rec. S11896, December 15, 2000, "The Act continues the CFTC's antifraud and anti-manipulation authority with regard to exempt transaction in energy and metals derivative markets."). By exempting metals and energy swaps from exchange trading, Congress disagreed with the unanimous recommendation of the President's Working Group that swaps concerning "finite" supplies not be removed from the exchange trading mandate of the CEA. *Id.*

barred from OTC derivatives oversight except for the limited fraud jurisdiction it maintained over securities-based swaps.[23]

Recognizing that the deregulation of swaps would encourage widespread speculation through derivatives trading, *the CFMA also expressly preempted state gaming and anti-bucket shop laws*,[24] which would have barred the otherwise unregulated betting authorized by the CFMA.[25]

Years later, during the Troubled Asset Relief Program ("TARP") hearings in September 2008, then-SEC Chairman Christopher Cox warned Congress about the need for "immediate legislative action," because he viewed the OTC credit derivatives market as a "regulatory blackhole" based on the deregulatory provisions adopted within the CFMA.[26]

To address the problems presented by the unregulated OTC derivatives market, on July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[27] into law. If properly implemented, the statute establishes a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity. Specifically, Dodd-Frank:

- provides for the registration and comprehensive regulation (including capital requirements and business conduct rules) of swap dealers and major swap participants;
- imposes collateral and trade execution requirements for most derivative products;
- imposes margin and capital requirements for all cleared swaps;
- creates recordkeeping and real-time reporting requirements; and
- enhances regulators' ability to observe these markets, thereby enhancing enforcement activities for fraud and manipulation and assisting in preventing systemically risky practices.

The Economic Meltdown as a Failure of OTC Derivatives Regulation

Although many factors contributed to the financial meltdown of 2008, principal among them was the collapse of the market in OTC derivatives. The OTC market in naked credit default swaps and synthetic collateralized debt obligations provided the trigger that launched the mortgage crisis, credit crisis, and systemic financial crisis that threatened to implode the global

[23] *See* FCIC Testimony, *supra* note 18, at 10.
[24] *See* DERIVATIVES REGULATION at 975, *supra* note 21.
[25] *Id.*
[26] Robert O'Harrow, Jr. and Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1(quoting former Chairman Christopher Cox, "The regulatory blackhole for credit-default swaps is one of the most significant issues we are confronting in the current credit crisis ... and it requires immediate legislative action.").
[27] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203.

financial system, were it not for a multi-trillion dollar U.S. taxpayer intervention.[28] At the time of the crisis, this OTC market was estimated to have a notional value of $596 trillion, including approximately $58 trillion in CDSs,[29] yet federal regulators (and most state regulators) were barred by a federal statute from ensuring stability in these transactions.[30] Before explaining below the manner in which naked credit default swaps (sometimes referred to as synthetic collaterized debt obligations) fomented this crisis, it is worth citing in the margin those many economists,[31] regulators,[32] market observers,[33] and financial columnists[34] who have described the central role unregulated CDS and synthetic CDOs played in the crisis.[35]

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[28] *See generally* Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 5, 2008, at B0; Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A0; Jon Hilsenrath et al., *Worst Crisis Since '30s, With no End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1; Testimony of Dr. Alan Greenspan, *The Financial Crisis and the Role of Federal Regulators: Hearing before the Committee on Oversight and Government Reform*, 111th Cong. (Oct. 23, 2008), *available at* http://clipsandcomment.com/wp-content/uploads/2008/10/greenspan-testimony-20081023.pdf.

[29] Naohiko Babo and Paola Gallardo, *OTC Market Activity in the Second Half of 2007*, BANK FOR INTERNATIONAL SETTLEMENTS (May 2008), *available at* http://www.bis.org/publ/otc_hy0805.pdf.

[30] Michael Greenberger, *Is Our Economy Safe? A Proposal for Addressing the Success of Swaps Regulation, in* WILL IT WORK? HOW WILL WE KNOW? THE FUTURE OF FINANCIAL REFORM 37 (Michael Konczal ed., Roosevelt Institute 2010) [hereinafter Greenberger].

[31] *See* Moshinsky, *supra* note 1; Blinder, *supra* note 1; Hu, *supra* note 1; Krugman, *supra* note 1; THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; INSIDE JOB, *supra* note 1; James K. Galbraith, Statement before the Subcommittee on Crime Senate Judiciary Committee (May 4, 2010), *available at* http://utip.gov.utexas.edu/Flyers/GalbraithMay4SubCommCrimeRV.pdf.

[32] Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 24, 2008; Anthony Faiola et al., *What Went Wrong*, WASH. POST, Oct. 15, 2008; Peter S. Goodman, *Taking Hard New Look at the Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008; *Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing before the House of Representatives Committee on Agriculture*, 110th Cong. (Nov. 20, 2008) *available at* http://www.ins.state.ny.us/speeches/pdf/sp0811201.pdf (prepared testimony of Eric Dinallo, Superintendent, New York State Insurance Dept); Gary Gensler, Remarks at OTC Derivatives Reform, Chatham House, London (Mar. 18, 2010) (stating that "OTC derivatives were at the center of the 2008 financial crisis" and "Capital requirements should take into account the unique risks that credit default swaps (CDS) pose"); Testimony of Alan Greenspan, *supra* note 28; Greg Robb, *Roots of Credit Crisis Laid at Fed's Door*, MARKET WATCH (Oct. 24, 2007), *available at* http://www.marketwatch.com/story/roots-of-credit-crisis-found-at-the-feds-door-says-expert; THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; Inside Job, *supra* note 1.

CDSs were the last step in a subprime securitization process that came to undermine the economy.[36] A counterparty investing in a CDS paid, at most, about a 2% "premium" to another counterparty for the latter to agree to "guarantee" that the weakest parts of a financial instrument, a collateralized debt obligation ("CDO"), would not fail.[37] Thus, a CDS can be seen as a form of insurance on the success of specified tranches of a CDO.[38] CDOs, in turn, involved the "pulling together and dissection into 'tranches' of huge numbers of [mortgage-backed securities

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[33] *See* INVESTOR'S WORKING GROUP, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS' PERSPECTIVE 1 (July 2009), *available at* http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf (listing the fundamental flaws of the U.S. financial services sector exposed by the credit crisis: "... gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both 'too big to fail' and too labyrinthine to regulate or manage effectively"); Jonathan Berr, *George Soros wants to outlaw credit default swaps*, DAILYFINANCE (June 12, 2009), *available at* http://www.dailyfinance.com/story/george-soros-wants-to-outlaw-credit-default-swaps/19065423/# ("Credit default swaps, insurance contracts on securities in the event of a default, are widely blamed as one of the causes of the current financial crisis. The unregulated, $70 trillion market became unhinged when the real estate market, particularly houses funded through subprime mortgages, collapsed."); Henny Sender, *Greenlight Capital founder[David Einhon] calls for CDS ban*, FINANCIAL TIMES, Nov. 6, 2009 (quoting Greenlight Capital founder David Einhorn: "... trying to make safer credit default swaps is like trying to make safer asbestos ... [as CDSs create] large, correlated and asymmetrical risks") *available at* http://www.ft.com/cms/s/0/6b1945e6-caf9-11de-97e0-00144feabdc0.html; Janet Tavakoli, *Washington Must Ban U.S. Credit Derivatives as Traders Demand Gold (Part One)*, HUFFINGTON POST, March 8, 2010, *available at* http://www.huffingtonpost.com/janet-tavakoli/washington-must-ban-us-cr_b_489778.html ("Congress should act immediately to abolish credit default swaps on the United States, because these derivatives will foment distortions in global currencies and gold."); THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; INSIDE JOB, *supra* note 1.

[34] *See* LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (CROWN BUSINESS, 2009); Robert Johnson, *Credible Resolution – What It Takes to End Too Big to Fail*, *in* ROOSEVELT INSTITUTE: MAKE MARKETS BE MARKETS 117–133 (2009) ("The recent crisis in the U.S. centered on the collapse of the housing bubble and the role of leverage, off balance sheet exposures, and complex OTC derivatives."); Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 5, 2008 ("Policy makers have been unnerved by the rise of the [CDS] market because they are worried that sellers of protection may not have enough reserves to pay future claims and that default by one party could lead to a cascade of failures throughout the financial system."); Jon Hilsenrath, et al., *Worst Crisis Since '30s, With No End Yet In Sight*, WALL ST. J., Sept. 18, 2008, at A1 ("The latest trouble spot [in the financial crisis] is an area called credit-default swaps ..."); Jeff Madrick, *At the Heart of the Crash*, NY REVIEW OF BOOKS, (June 10, 2010) (reviewing MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010)), *available at* http://www.nybooks.com/articles/archives/2010/jun/10/heart-crash/?pagination=false ("As we now know, derivatives were the instruments that enabled Wall Street to stretch capital dangerously far – and were at the center of the financial crisis that began that year."); Gretchen Morgenson, *Naked Came the Speculators*, N.Y. TIMES, Aug. 10, 2008, ("As the sheriffs begin to confront the C.D.S. cowboys, more losses are bound to show up in this Wild West."); THE BIG SHORT, *supra* note 1; 13 BANKERS, *supra* note 1; CAPITAL OFFENSE, *supra* note 1; ALL THE DEVILS ARE HERE, *supra* note 1; INSIDE JOB, *supra* note 1.

[35] *See infra* notes 139, 140, and 142.

[36] Michael Greenberger, *Out of the Black Hole: Regulatory Reform of the Over-the-Counter Derivatives Market*, *in* ROOSEVELT INSTITUTE: MAKE MARKETS BE MARKETS 99, at 100–02 (2010), *available at* http://www.michaelgreenberger.com/files/Greenberger-Derivatives-MMBM.pdf.

[37] *Id.* at 100.

[38] *Id.*

('MBSs')]," based for their part on mortgage loans and, in the years before the crisis, subprime mortgages in particular.[39]

Importantly, by "reframing the form of risk (*e.g.*, from subprime mortgages to MBSs to CDOs)," those investors providing the guarantees of or insurance for the subprime market through CDSs lost sight of the fundamental transaction at issue, *i.e.*, whether noncreditworthy borrowers would pay home loans, and, because of the confusion caused by the reframing of risk, mistakenly thought that their investments were safe.[40] This problem was compounded by "misleadingly high evaluations" by credit rating agencies of those self-evidently weak tranches.[41] In addition, issuers of CDSs relied upon the faulty assumption that housing prices would never go down, so that they would never have to pay the guarantees they were providing.[42]

Because CDSs were widely understood to be risk-free, financial institutions began writing "naked" CDSs to investors who had no direct investment in or risk from CDOs or MBSs.[43] That is, investors bet with relatively small insurance-type premiums that certain handpicked mortgage-based instruments would fail, and that they would receive a hefty payment if they did.[44] Estimates suggest that before the crisis, there were almost certainly multiples of "naked" CDS to those based on insuring actual risk.[45]

All of this came to a head when housing prices began to plummet.[46] Homeowners began to default on loans, leading to the failure of CDOs and triggering obligations of CDS issuers.[47] Synthetic CDOs and naked CDSs added exponentially to the obligations owed, *i.e.*, the economy was not only confronted with real economic losses from the actual defaults, but from the multiplier effect of the betting losses on the wagers of whether those loans would be paid.[48]

This problem was especially insidious, because those who sold the guarantees believed that these provisions would never be triggered, issuers had not set aside sufficient capital to pay them off and therefore could not honor their contractual commitments.[49] In addition, because the investments were not reported to regulators, both the government and the financial community were surprised by the size of the market upon widespread defaults, which led to uncertainty and a tightening of credit.[50] Because the "bets" were private and unreported transactions, in a panic with failures of household financial institutions, the assumption was that all such institutions had or would have betting liabilities. All of these actual losses and fears of further losses resulted in the downward cycle of the economic meltdown, exacerbated by the fact that CDOs and CDSs existed not just in the subprime mortgage market, but in most credit markets.[51]

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[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.* at 101.
[44] *Id.*
[45] *Id.*
[46] *Id.* at 102.
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*

The analysis surrounding this subject estimates that there may have been three to four times as many "naked" CDS instruments extant at the time of the meltdown than CDSs guaranteeing actual risk.[52] This means that to the extent the guarantor of a CDS (*e.g.,* AIG) had to be rescued by the U.S. taxpayer, the chances were very high that the "bail out" was of failed naked CDS bets that mortgages would be paid.[53] (Prominent members of Congress have maintained that the holders of bets that mortgages would fail have formed a strong political constituency against the "rescue" of subprime borrowers through the adjustment of mortgages to keep homeowners from defaulting).[54]

The fact that "naked" CDS and "synthetic" CDOs were nothing more than "bets" on the viability of the subprime market also demonstrates the importance of the CFMA expressly *preempting state gaming and anti-bucket shop laws.*[55] Had those laws not been preempted, it is almost certain that at least some states would have banned these investments as unlicensed gambling or illegal bucket shops.[56] An action of this sort by even a single state would have made the "naked" CDS market economically unviable throughout the country.[57]

Moreover, doubtless because Eric Dinallo, in his then capacity as New York Insurance Superintendent, seriously considered regulating CDS as insurance[58] and because the National Council of Insurance Legislators were working on a model code to regulate CDS as insurance,[59] Wall Street lobbyists ensured that the Dodd-Frank Act would also preempt state insurance law as it applies to swaps that are neither cleared or exchange traded.[60]

Dodd-Frank's Solutions for Regulating Swaps

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") into law.[61] Title VII of the Dodd-Frank Act

[52] *Id.* at 101; *see also The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Senate Agricultural Comm.*, 110th Cong. at 3 *(Oct. 14, 2008) available at* http://www.ins.state.ny.us/speeches/pdf/sp0810141.pdf (prepared testimony of Eric Dinallo, Superintendent, New York State Insurance Dept.)(". . . [I]t appears that swaps on that debt could total at least three times as much as the actual debt outstanding."); Dawn Kopecki and Shannon D. Harrington, *Banning 'Naked' Default Swaps May Raise Corporate Funding Costs,* N.Y. TIMES (July 24, 2009), *available at* http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk.
[53] *See* Dinallo, *supra* note 52, at 3-4.
[54] *See* Ryan Grim, *Dick Durbin: Banks "Frankly Own The Place"*, HUFFINGTON POST, April 29, 2009, *available at* http://www.huffingtonpost.com/2009/04/29/dick-durbin-banks-frankly_n_193010.html (referring to rising number of Senate Democrats' opposition to cram down).
[55] DERIVATIVES REGULATION, *supra* note 21 at 975 (referencing 7 U.S.C. § 16(e)(2)).
[56] *See* Dinallo, *supra* note 52, at 4-5.
[57] FCIC Testimony, *supra* note 18.
[58] Press Release, *New York State Insurance Dept., Recognizing Progress by Federal Government in Developing Oversight Framework for Credit Default Swaps, New York Will Stay Plan to Regulate Some Credit Default Swaps* (Nov. 20, 2008) ("Dinallo announced that New York had determined that some credit default swaps were subject to regulation under state insurance law and that the New York State Insurance Department would begin to regulate them on January 1, 2009.") [hereinafter Dinallo Press Release].
[59] *See* NATIONAL CONFERENCE OF INSURANCE LEGISLATORS, CREDIT DEFAULT INSURANCE MODEL LEGISLATION (Nov. 22, 2009), *available at* http://www.ncoil.org/HomePage/2010/03212010CDIModel.pdf.
[60] Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 722(b).
[61] Brady Dennis, *Obama Signs Financial Overhaul Into Law*, WASH. POST, July 22, 2010, at A13.

transforms the regulation of OTC derivatives by generally requiring that swaps be subject to clearing and exchange-like trading, including capital and margin requirements.[62]

The Act first requires that all "swap dealers" and "major swap participants" register with the appropriate banking regulators, the CFTC, and/or the SEC.[63] A swap dealer is an entity that (1) holds itself out as such, (2) makes a market in swaps, (3) regularly enters into swaps for its own account in the ordinary course of business, or (4) engages in activity generally recognized in the trade as dealing in swaps.[64] Major swap participants are entities that are not swap dealers and (1) maintain a substantial position in swaps, excluding transactions used to hedge commercial risk, (2) create substantial counterparty exposure that could undermine the banking system or financial markets, or (3) are highly leveraged, not subject to capital requirements, and maintain a substantial position in swaps.[65]

Registered swap dealers and major swap participants must disclose any material risks of swaps and any material incentives or conflicts of interests.[66] In addition, they must meet capital and margin requirements and conform to business conduct rules, including those related to fraud and market manipulation, that are set by the regulators (while clearing organizations and exchanges can supplement these requirements).[67] They must also conform to position limits on their trading volume in commodity swaps, which are to be set by the regulators.[68] The Dodd-Frank Act also requires that swaps transactions be reported.[69]

The Dodd-Frank Act imposes the clearing and exchange-like trading requirements on most swap transactions.[70] Both types of regulation are central features of the CEA's regulation of futures.[71] Under a clearing system, a clearing facility stands between the buyer and seller of a contract to guarantee each against failure of the other party.[72] To avoid their own liability, clearing facilities have a strong incentive to establish and enforce the capital adequacy of traders, including the collection of margin, *i.e.*, deposits on the amount at risk in a trade.[73] Under the Dodd-Frank Act, the regulatory agencies decide whether specific types of swaps must be cleared, and designated clearing organizations ("DCOs") must inform regulators about which types of swaps they plan to clear.[74] DCOs must allow "non-discriminatory" access to clearing.[75] Swaps

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[62] BAIRD WEBEL ET AL., CONG. RESEARCH SERV., R40975, FINANCIAL REGULATORY REFORM AND THE 111TH CONGRESS 12 (2010) *available at* http://assets.opencrs.com/rpts/R40975_20100601.pdf ("H.R. 4173 . . . mandate[s] reporting, centralized clearing, and exchange-trading of OTC derivatives . . . The bill[] require[s] regulators to impose capital requirements on swap dealers and 'major swap participants.'").
[63] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731(a) (2010).
[64] *Id.* § 721(a).
[65] *Id.*
[66] *Id.* §§ 731(h)(3)(B), 764(g)(3)(B)(i)–(ii).
[67] *Id.* §§ 731(e), 764(e)–(h).
[68] *Id.* §§ 737, 763(h).
[69] *Id.* § 727(c).
[70] *See* Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65882 (Oct. 26, 2010) (explaining some of the regulations that the Dodd-Frank Act imposes on swap transactions).
[71] FCIC Testimony, *supra* note 18, at 99.
[72] *Id.*
[73] *Id.*
[74] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 723(h)(2)(A), 763(a)(1) (2010).

that are required to be cleared must also be traded on a designated contract market, securities exchange or swap execution facility ("SEF").[76] Swaps do not have to be cleared or exchange traded if no existing entity lists a particular swap product.[77]

The Dodd-Frank Act contains an "end-user" exception to clearing designed to ease the burden on businesses using swaps to mitigate risk associated with their commercial activities.[78] For example, airlines buying fuel may use uncleared swaps to hedge against price increases. The exception applies to parties that are not financial entities, are using swaps to hedge or mitigate commercial risk, and have notified the CFTC and/or SEC as to how they meet financial obligations of non-cleared swaps.[79] It does not cover swaps in which both parties are major swap participants, swap dealers, or other financial entities.[80]

Despite the end-user exception, the Dodd-Frank Act imposes its reporting requirements for all swaps, whether or not they are cleared.[81] The swaps must be reported to a registered swap data repository, the CFTC or the SEC, and reporting must occur as soon as technologically possible after execution.[82] The Act's sponsors and the regulators have now stated that margin requirements are not intended to apply to end-users.[83]

An important provision in the Dodd-Frank Act is the Lincoln or "Push-Out" Rule, which prohibits federal assistance to any bank operating as a swap dealer in most commodity-type derivatives transactions.[84] Federal assistance is defined broadly to include, *inter alia*, federal deposit insurance or access to the Federal Reserve's discount window.[85] Although the Push-Out Rule does not take effect for two years, its logical consequence may be to encourage banks to "push out" or divest their commodity-based swap divisions, so that they can maintain access to federal banking resources.[86]

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[75] *Id.* § 763(a)(2)(B).
[76] *Id.* §§ 723(e), 763(a)(2)(B).
[77] *Id.* § 763.
[78] *See* Letter from Christopher Dodd, Chairman, Senate Committee on Banking, Housing, and Urban Affairs & Blanche Lincoln, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, to Barney Frank, Chairman, Financial Services Committee & Colin Peterson, Chairman, Committee on Agriculture, (June 30, 2010), *available at* http://www.wilmerhale.com/files/upload/June%2030%202010%20Dodd_Lincoln_Letter.pdf (explaining that the end-user exception is "for those entities that are using the swaps market to hedge or mitigate commercial risk.").
[79] Dodd -Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 723(h)(7), 763(g) (2010).
[80] *Id.*
[81] *Id.* §§ 727, 731, 764.
[82] *Id.* §§ 727, 729, 763, 764.
[83] *Id.* §§ 731, 764; *See* Clearly Gottlieb, *Dodd-Frank Wall Street Reform and Consumer Protection Act Poised to Usher in Sweeping Reform of U.S. Financial Services Regulation*, July 9, 2010, at 25, *available at* http://www.cgsh.com/files/News/8a4361fa-131b-46b9-a3ad-779430dac8a6/Presentation/NewsAttachment/153327b9-3da0-4d63-b2cb-32c8022d8159/Cleary%20Gottlieb%20Dodd-Frank%20Alert%20Memo.pdf ("Recent correspondence between Senators Dodd and Lincoln states that the margin requirements are not intended to be interpreted to require end user counterparties to post margin to a swap dealer or major swap participant.... [R]egulators and commentators will need to consider what weight, if any, to give to this legislative history.").
[84] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716 (2010).
[85] *Id.*
[86] *Id.*

Similarly, the Volcker Rule generally prohibits banks from engaging in proprietary trading (that is, trading that is on its own behalf and not a customer's) or acquiring or retaining an interest in a hedge fund or private equity fund.[87] While the Volcker Rule will not be implemented immediately,[88] the consequence almost certainly is that many of these activities will also move from banks to other smaller and less systemically risky entities.[89]

Dodd-Frank also creates a resolution authority, which allows complicated questions of the orderly unwinding of a too-big-to-fail institution to be handled administratively rather than in a bankruptcy proceeding.[90] However, as one noted economist has recently made clear, the unwinding of the obligations of OTC counterparties may, in the absence of effective implementation of the Dodd-Frank OTC derivative reforms, be far too complex regardless of whether it is conducted by banking regulators or by a court.[91] Robert Johnson has concluded:

> [W]hen a [too big to fail institution] is in trouble — and there are substantial holdings of complex and opaque derivatives on the balance sheets of all [such] firms — resolution authorities have difficulty unraveling web of exposures and valuing them properly. . . .Unfortunately, it is easy to understand why resolution authorities could be induced to forebear rather than resolve [an too big to fail institution] when they have no clarity about its structure and patterns of exposures. In such a circumstance, it may be easier to incur the risk that the insolvent [firm's] balance sheet should continue to deteriorate. . . .[92]

How Will We Know If the Dodd-Frank Act Is Working?

Dodd-Frank has been hailed as an important and comprehensive financial reform.[93] But like many reforms before it, proof of its success lies not within the text of the law, but in how it is administratively implemented. Those questions of implementation are now hotly contested in SEC and CFTC rulemakings. In thinking about how those rulemakings will be carried out, it is worth asking, for example, what will that previously destabilizing market look like in five years? How will we know if the Act has successfully changed the landscape of the U.S. financial system? How will we know if taxpayers and consumers are better protected against another economic meltdown? If effectively implemented, OTC markets should ultimately have:

1. Ninety per cent of standardized OTC derivatives being cleared and exchange traded, with just 10% exempt based on the end-user exclusion.

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[87] *Id.* § 619.

[88] The Financial Stability Oversight Council will first conduct a six-month study, after which regulators will have nine months to write regulations; the provisions will take effect the earlier of 12 months after the agencies issue regulations or two years after enactment of Dodd-Frank, but banks will have a two-year transition period that can be extended up to three years. *Id.*

[89] Greenberger, *supra* note 30, at 38.

[90] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 201–217 (2010).

[91] *See* Johnson, *supra* note 34, at 123.

[92] *Id.*

[93] *See, e.g.*, Dennis, *supra* note 61 ("President Obama launched a new era in the relationship between Washington and the financial world when he placed his signature Wednesday on a massive bill to rewrite the nation's financial rules.").

The basic rule of the Dodd-Frank Act is that swaps must be cleared and exchange traded. One of the few exceptions is for commercial end users.[94] As CFTC Chairman Gary Gensler has said, the "exception should be . . . defined to include only nonfinancial entities that use swaps as an *incidental part of their business* to hedge actual commercial risks. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system."[95]

To achieve this end, regulators must carefully consider how they define hedging for commercial risk. A model for doing so may come from proposed CFTC position limit regulations promulgated in January 2010, which would have imposed potential speculative position limits on futures contracts for certain energy commodities.[96] Suggesting an exemption for bona fide hedging, the CFTC relied on a definition from regulation 1.3(z), under which bona fide hedging includes "transactions or positions [that] normally represent a substitute for transactions to be made or positions to be taken at a later time *in a physical marketing channel*, and where they are economically appropriate to the reduction of risks in the conduct and management of a *commercial enterprise*."[97] Further, the CFTC emphasized that "[u]nder the proposed regulations, traders holding positions pursuant to a *bona fide* hedge exemption would generally be prohibited from also trading speculatively. This definition limits the end-user exemption to those whose intent is, ultimately, to purchase or sell a physical commodity, rather than a bank."[98] Such an approach would be sufficiently narrow to limit financial entities from circumventing the central Dodd-Frank regulatory tenets: clearing and exchange-like trading.

2. Swap dealers or major swap participants will have no more than 20% ownership of any derivative clearing organization ("DCO"), board of trade ("BOT"), or swap execution facility ("SEF").

One of the main principals shaping derivatives regulation under the Dodd-Frank Act is to provide free and open access to clearing and exchange trading by financial institutions.[99] Simply put, clearing and exchange trading are designed to reduce risk by providing price transparency, requiring that investors set aside adequate capital in case of default, and producing public

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[94] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723(a)(7) (2010) (providing an exception to the clearing requirement for some non-financial entities); *see also* End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747 (proposed Dec. 23, 2010).

[95] Gary Gensler, Chair of the CFTC, Remarks at Exchequer Club of Washington, (Nov. 18, 2009), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-20.html (emphasis added).

[96] *See* Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (proposed Jan. 26, 2010) (withdrawn 75 Fed. Reg. 50950 (Aug. 18, 2010)). The January 2010 proposal was withdrawn to accommodate a broader position limit proposal reflecting the expanded authority provided by the Dodd-Frank Act, but the substance as it relates to the text above is virtually identical. *See* Position Limits for Derivatives, 76 Fed. Reg. 4752, 4756 (proposed Jan. 26, 2011).

[97] *See id.*, at n. 49 (citing 17 CFR 1.3(z)(1)).

[98] *See* Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144, 4159 (Jan. 26 2010).

[99] *See, e.g.*, S. REP. NO. 111-176, at 32–35 (2010) (noting that draft provisions concerning OTC derivatives were designed to minimize non-cleared, off-exchange trades); CFTC & SEC, PUBLIC ROUNDTABLE ON GOVERNANCE AND CONFLICTS OF INTEREST IN THE CLEARING AND LISTING OF SWAPS 33 (Aug. 20, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission9_082010.pdf (statement of Randy Kroszner, University of Chicago, Booth School of Business) ("And the law is clear: Open access is the fundamental principle.") [hereinafter CFTC/SEC Roundtable].

information on who is involved in trading and to what extent.[100] But if large numbers of trading institutions are excluded from clearing organizations or exchanges, the protections otherwise contributed by these requirements will be undermined.[101]

Already, large swap dealers and banks are working by lobbying and through the proposed rulemaking process to limit access by and competition from smaller entities by creating ways to exert large bank control over DCOs, BOTs, and SEFs.[102] According to the Office of the Comptroller of the Currency, *just five U.S. banks represent 98% of the total amount invested by banks in swaps*.[103] In many cases, clearinghouses and exchanges are dominated by very large financial institutions, including those that are the five dominant swaps dealers.[104] In an apparent attempt to discourage competition, the big banks, in their roles as clearinghouse owners, have imposed unnecessarily high capital requirements or other thresholds, far in excess of that needed for conservative risk management, as minimums for satisfying the clearinghouse membership eligibility, in order to keep smaller but highly credit worthy institutions out of the clearing process.[105]

While several proposals have been advanced, a simple solution to this problem is to curtail the influence and control of large banks over clearing and exchange institutions by capping their ownership at a maximum of 20%. Indeed, the CFTC proposed a rule that included imposing the 20% ownership limitations on October 1, 2010.[106] The 20% ownership restriction is similar to an amendment proposed in 2009 by Representative Stephen Lynch and included in the House version of the Dodd-Frank bill. This amendment would have restricted the beneficial ownership interest to an aggregate of 20% of all swap dealers and major swap participants, as well as those associated with them.[107] Although the Lynch amendment was removed from Dodd-Frank by the Conference Committee before final passage, the Dodd-Frank Act requires the CFTC and SEC to adopt rules eliminating conflicts of interest arising from the control of clearing and exchange institutions where a swap dealer or major swap participant has "a material

[100] S. REP. NO. 111-176, at 29–35 (2010) ("The combination of these new regulatory tools will provide market participants and investors with more confidence during times of crisis, taxpayers with protection against the need to pay for mistakes made by companies, derivatives users with more price transparency and liquidity, and regulators with more information about the risks in the system.").
[101] Greenberger, *supra* note 30, at 39.
[102] *Id.*
[103] COMPTROLLER OF THE CURRENCY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, FIRST QUARTER 2010, at Graph 4, *available at* http://www.occ.treas.gov/ftp/release/2010-71a.pdf [hereinafter OCC Report] (finding swaps transactions that involved banks outside the top five were just $3,186 out of a total of $136,330).
[104] *E.g.*, CFTC/SEC Roundtable, *supra* note 99, at 112 (statement of Michael Greenberger) (stating that one exchange's ownership structure includes nine banks taking 50% of profits).
[105] *See id.* at 25–26, 39 (statements of Jason Kastner, Vice Chairman, Swaps and Derivatives Market Association) (stating that banks have been "really clever about keeping people out of the system" and providing example that one clearinghouse has set high capital requirements and large amounts of previously cleared swaps for institutions to join).
[106] Matthew Leising, *CFTC Proposes Capping Bank Stakes in Clearinghouses*, BLOOMBERG.COM (Oct. 1, 2010), *available at* http://www.bloomberg.com/news/2010-10-01/cftc-proposes-20-bank-ownership-caps-on-swaps-clearinghouses.html; *see* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732, 63733 (October 18, 2010).
[107] *See* H.R. REP. NO. 111-370, pt. 5, at 188 (2009).

debt or material equity investment."[108] In carrying out the duties expressly delegated by the Act, the CFTC and SEC have complete and unfettered discretion to create restrictions on ownership—including aggregate numerical caps.[109] These restrictions would be effective and clear tools for ensuring that large banks would not employ highly anti-competitive policies over clearing and exchange institutions in a manner that would exclude smaller, but fully capitalized, participants.

Some observers have argued that requiring an independent board of governors—that is, one that is not comprised of banks, but outside experts or other members—would effectively avoid the problem of overly concentrated power.[110] However, a recent example shows the futility of relying on that approach alone: In 2009, ICE Trust acquired the Clearing Corp., creating a clearinghouse essentially owned by nine of the largest swap trading banks.[111] Although ICE Trust claims to be managed by an independent board, the acquisition involved a profit-sharing scheme in which these banks not only have an ownership in ICE Trust, but, in addition, will receive collectively in their own names 50% of the profits. The founding banks will be subject to a pricing structure distinct from that applied to other banks.[112] In order to mitigate the potential conflicts of interest in the operation of a DCO, DCM, and SEF, the CFTC and the SEC separately proposed rules to mandate more outside directors to serve on the board of a DCO, DCM and SEF.[113] However, when confronting the kind of massive concentration of

[108] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 726, 765. *See also* CONG. REC. 5217(June 30, 2010) (in a colloquy with Rep. Lynch, House Financial Services Chair Barney Frank agreeing that Sections 726 and 765 of the Dodd-Frank Act require the SEC and CFTC to adopt rules eliminating the conflicts of interest arising from the control of clearing and trading facilities by entities such as swap dealers, security-based swap dealers, and major swap and security-based swap participants).

[109] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 726, 265. *See, e.g.*, Matthew Leising, *CFTC May Limit Banks to 20% Stakes for Clearinghouses*, BLOOMBERG.COM (Sept. 30, 2010), *available at* http://www.bloomberg.com/new/2010-09-29/cftc-said-to-propose-20-bank-ownership-of-swaps-clearinghouses.html ("The Commodity Futures Trading Commission is considering limiting banks and investors to owning no more than 20 percent of swaps clearinghouses, exchanges and trading systems."); *see also* Jonathan Spicer & Roberta Rampton, *CFTC Eyes Ownership Caps for Swaps Infrastructure*, REUTERS (Sept. 29. 2010), *available at* http://www.reuters.com/article/idUSN2911906520100930; *see also* CFTC/SEC Roundtable, *supra* note 99, at 112 (stating that the conflict of interest "provision is extraordinarily broad"); *see also* Comment Letter by Christine A. Varney, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, to David Stawick, Secretary, Commodity Futures Trading Commission, Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest (December 28, 2010), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26809&SearchText= (DOJ Antitrust Division strongly advises the CFTC to adopt a strict aggregate limit on ownership by swap dealers and major swap participants for DCOs, DCMs and SEFs).

[110] *See, e.g.*, *id.* at 120–21 (statement of Lynn Martin, NYSE Life) (stating that board independence is a more effective way to handle conflicts of interest than mandating ownership restrictions, because it ensures broad representation of constituency interests).

[111] INTERCONTINENTALEXCHANGE, ANNUAL REPORT 2 (2009), *available at* https://materials.proxyvote.com/Approved/45865V/20100323/AR_56919/images/IntercontinentalExchange-AR2009.pdf.

[112] *ICE Trust to Begin Processing and Clearing Credit Default Swaps March 9*, THE CLEARING CORP., March 6, 2009, *available at* http://www.clearingcorp.com/press/pressreleases/20090306-ice-process-cds.html.

[113] Rachelle Younglai & Roberta Rampton, *FACTBOX-Differences in SEC, CFTC Clearinghouse Proposals*, REUTERS, Oct. 13, 2010, *available at* http://www.reuters.com/article/idUSN1318594320101013; *see* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest, 75 Fed. Reg. 63732 (Oct. 18, 2010).

market power through the ownership of the strongest swaps dealers as is presently the case with ICE Trust, even the most demanding requirements for the inclusion of independent board directors, in and of themselves, can by no means realistically insure Dodd-Frank's "free and open access" mandate. There must be strict aggregate ownership limits to complement strong independent director requirements.

3. All large financial institutions that deal in or buy swaps would be subject to strict capital requirements and rigorous business conduct rules.

As noted above, swap dealers and major swap participants must conform to capital requirements and business conduct rules set by the regulators. As they define the term "swap dealers," regulators should aim to capture the top 200 or so entities dealing in derivatives.[114] As Chairman Gensler recently stated, "initial estimates are that there could be in excess of 200 entities that will seek to register as swap dealers [under the Dodd-Frank Act]," including "[209] global and regional banks currently known to offer swaps" as "Primary Members" of the International Swaps and Derivatives Association ("ISDA").[115] These entities should be encompassed by the definitions adopted by the CFTC and SEC.

To achieve this number, these agencies should consider how they define several terms. First, the CFTC and SEC should adopt a definition used by ISDA for deciding which institutions should be registered. The ISDA definition includes all business organizations and entities that deal in derivatives except those who do so "solely for the purposes of risk hedging or asset or liability management."[116] In adopting this definition, the regulators should also clarify that it does not exclude entities that claim to use derivatives for risk hedging or asset or liability management, but for whom the transactions could materially affect their financial condition based on the significant revenue generated by the swaps.

Another key issue will be how to determine whether a firm enters into swaps in the course of "regular business," because swap dealers do not include persons who enter into swaps for their own account, as long as they do not do so as part of their regular business.[117] To ensure that regulation will cover the largest dealers, regulators should define regular business based on an institution's annual average trading revenue from all swaps activities, as a percentage of total trading revenue. This percentage provides insight as to the nature of an institution's business, and agencies should use it to compare the relative positions of various institutions as well as the importance of swaps to a particular firm.[118]

Because trading revenue from swaps activities is currently unavailable to the public or regulators,[119] in order to allow regulators to assess this percentage, the regulators should require

[114] Greenberger, *supra* note 30, *at* 40.
[115] Statement of Chairman Gary Gensler, ISDA Regional Conference (Sept. 16, 2010), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-50.html.
[116] *See* Official Website of International Swaps and Derivatives Association, Inc., *"Primary Membership," available at* http://www.isda.org.
[117] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721(a)(21) (2010); *see also* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security- Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80173 (proposed Dec. 21, 2010).
[118] Greenberger, *supra* note 30, at 40.
[119] *Id.*

all entities that have annual trading revenue over one billion dollars to provide the appropriate regulator with audited financial statements reporting gross and net trading revenue from all swap activities. The percentage triggering regulation should be two percent, and the percentage should be adjusted accordingly based on the reported data going forward.

The term "major swap participant" encompasses three broad categories: entities that maintain a substantial position in "major swaps categories," those that pose substantial risk to counterparties, and those that are highly leveraged.[120]

Here, "major swaps categories" should be broken down to reflect relatively specific commodity products, so that entities that are heavily involved in a commodity—and thus can influence prices—do not escape regulation by "hiding" within a larger category. For example, the categories should be defined not just as "energy" or even "crude oil," but should be broken down to a precise commodity product, *i.e.*, "light sweet crude oil." In addition, "substantial position" should be measured by the notional value of an entity's swap positions, as a proportion of the notional value of all swaps positions held by all entities. This illustrates how concentrated risk is, and regulators can use the information to ensure that the firms with the most risk are covered by regulation.

Entities creating substantial counterparty exposure can be determined by looking at two factors: (1) how much is currently at risk in case of default, measured by the market value of contracts, and (2) how much could potentially be at risk in the future over the life of the contract.[121] To assess both, agencies should consider how many counterparties are at risk through swaps transactions with a given entity—a measure of interconnectedness, or the extent to which an institution's failure would have a ripple effect into the overall economy. In addition, agencies should consider the financial stability of counterparties to capture transactions that involve one or very few counterparties but may still create substantial risk.

Highly leveraged entities can be identified based on the entities' current credit risk relative to their capital.[122] Where agencies find that entities have taken on too much risk, they should restrict them from additional swaps activities and/or require an increase in available capital. This will prevent an excessively leveraged firm from triggering significant market dysfunction.[123]

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[120] *See id.*; *see also* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security- Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80173 (proposed Dec. 21, 2010).
[121] *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 9 (April 1999), *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.
[122] *See* OCC Report, *supra* note 103, at 4 ("Net current credit exposure is the primary metric used by the OCC to evaluate credit risk in bank derivatives activities."); *see also* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security- Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80173, 80198 (proposed Dec. 21, 2010).
[123] *See generally* DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009).

4. Proprietary and commodity trading, hedge and equity funds, and uncleared credit default swaps will be generally moved from large banks to smaller structures with fewer potential adverse impacts on the overall financial system.

As noted earlier, the Dodd-Frank Act includes both the "Volcker Rule," which generally prohibits banks from engaging in proprietary trading or ownership of hedge or equity funds, and the "Lincoln" or "Push-Out Rule," which requires bank holding companies to establish separate affiliated corporations for, *inter alia*, most commodity swaps dealings and unregulated CDSs in order to benefit from federal assistance.[124] Although both provisions have long lead times before implementation, they are already having their intended effects.[125]

In anticipation of the Volcker Rule, for example, a private equity division at Bank of America left in the fall of 2010 to form a new hedge fund.[126] Even before the final bill was passed, Citigroup sold a private equity fund, and it is considering moving at least one of its proprietary trading units into a separate hedge fund.[127] At Goldman Sachs, proprietary traders are reportedly leaving to join new or existing hedge funds.[128] Moreover, Bloomberg reported that "Goldman Sachs during 2010 'liquidated substantially all of the positions' in the principal-strategies unit that operated within the firm's equities division."[129] JP Morgan recently announced it will shut down its proprietary trading in commodities as a first step in closing down all proprietary trading.[130] All of these firms, and traders within them, have stated that they are taking action to resolve regulatory uncertainty, so that they are not ". . .worrying about what they're going to be doing a couple of years from now. . . ."[131]

As Kansas City Federal Reserve President Hoening has recently made clear, this movement is healthy[132]—a sign that the Volcker and Lincoln Rules will have a powerful impact. The transactions covered by the Rule will move from banks that are too-big-to-fail to more diverse and less systemically risky parts of the market. As the Senate Committee on Banking suggested, the Volcker Rule ". . . will reduce the scale, complexity, and interconnectedness of

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[124] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 619 and 716 (2010).
[125] Randall Smith et. al., *The New Rules of Finance: Impact to Reach Beyond Wall Street — Key Questions Unresolved for Businesses and Consumers Until Bill Goes Into Effect*, WALL ST. J., July 16, 2010, at A4.
[126] Martin Arnold & Francesco Guerrera, *Buy-out Spin-off Move by B of A*, FIN. TIMES (London), Aug. 4, 2010, at Companies – International 19.
[127] *Id.*; *see also* Dawn Kopecki & Chanyaporn Chanjaroen, *JPMorgan Said to End Proprietary Trading to Meet Volcker Rule*, BLOOMBERG NEWS (Aug. 31, 2010), *available at* http://www.bloomberg.com/news/2010-08-31/jpmorgan-is-said-to-shut-proprietary-trading-to-comply-with-volcker-rule.html.
[128] Christine Harper & Saijel Kishan, *Goldman Sachs Said to Shut Principal Strategies Unit*, BLOOMBERG NEWS (Sep. 4, 2010), http://www.bloomberg.com/news/2010-09-03/goldman-said-to-shut-principal-strategies-unit-to-comply-with-volcker-rule.html.
[129] *See* Christine Harper, *Goldman Sachs Liquidates 2 Proprietary Trading Units to Comply with Rules*, BLOOMBERG.COM (March 1, 2011), *available at* http://www.bloomberg.com/news/2011-03-01/goldman-sachs-liquidates-2-proprietary-trading-units-to-comply-with-rules.html.
[130] Kopecki & Chanjaroen, *supra* note 127.
[131] Harper & Kishan, *supra* note 128.
[132] *See* Thomas M. Hoening, President, Federal Reserve Bank of Kansas City, *Remarks at Women in Housing and Finance on Financial Reform: Post Crisis?* (Feb. 23, 2011), *available at* http://www.kansascityfed.org/publicat/speeches/hoenig-DC-Women-Housing-Finance-2-23-11.pdf (stating that "We must break up the largest banks, and could do so by expanding the Volcker Rule and significantly narrowing the scope of institutions that are now more powerful and more of a threat to our capitalist system than prior to the crisis.").

those banks that are now actively engaged in proprietary trading, or have hedge fund or private equity exposure. [It] will reduce the possibility that banks will be too big or too complex to resolve in an orderly manner should they fail."[133] In addition, investment banks will not be able to create risky financial products and sell them to investors, while holding on to the other side of the bets to make profits at customers' expense.[134]

The Lincoln or Push-Out Rule is also already driving risky trades into more diverse structures.[135] JP Morgan, for example, is spinning off its high-risk commodity derivatives into a unit that will be separate from its other investments.[136] This movement is healthy, because speculation in commodity swaps has almost certainly contributed significantly to price volatility in commodities and commodity index funds, an effect that has increased with the influx of more speculation, including "the rapid growth of index investment" in commodity futures markets.[137] To the extent that smaller and more diverse entities engage in such speculation, they will have a lessened impact on commodity index fund prices, simply because they have less influence in these markets.[138] Moreover, where commodity index funds for passive investors do have swaps subject to Dodd-Frank, they will be subject to clearing and exchange-like trading.[139]

5. Energy and food prices will be explained by market fundamentals rather than factors that may be attributable to excessive speculation.

The Dodd-Frank Act *requires* the CFTC to set aggregate position limits on the amount of swaps trading that entities can conduct[140] with the goal of limiting excessive speculation and subsequent volatility in commodities.[141] Too much speculation can unmoor prices from market fundamentals such as supply and demand.[142] In essence, prices are usually determined by a healthy tension between commercial users, who want low prices, and producers, who want high ones. Speculators, however, are unconcerned about what a fair price for a commodity might be, but rather they want prices to move dramatically in the direction of their bets.[143] Since the passage of the Commodity Exchange Act in 1936, as reinforced by Dodd-Frank, position limits,

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[133] S. REP. NO. 111-176, at 7 (2010).
[134] Abigail Field, *Inside the SEC's Legal Claim Against Goldman Sachs*, DAILY FINANCE (Apr. 16, 2010), *available at* http://www.dailyfinance.com/story/investing/inside-the-secs-legal-case-against-goldman-sachs/19443106/.
[135] Francesco Guerrera, *Dimon Attacks Post-Crisis Regulation*, FIN. TIMES (London), Sept. 15, 2010, at Companies – International 17.
[136] *Id.*
[137] Ke Tang & Wei Xiong, *Index Investing and the Financialization of Commodities* 2 (NBER Summer Institute Workshop on Capital Markets and the Economy, Working Paper, 2009), *available at* http://www.princeton.edu/~wxiong/papers/commodity.pdf; *see also* AHMAD R. JALALI-NAINI, PETROLEUM STUDIES DEP'T, OPEC SECRETARIAT, THE IMPACT OF FINANCIAL MARKETS ON THE PRICE OF OIL AND VOLATILITY: DEVELOPMENTS SINCE 2007, 9 (2009).
[138] Tang & Xiong, *supra* note 137, at 6.
[139] *Id.*
[140] Position Limits for Derivatives, 76 Fed. Reg. 4752 (Jan. 26, 2011).
[141] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 737 and 763(h) (2010).
[142] Gerald P. O'Driscoll Jr., *The Fed Can't Solve Our Economic Woes*, WALL ST. J., Aug. 16, 2010, at A15.
[143] *See Staff of Senate Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs*, EXCESSIVE SPECULATION IN THE WHEAT MARKET 152–57 (2009); *Staff of Senate Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs*, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET 29 (2007); Tang & Xiong, supra note 137, at 2.

when properly enforced, minimize the role of speculation by limiting both its volume and impact, allowing market fundamentals to be the primary driver of prices.[144]

The impact of weak position limits and excessive speculation on oil pricing was evident between 2007 and 2009, when prices rose from $65 per barrel in June 2007, to $145 in July 2008, to the $30s in winter 2008-09, shifting to the $60s and $70s in 2009 and now back up to $100.[145]

There can be little doubt that the American consumer's pocketbooks will take a serious beating because of destabilizing price spikes in traditional physical commodities, such as oil, gasoline, heating oil and basic food staples.[146] As one prime example, we have seen a spike in crude oil prices during the last six months: with no underlying change in supply and demand, the price of crude oscillated from $73 per barrel in September 2010 to $99 in February 2011, an increase of over 35 percent.[147] According to International Energy Agency's Oil Market Report, during the third and fourth quarters of 2011, the world oil demand increased by 0.2 mb/d.[148] Notably, the world oil supply increased by 0.7 mb/d.[149]

Furthermore, while it is true much has been said about political destabilization within oil producing countries having caused market "fears" of oil shortages, the recent surge in the oil price still seems to defy market fundamentals because Saudi Arabia, the largest world oil supplier, has offered to "make up for supplies lost because of unrest in Lybia."[150] The International Energy Agency said "it will release emergency stockpiles, if needed."[151] Most economists and market watchers acknowledge that there is not now a supply/demand problem, and that the present oil price volatility caused by "adverse" expectations should be short term as supply stability becomes clear. However, they acknowledge that permanent crude oil price spikes cannot be fully explained by either market realities or fears, but by excessive speculation. The

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[144] Greenberger, *supra* note 30, at 41.

[145] Ianthe Jeanne Dugan & Alistair MacDonald, *Traders Blamed for Oil Spike — CFTC Will Pin '08 Price Surge on Speculators, in a Reversal From Bush Findings*, WALL ST. J., July 28, 2009, at A1.

[146] *See* Sylvia Pfeifer, *Oil Price 'Threat to Recovery,'* FIN. TIMES, Jan. 4, 2011 (quoting Fatih Birol, Chief Economist, International Energy Agency, "Oil prices are entering a dangerous zone for the global economy. . . . The oil import bills are becoming a threat to the economic recovery. This is a wake-up call to the oil consuming countries and to the oil producers."), *available at* http://www.ft.com/cms/s/0/056db69c-1836-11e0-88c9-00144feab49a.html#axzz1AjjrGQio; *see also* Alejandro Barbajosa, *Oil Price Volatility to Increase in 2011 - HSH Nordbank*, REUTERS, Jan. 6, 2011 (quoting Sintje Diek, Oil Analyst, German Bank, "The economic development is not so bad this time and the recovery will continue, but it will not be so dynamic. At the moment, oil prices are too high for this kind of economic environment."), *available at* http://uk.reuters.com/article/idUKTRE70521U20110106; *See also* U.S. ENERGY INFORMATION ADMINISTRATION, CUSHING, OK WTI SPOT PRICE FOB (DOLLARS PER BARREL), *available at* http://www.eia.doe.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RWTC&f=D.

[147] *See* U.S. ENERGY INFORMATION ADMINISTRATION, INDEPENDENT STATISTICS & ANALYSIS ON PETROLEUM & OTHER LIQUIDS (Feb. 24, 2011), *available at* http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=WTOTWORLD&f=W.

[148] *See* International Energy Agency, Oil Market Report (Feb. 10, 2011), *available at* http://omrpublic.iea.org/World/Wb_all.pdf.

[149] *Id.*

[150] Ben Sharples, *Oil Trades Near One-Week Low After Saudi Arabia Offers to Cover Supplies*, BLOOMBERG (Feb. 28, 2011), *available at* http://www.bloomberg.com/news/2011-02-28/oil-trades-near-one-week-low-after-saudi-arabia-offers-to-make-up-supplies.html.

[151] *Id.*

Dodd-Frank position limit mandate is designed to combat the adverse impact of too much or "excessive" speculation.

In addition to the recent oil price spike, the 2007-2008 worldwide food crisis is resurgent. Recently, the United Nation's Food and Agriculture Organization's economist Abdolreza Abbassian has stated: "In terms of price levels internationally I think the situation is certainly getting closer to the levels that we had seen [in 2007-2008]."[152] He further added that increasing food price volatility was, as a general matter, *alarming* and could *threaten future food security*.[153] Furthermore, the U.S. food staples prices are rising faster than overall inflation. According to the U.S. Bureau of Labor Statistics, "the consumer price index for all items minus food and energy rose 0.8% over the year to September [2010], the lowest 12-month increase since March 1961. [...] The food index rose 1.4%, however."[154] Spikes in food prices have dramatically increased since September. The rise in commodity prices almost certainly cannot be *entirely* explained by supply and demand. In fact, one market participant recently stated: "We are on the verge of another commodity bull run [...] Wealthy clients are looking to buy commodity futures, physical commodities, exchange-traded funds and equities with commodity exposure."[155] Notably, he also stated: "Some investors, however, are troubled about the prospect of contributing to another food price spike as seen in 2007/08 or about the sustainability of using food stocks as biofuels, raising questions about the ethics of agriculture investing."[156]

As noted in footnote 11 above, the Commodity Markets Oversight Coalition has just released a listing of dozens of analyses demonstrating that excessive speculation by passive investors betting on price direction in commodity staples through derivatives causes unnecessary volatility in commodity prices. On July 24, 2009, the Senate Permanent Subcommittee on Investigations released a bipartisan 247-page staff report demonstrating conclusively that the commodity bubble in red wheat from 2004 to 2008 can be attributed to excessive derivatives speculation, as is true of the entire commodity bubble experienced during that period.[157] On January 13, 2011, the CFTC released by a 4-1 vote a proposed position limits rule that many consumer advocates will likely find to be a far too weak implementation of the position limit requirements of section 737 of the Dodd-Frank Act. Two of the four Commissioners voting for the proposed rule indicated that they would likely oppose that rule if it is returned in similar form as a final rule by the CFTC staff. Comments are due on that proposed rule by March 28, 2011. Hopefully, the CFTC will be persuaded by those commenters calling for greater controls of passive speculators. However, many now fear that even a weak rule implementing Dodd-Frank

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[152] Svetlana Kovalyova, *Food prices near '08 levels, supply stronger*, REUTERS NEWS (Nov. 2, 2010), *available at* http://www.futurespros.com/news/futures-news/interview-update-1-food-prices-near-'08-levels,-supply-stronger-1000003906.
[153] *Id.* (emphasis added).
[154] *See* Julie Jargon and Ilan Brat, *Food Sellers Grit Teeth, Raise Prices Packagers and Supermarkets Pressured to Pass Along Rising Costs, Even as Consumers Pinch Pennies*, WALL ST. J. (Nov. 4, 2010), *available at* http://online.wsj.com/article/SB10001424052748704506404575592313664715360.html.
[155] Laura MacInnis, *Investors primed for higher farm commodity prices*, REUTERS (Nov. 17, 2010), *available at* http://www.reuters.com/article/idUSLDE6AG0U320101117.
[156] *Id.*
[157] *See* PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, EXCESSIVE SPECULATION IN THE WHEAT MARKET (JUNE 24, 2009).

position limit requirements will not see the light of day, because it will not get the support of three CFTC commissioners.

If the price spike in commodity staples continues to increase, many respected economists believe it will break the back of the financial recovery and likely send the economy into a "double dip" recession. The merits of this debate cannot be resolved in this hearing, but this Committee should certainly devote substantial oversight to the causative factors of the present inflationary prices in food and energy and towards ensuring that Dodd-Frank's position limit requirements are properly implemented at the regulatory level.

6. *Even swaps that do not clear or exchange trade will be subject to real-time reporting requirements.*

As noted above, the Dodd-Frank Act affords the CFTC and SEC the authority to require that uncleared swaps adhere to "real-time reporting." In particular, those swaps that are not accepted for clearing must be reported to a registered swap data repository or, if no swap data repository will accept the report, to regulators in a manner that does not disclose the business transactions and market positions of any person.[158] The Act defines "real-time reporting" as public dissemination of data relating to a transaction, including price and volume, as soon as technologically practicable after the time at which the swap transaction has been executed.[159]

Also, the Act authorizes the CFTC and SEC to make swap transaction and pricing data available to the public in such forms and at such times as are deemed appropriate to enhance price discovery.[160] In light of this, Chairman Gensler has recently stated:

> [The CFTC] anticipate[s] rules in [the data reporting] area to require swap data repositories to perform their core function of collecting and maintaining swaps data and making it directly and electronically available to regulators. . . . It will be important that swaps data be collected not only when the transaction occurs, but also for each lifecycle event and valuation over its duration.[161]

Under these reporting requirements, regulators will receive all relevant and necessary data in a timely manner.[162] As such, the reporting requirements are significant because they are one of the only ways that regulators and other observers can assess whether derivatives pose a significant risk to the market through their size or the interconnectedness of counterparties.[163] Indeed, the lack of reporting and transparency was a main cause of the Federal Reserve's, the Treasury's, and all other prudential and market regulators' inability to anticipate the effect of undercapitalized swaps on the worldwide economy in late 2007, 2008 and early 2009.[164] Had the mounting synthetic CDO bets been apparent to federal regulators, they doubtless would have intervened with corrective actions much sooner.

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[158] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§727, 729, 763, 764 (2010).
[159] *See id.* §727.
[160] *Id.*
[161] Gensler, *supra* note 32; *see also* Swap Data Repositories, 75 Fed. Reg. 80898 (proposed Dec. 23, 2010).
[162] Greenberger, *supra* note 30, at 42.
[163] *Id.*
[164] *Id.*, at 14–15.

The issue of whether there will be *meaningful* "real time reporting" as Dodd-Frank contemplates or reporting of information that is too far out of date is now being hotly debated before the regulatory agencies in the proposed rulemakings. The regulatory result here bears careful watching by this Committee.

Senate Committee on Agriculture, Nutrition & Forestry

Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act

Statement of Jill Harlan, Corporate Risk Manager, Caterpillar, Inc.

March 3, 2011

Good afternoon, Madame Chairwoman and members of the Committee. Thank you very much for the opportunity to be with you today. My name is Jill Harlan and I am the Corporate Risk Manager for Caterpillar Inc. I am also testifying on behalf of the Coalition for Derivatives End-Users ("Coalition"), of which Caterpillar is a member. The Coalition represents thousands of companies across the country that use derivatives to manage their day-to-day business risks.

For more than 85 years, Caterpillar Inc. has been a leader in making sustainable progress possible. With 2010 sales and revenue of $42.6 billion, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives. The company also is a leading services provider through Caterpillar Financial Services, Caterpillar Remanufacturing Services, Caterpillar Logistics Services and Progress Rail Services. We are headquartered in Peoria, Illinois and have manufacturing facilities, distribution facilities and offices across the United States. We directly employ 47,000 people in the United States, and our dealer network employs an additional 34,000. We successfully compete globally from a significant U.S. production base, with approximately 70% of our sales outside the United States in 2010.

We support this Committee's efforts to ensure that derivatives markets operate efficiently and are well-regulated. However, the prudent use of derivatives by Caterpillar and other end-user companies does not generate instability in the financial markets; regulation, therefore, should be focused on those entities and transactions that played a role in the financial crisis.

Understanding and managing risk is key to successfully operating our business and thousands of others in virtually every sector of the U.S. economy. The best-run companies identify risks associated with external and internal factors and seek to mitigate both. At Caterpillar, for example, we can control internal risk factors linked to the way our factories are designed, and the velocity with which we transform input materials into assembled product. We can't, however, control many external factors like the global price of copper, fluctuation in the value of the Japanese yen, or the movement of interest rates in key economies. We mitigate these risks by hedging our net exposures with derivative contracts after taking advantage of any offsetting positions.

As an example, we sell a large quantity of mining truck replacement parts manufactured in Decatur, Illinois, to our dealers in Australia. We pay the costs associated with the production of Decatur parts in U.S. dollars. When we sell those parts, we receive revenues in Australian dollars. The relative value of the Australian dollar versus the U.S. dollar can significantly impact the economic viability of these types of transactions. To manage the risk, we may enter into a forward contract with a bank counterparty to sell a certain amount of Australian dollars, equal to our net exposure, on a certain date to lock in the current market forward rate. We enter into similar hedging transactions to limit our risk exposure to the cost of key input commodities, like copper, as well as to interest rates.

The market for these types of transactions operates extremely efficiently. Through the use of electronic screens, for example, we have the ability to evaluate pricing from multiple potential counterparties before finalizing our trade. The result is efficient and competitive pricing, as well as the ability to further develop relationships with banks.

It is important to understand that Caterpillar does not use derivatives contracts for speculative purposes. Doing so would bring an element of risk to our business that is unacceptable to our Board of Directors and our stockholders. Caterpillar's derivatives policies are specifically written to ensure we only focus on the management of risks associated with our business operations. In fact, our finance subsidiary is subject to legal prohibitions against using derivatives for speculative purposes. Plainly said, Caterpillar does not use derivatives to speculate.

Caterpillar and our Coalition partners have many concerns about the impact of potential rulemaking on our end-user derivative activities. I'll focus today on four primary areas: (1) the potential impact of margin requirements; (2) uncertainty concerning application on foreign-exchange forwards; (3) the need for clarity concerning the impact of regulations on captive finance affiliates; and, finally, (4) the compressed timeframe for rulemaking.

We appreciate greatly that, in passing the Dodd-Frank Act, Congress recognized the fundamental differences between end-users and other participants in the over-the-counter derivatives market. Accordingly, you established an exemption from mandatory clearing requirements for derivatives end-users in the Dodd-Frank Act; however, in the course of the lengthy debate over financial regulatory reform, the statutory language regarding margin requirements ended up being less than clear. While we think that we have a strong legal argument that regulators do not have the authority to either directly impose margin requirements upon end-users or to require end-user counterparties to collect margin from us, we are very concerned that certain regulatory agencies do not appear to agree. We appreciate the fact that CFTC Chairman Gary Gensler has indicated that the CFTC will not impose margin requirements on non-financial end-users; however, it is important to note that because most end-users enter into hedging derivatives trades with *bank* swap dealers, it is the prudential regulators—and not the CFTC—that will set margin rules for most end-user trades. Moreover, the Federal Reserve recently testified that it believes it is *required* to impose some margin requirement on *all* non-cleared trades, *without exception*. Such a position appears contrary to congressional intent and would harm our ability, and the ability of end-user companies generally, to manage our risks.

According to a 2011 Coalition survey, a 3 percent initial margin requirement, assuming no exemptions, would require average collateral of $192 million per respondent. Extending the survey results to all S&P 500 companies, this margin requirement could reduce overall capital spending by as much as $5-7 billion per year, which, according to the survey report, could lead to a loss of 100,000 to 120,000 jobs nationwide. At Caterpillar, we have much more productive potential uses for that capital—such as investing in our production facilities to meet rapidly growing demand for our product. Also, anything that adds to our U.S. cost structure hampers our ability to compete in critical, fast-growing foreign markets. We ask regulators to work together to ensure that margin requirements do not hamper the ability of end-user companies to manage risk through the prudent use of derivatives, and increase our costs to the detriment of investments in core business functions and job creation.

Another area of uncertainty and concern is how and whether the derivative rules will apply to foreign exchange forward contracts. Under the Dodd-Frank Act, the Treasury Secretary is given authority to exempt foreign exchange swaps and forwards from the regulations that will be applied to other derivative contracts. Even if FX swaps and forwards are exempted from the clearing and exchange trading requirements imposed on derivative contracts by the Dodd-Frank Act, all FX swaps and forwards must be reported either to a swap data repository, or if no such repository will accept them, to the CFTC.

We feel that foreign exchange swaps and forwards are very different from other derivative contracts and should be exempted. The FX market is already subject to appropriate oversight by central banks around the world, and it functioned remarkably well during the credit crisis. This market has developed robust risk mitigation practices over the last two decades—including settlement systems and increased bilateral collateralization of exposures—that have successfully mitigated the potential for the market to create systemic risk. We're also concerned that FX swap and forward contract regulation contemplated by Dodd-Frank, if applied to end users, could actually increase systemic risk by introducing significant liquidity risks into the system where none existed, deterring prudent FX hedging and risk management by corporations.

Congress recognized the value that industrial captive finance affiliates bring to the overall economy. During the crisis, organizations like Caterpillar Financial Services brought an additional source of liquidity to small and medium-sized businesses. Accordingly, Title VII of the Dodd-Frank Act includes exemptions from the mandatory clearing requirement and the Major Swap Participant definition for

> ...entities whose primary business is providing financing and use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured

> by the parent company or another subsidiary of the parent company.

As you can tell from that direct quote from the statutory language, this is an area in need of greater regulatory clarity. We hope and expect that given the recognized value of Cat Financial and other similar captives, this language, and specifically the "facilitates the purchase or lease of products" provision, will be read broadly.

For example, in order to facilitate the sale of the parent's manufactured goods, captive finance affiliates often finance the sale or lease of products that are intimately connected to the underlying product. Examples include the financing of an implement or accessory to a tractor, the purchase of a used tractor to facilitate the sale of a new one, or the financing of a marine vessel to facilitate the sale of the vessel's engines. In each of these examples, the financing offered by the captive finance unit is essential to facilitating the sale of their parent or affiliate's manufactured goods.

The Coalition also urges that, where no distinction is drawn between non-financial and financial end-users in the Dodd-Frank Act, regulators should not draw one themselves. Both financial and non-financial end-users, for example, should not be subject to margin requirements, provided that they are using swaps to hedge commercial risk, and not for speculative purposes.

A lot is at stake in the regulatory rulemaking process. The current statutory effective date requires regulators to promulgate literally hundreds of rules in a short period of time, creating the risk that speed will take priority over quality. Poorly considered regulation would increase uncertainty and negatively impact companies' ability to manage risks. We would like Congress to provide regulators and affected parties with more time for rulemaking and for regulators to allow market participants sufficient time for implementation. We would note also that implementation flexibility, while desirable, can not overcome a rulemaking process that is hurried, does not allow for sufficient input from affected parties, and could produce ill-conceived regulations as a result.

The end-user market for over-the-counter derivatives functioned well before, during and after the crisis. The responsible and effective use of these products by Caterpillar and other end-users helped reduce risk at both the individual company and at the systemic level. We hope that active oversight from this Committee will help avoid a situation where implementation of rules increases costs for main street businesses and drives behavior that inhibits economic growth.

On behalf of Caterpillar and the Coalition, I'd like to thank you very much for your time this afternoon and the opportunity to share our thoughts on these important issues. I'm happy to answer any questions that you may have.

Testimony on Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act by the U.S. Securities and Exchange Commission

by

Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

Before the United States Senate Committee on Agriculture, Nutrition and Forestry
March 3, 2011

Chairman Stabenow, Ranking Member Roberts, and members of the Committee:

Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission regarding its implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"), which primarily relates to the regulation of over-the-counter ("OTC") derivatives. Title VII of the Act requires the SEC, among other regulators, to conduct a substantial number of rulemakings and studies. Although this task is challenging, particularly when viewed in the context of the SEC's other Dodd-Frank Act rulemaking responsibilities, we are committed to fulfilling the objectives of the Act in a responsible and diligent manner, while seeking the broad public input and consultation needed to get these important rules right. My testimony today will briefly describe our progress and plans for implementing Title VII of the Dodd-Frank Act.

Background

OTC Derivative Marketplace

As has been frequently noted, the growth of the OTC derivatives marketplace has been dramatic over the past three decades. From its beginnings in the early 1980s, when the first swap agreements were negotiated, the notional value of these markets has grown to almost $600 trillion globally.[1] However, OTC derivatives were largely excluded from the financial regulatory framework by the Commodity Futures Modernization Act of 2000. As a securities and capital markets regulator, the SEC has been particularly concerned about OTC derivatives products that are related to, or based on, securities or securities issuers, and as such are connected with the markets the SEC is charged with overseeing.

Dodd-Frank Act

The Dodd-Frank Act mandates oversight of the OTC derivatives marketplace. Title VII of the Act requires that the SEC write rules that address, among other things, mandatory clearing, the operation of security-based swap execution facilities and data repositories, capital and margin requirements and business conduct standards for security-based swap dealers and major security-based swap participants, and regulatory access to and public transparency for information regarding security-based swap transactions. This series of rulemakings should improve transparency and facilitate the centralized clearing of security-based swaps, helping, among other things, to reduce counterparty risk. It should also enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. In addition, these rulemakings should establish a regulatory framework that allows OTC derivatives markets to continue to develop in a more transparent, efficient, accessible, and competitive manner.

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1 *See* Bank of International Settlements, Positions in Global Over-the-Counter (OTC) Derivatives Markets at End-June 2010, Monetary and Economic Department (Nov. 2010), http://www.bis.org/publ/otc_hy1011.pdf.

Implementation Generally

The implementation of Title VII is a substantial undertaking and raises a number of challenges. Accordingly, we have been engaging in an open and transparent implementation process, seeking input on the various rulemakings from interested parties even before issuing formal rule proposals. We will continue to seek input on each proposal with the goal of producing effective and workable regulation of derivatives activities.

Public Consultation

We have enhanced our public consultative process by expanding the opportunity for public comment beyond what is required by law. For instance, we have made available to the public a series of e-mail boxes to which interested parties can send preliminary comments before rules are proposed and the official comment periods begin. These e-mail boxes are on the SEC website, organized by topic. We also specifically solicited comment, along with the CFTC, on the definitions contained in Title VII of the Act.

In addition, our staff has sought the views of affected stakeholders. This approach has resulted in meetings with a broad cross-section of interested parties. To further this public outreach effort, the SEC staff has held joint public roundtables and hearings with the CFTC staff on select key topics. Through these processes, we have received a wide variety of views and information that is useful to us in proposing and, ultimately, adopting rules that are appropriate for these markets.

Coordination with the CFTC and Other Regulators

In implementing Title VII, our staff is meeting regularly, both formally and informally, with the staffs of the CFTC, Federal Reserve Board, and other financial regulators. In particular, SEC staff has consulted and coordinated extensively with CFTC staff in the development of the proposed rules. Although the timing and sequencing of the CFTC's and SEC's proposed rules may vary, they are the subject of extensive interagency discussions. The SEC's rules will apply to security-based swaps and the CFTC's rules will apply to swaps, but our objective is to establish consistent and comparable requirements, to the extent possible, for swaps and security-based swaps. Due in part to differences in products, participants, and markets, some of our rule proposals contain different approaches to various issues. Nonetheless, as we move toward adoption, the objective of consistent and comparable requirements will continue to guide our efforts.

In addition, as required by the Act, we are working with the CFTC to adopt joint rules further defining key terms relating to the products covered by Title VII and certain categories of market intermediaries and participants. Joint rulemaking regarding key definitions will promote regulatory consistency and comparability, and thus help to prevent regulatory gaps that could foster regulatory arbitrage and overlaps that could confuse, or impose unnecessary added costs upon, market participants.

Finally, we recognize that other jurisdictions are also developing regulatory frameworks that will address many of the areas covered by Title VII. The manner and extent to which we and foreign regulators regulate derivatives will affect both U.S. and foreign entities and markets. Consequently, as we progress with the implementation of

Title VII, we will continue to consult with regulatory counterparts abroad in an effort to promote robust and consistent standards and avoid conflicting requirements, where possible. The SEC and CFTC are, in fact, directed by the legislation to consult and coordinate with foreign regulators on the establishment of consistent international standards governing swaps, security-based swaps, swap entities, and security-based swap entities. We believe that bilateral discussions with foreign regulators, as well as our engagement in the recently formed IOSCO Task Force on OTC Derivatives Regulation, which the SEC co-chairs, and our participation in other international forums will help us achieve this goal.

In short, we remain committed to working closely, cooperatively, and regularly with our fellow regulators to facilitate our implementation of the regulatory structure established by the Dodd-Frank Act.

Rulemaking

Actions Already Taken

The SEC has taken significant steps in implementing the rulemaking required by Title VII. To date, the SEC has proposed a number of rulemakings required by this title.

In October 2010, we proposed rules to mitigate conflicts of interest involving security-based swaps. These proposed rules seek to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

In November 2010, we proposed anti-fraud and anti-manipulation rules for security-based swaps that would subject market conduct in connection with the offer, purchase, or sale of any security-based swap to the same general anti-fraud provisions that apply to all securities and reach misconduct in connection with ongoing payments and deliveries under a security-based swap. We also proposed rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps. Those rules lay out who must report security-based swap transactions, what information must be reported, and where and when it must be reported. In addition, we have proposed rules regarding the obligations of security-based swap data repositories, which would require security-based swap data repositories to register with the SEC and specify other requirements with which security-based swap data repositories must comply.

In December 2010, we proposed rules relating to mandatory clearing of security-based swaps. These rules would set out the way in which clearing agencies would provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing. We also proposed rules relating to the exception to the mandatory clearing requirement for end users. These rules would specify the steps that end users must follow, as required under the Act, to notify the SEC of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement. In addition, we proposed joint rules with the CFTC regarding the definitions of swap and security-based swap dealers, and major swap and major security-based swap participants. These rules lay out objective criteria for these definitions and are a first step in helping the SEC appropriately address the market impacts and potential risks posed by these entities.

Thus far in 2011, we have proposed rules regarding the confirmation of security-based swap transactions, which would govern the way in which certain security-based swap transactions are acknowledged and verified by the parties who enter into them. We also proposed rules regarding registration and regulation of security-based swap execution facilities, which would define security-based swap execution facilities, specify their registration requirements, and establish their duties and core principles. And most recently, we proposed rules regarding standards for the operation and governance of clearing agencies. On the same day as this recent proposal, we also reopened the comment period for our October proposal regarding conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

In addition, we adopted interim final rules in October 2010 regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act. These interim final rules require certain security-based swap dealers and other parties to preserve and report to the SEC or a registered security-based swap data repository certain information pertaining to any security-based swap entered into prior to the July 21, 2010 passage of the Dodd-Frank Act and whose terms had not expired as of that date.

Upcoming Actions

This spring, we expect to propose rules regarding registration procedures, business conduct standards, and capital, margin, segregation, and recordkeeping requirements for security-based swap dealers and major security-based swap participants. We also expect to propose joint rules with the CFTC governing the definitions of "swap" and "security-based swap", as well as the regulation of "mixed swaps."

The SEC has been carefully reviewing all the comments received regarding the rules that already have been proposed and we are in the process of considering those comments. We also are continuing discussions with various market participants about their concerns and ideas regarding the proposed rules. This information is invaluable as we move toward consideration of final rules designed to further the purposes of the Dodd-Frank Act and the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation and provide effective regulation of the security-based swap markets without imposing unjustified costs or having unforeseen adverse consequences. We will, of course, be engaged in the same process for our upcoming proposed rulemakings, and I would like to take this opportunity to encourage market participants and the public to continue submitting comments on these upcoming proposed rulemakings.

Anticipated Completion of Rulemaking

We are working to complete the rulemaking proposal and adoption process under Title VII within Congress' deadlines for implementation. Nonetheless, this is a very challenging task. The OTC derivatives markets are large and interconnected. The issues are complex and do not lend themselves to easy solutions. We are progressing at a deliberate pace, taking the time necessary to thoughtfully consider the issues raised by the various rulemakings before proposing specific rules. We will take a similar approach as we move toward consideration of final rules.

Impact of Rulemaking on Existing Markets

There are unique challenges involved in imposing a comprehensive regulatory regime on existing markets, particularly ones that until now have been almost completely unregulated. For example, in proposing margin rules, we will be mindful both of the importance of security-based swaps as hedging tools for commercial end users and also of the need to set prudent risk rules for dealers in these instruments. We also need to carefully consider how our rules might impact pre-existing contracts. For example, in developing rules that concern the capital and margin requirements for security-based swap dealers, we will need to consider dealers' pre-existing security-based swaps. The application of new rules to existing security-based swaps could be very disruptive and impose burdens on dealers or their counterparties that they did not bargain for or anticipate. We discussed this issue, along with the end-user margin issue, with various stakeholders at a joint SEC-CFTC roundtable in December, and are taking the input we received at the roundtable and from other sources into account in writing proposed rules.

Conclusion

The Dodd-Frank Act provides the SEC with important tools to better meet the challenges of today's financial marketplace and fulfill our mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As we proceed with implementation, we look forward to continuing to work closely with Congress, our fellow regulators, and members of the financial and investing public. Thank you for inviting me to share with you our progress on and plans for implementation. I look forward to answering your questions.

Senate Committee on Agriculture, Nutrition, and Forestry

Testimony of

Larry Thompson
Managing Director and General Counsel

The Depository Trust & Clearing Corporation

March 3, 2011

Chairman Stabenow, Ranking Member Roberts and Members of the Committee, my name is Larry Thompson. I am General Counsel of The Depository Trust & Clearing Corporation ("DTCC"). DTCC is a non-commercial "utility" supporting the financial services industry. Through its subsidiaries and affiliates, DTCC provides clearing, settlement and information services for virtually all U.S. transactions in equities, corporate and municipal bonds, U.S. government securities and mortgage-backed securities and money market instruments, mutual funds and annuities. It also provides services for a significant portion of the global over-the-counter ("OTC") derivatives market. To give you some idea of the magnitude of DTCC's involvement in U.S. capital markets, in 2010, the Depository Trust Company ("DTC") settled more than $1.66 quadrillion in securities transactions.

Since 2003, DTCC has been working with the industry—and with regulators—to automate the trade confirmation process for credit default swaps ("CDS"), essentially replacing the manual error prone process where only 15% of all CDS trades were matched with a process where virtually all CDS trades are being matched through an automated system that DTCC created.

Following that effort, DTCC moved in 2006 to create its Trade Information Warehouse, ("TIW" or "Warehouse"). The Warehouse is a centralized, comprehensive global electronic data repository containing detailed trade information for the global CDS markets. The TIW database currently represents about 98% of all credit derivative transactions in the global marketplace. It holds approximately 2.3 million separate contracts with a gross total notional value of $29 trillion.

I appreciate the opportunity to share DTCC's thoughts on the implementation of Title VII of the Dodd-Frank Act. In particular, my comments today will focus on issues raised by the Dodd-Frank Act's creation of a swap data repository ("SDR") system.

The primary goal Congress set for the new SDR system is to provide regulators and the public necessary transparency into the global OTC derivatives markets as a way to mitigate systemic risk. Based on our experience in constructing and managing the world's first and most comprehensive derivatives repository, we are convinced that a properly constructed SDR system will play a fundamental role to promote more transparent markets for global regulatory oversight and systemic risk mitigation, protect the public and help ensure liquid and efficient capital markets. While many of the regulatory aspects of the Dodd-Frank Act remain in development, transparency is one policy option that is ripe for implementation.

Summary of Critical Points

DTCC would emphasize two points for the Committee:

1. *Transparent Access to Comprehensive Market Data for Regulators is the Key to any Attempt to Mitigate Systemic Risk in the Swap Markets*

The Dodd-Frank Act requires that all swaps, whether cleared or uncleared, be reported to SDRs. Such universal reporting to repositories is essential to providing transparency. While there remains on-going debate about the contributing factors that led to the financial crisis of 2008, there is broad consensus that, to the extent OTC derivatives contributed to the crisis, they did so based on two major elements. First, American International Group, Inc. ("AIG") took large one-way positions in mortgage-related credit default swaps, which threatened the continued viability of a systemically important firm and its counterparties and went unnoticed until it was too late. Second, there was a general lack of understanding with respect to the extent of the exposures across all asset classes of the swap markets. This lack of understanding contributed to a lack of confidence in the creditworthiness of financial institutions at just the wrong time.

The core infrastructure and database capabilities to protect against such situations had been put in place for the global CDS market prior to the 2008 crisis. Since 2008, DTCC has provided public reporting of aggregate CDS activity through its public Web site and more detailed reports to regulators to support their risk management activities. However, it wasn't until 2009 that this data set included the non-standardized mortgage-related swaps held by AIG.

Moreover, it was only last year that market participants and regulators worldwide were able to agree on a more structured and harmonized approach to the reporting and disclosure of this data, which took place under the auspices of the OTC Derivatives Regulators' Forum ("ODRF"), which is comprised of over 40 regulators and other authorities worldwide, including all of the major regulators and central banks in the U.S. and Europe.

Today, DTCC offers regulators a model for how a fully comprehensive global CDS data set can be made available to offer greater transparency and more effective management of systemic risk. This model was obtained through the cooperative efforts of the ODRF and the over 1,700 participants in the CDS market from over 50 countries and DTCC. DTCC now provides comprehensive standard position risk reports to appropriate authorities worldwide (as well as responding to over 100 *ad hoc* requests from such authorities last year).

More recently, DTCC introduced additional automated tools or what we call an "on-line" regulators' portal through which regulators and other authorities can directly access and query through secure interfaces more tailored and detailed position reports from a global data set relating to their regulatory oversight requirements. To date, 20 different regulators worldwide have linked to this portal, including the Federal Reserve Bank of New York and the Office of the Comptroller of the Currency.

If the system for reporting and disclosure of data created through these cooperative efforts had existed in 2008, and been applied over the complete global data set subsequently created, regulators would have been provided with sufficient early warning of the build-up of risky AIG positions.

The Warehouse has demystified the size and level of trading in global CDS derivatives markets, and it has provided added protection, allowing regulators to see the risk posed by a single trading entity from a central vantage point across this market. We believe this trade repository model and systemic architecture design can—and should—be replicated across other asset classes of derivatives, to capture and ensure market transparency. We believe this goal can be accomplished without the need for the government to develop completely new data systems at a significant cost to taxpayers.

The comprehensive global market information that DTCC is now able to publish includes, among other things, net market-wide exposures to each CDS index and index tranche, as well market-wide exposures to each of the top 1,000 individual corporate and governmental entities on which CDS are written (top 1000 ranked by size of exposure). This allows market participants, regulators and the public to assess risks, in real-time, on the basis of comprehensive data to enable them to develop much more informed views. The published data also indicate which broad category of market participants holds what positions in relation to important areas of the market, such as overall exposure to sovereign debt, corporate debt and other broad categories, although not in such detail as would threaten to disclose the identity of position holders. Had this global and sector-based market information been available and published in the run-up to the 2008 crisis, much of the exposure uncertainty that contributed to market instability at the time, at least in the CDS market, would have been mitigated.

2. *Providing Transparency is a Cooperative Effort.*

The creation of an integrated warehouse of CDS data would not have been possible without the substantial and unusual degree of global regulatory cooperation achieved through the ODRF and the OTC Derivatives Regulators Supervisors Group ("ODSG"). For this process to work, it was critical that the entity holding the repository, in this case, DTCC, was not a traditional commercial entity. By removing commercial concerns from what is and should remain primarily a regulatory and supervisory support function, the Warehouse was able provide a central place for data to be reported and for regulators to access it *for both market surveillance and risk surveillance purposes*, simultaneously helping both the regulators and market participants.

As a true industry-governed utility, with buy-side firms, sell-side firms and self-regulatory organizations as stakeholders, DTCC has been able to secure the cooperation of virtually all market participants and clearers and trading platforms with any significant volume. This comprehensiveness has made the Warehouse effective.

It is critical that the SDR system which emerges from the Dodd-Frank Act regulatory process ensure that the kind of comprehensive data, such as that maintained in the Warehouse for all derivatives markets on a global basis, is maintained and expanded.

If a system were to develop that did not ensure regulatory cooperation or the cooperation of market participants and their respective clearers and trading platforms, both the published and regulator accessible data would be fragmented, inevitably leading to misleading reporting of exposures and a very expensive "fix" for the regulators and the marketplace generally.

Fragmentation of data would leave the task to regulators of rebuilding in multiple instances the complex data aggregation and reporting mechanisms (including extra-territorial trades on locally relevant underlyings) that had already been created. That task was one of the primary reasons that the industry and regulators themselves created a single place for the CDS data within DTCC.

The challenge going forward is to bring similar regulatory and public transparency to other parts of the swap markets.[1] Throughout the existing rulemaking process, both the SEC and the CFTC have taken a thorough and thoughtful approach with respect to the very complex subject of swap data reporting, including suggesting improvements to the current structure for reporting credit default swaps and proposals regarding which features of the current reporting structures would meet regulatory needs in other swap asset classes.

Given the need to move expeditiously and to assure the continuation of the necessary cooperative attitude among regulators, market participants, clearinghouses and trading platforms worldwide, we urge that regulatory focus be on expanding the existing cooperative achievements of providing both regulatory and public transparency to the swap markets. Such cooperative efforts take some minimal amount of time to implement safely and soundly (our experience suggests a minimum of 24-36 weeks if participants cooperate). If there is a lack of cooperation, it could take significantly longer.

From our vantage-point as a user governed and regulated utility servicing most of the major regulators worldwide, it is our sense that, globally, market participants and regulators are poised to undertake the

[1] There are two other global swap repositories in existence today, one for OTC equity derivatives operated by DTCC in London and one for OTC interest rate derivatives operated by TriOptima in Sweden. These repositories, however, were designed solely as a means to facilitate certain high-level position reporting by the major global dealers and do not hold sufficient data to meet the regulatory needs specified by either the Dodd-Frank Act or the ODRF (including both market surveillance and risk surveillance), which have superseded the initial requirements set forth for these entities.

significant cooperative effort necessary to provide complete transparency to these markets as contemplated by the Dodd-Frank Act.

DTCC implores this Committee, in exercising its oversight function, to focus on removing obstacles to this process and to urge the continued use of proven infrastructure in a manner that distinguishes the SDR function from purely commercial considerations and jurisdictional quarrels, which could hinder the cooperative attitude that has made progress possible thus far.

Overview of DTCC

As stated above, DTCC is a user owned market utility. Through its subsidiaries, it provides clearing, settlement and information services for virtually all U.S. transactions in equities, corporate and municipal bonds, U.S. government securities and mortgage-backed securities transactions and money market instruments and for many OTC derivatives transactions. DTCC is also a leading processor of mutual funds and annuity transactions, linking funds and insurance carriers with their distribution networks. DTCC does not currently operate a clearing house for derivatives. However, DTCC owns a 50% equity interest in New York Portfolio Clearing, LLC ("NYPC"), which has been granted registration as a derivatives clearing organization ("DCO") by the CFTC.

DTCC has three wholly-owned subsidiaries which are registered clearing agencies under the Exchange Act, subject to regulation by the SEC. These three clearing agency subsidiaries are DTC, National Securities Clearing Corporation ("NSCC") and Fixed Income Clearing Corporation ("FICC"). DTCC is owned by its users and operates as a not-for-profit utility with a fee structure based on cost recovery.

DTC currently supports the launch of new securities issues and IPOs and provides custody and asset servicing for 3.6 million securities issues from the United States and 121 other countries and territories, valued at almost $36 trillion. In 2010, DTC settled more than $1.66 quadrillion in securities transactions, which is equivalent to the full value of the annual U.S. Gross Domestic Product every three days. NSCC provides clearance and settlement, risk management, central counterparty trade guarantee services and the netting down (reducing the total number of trade obligations that require financial settlement by an average of 98% per day) for all cash equity transactions completed by the 50+ exchanges and alternative trading platforms ("ECNs") operating in U.S. capital markets. FICC provides clearance and settlement, risk management and central counterparty trade guarantee services and netting (for most securities) in the U.S. government securities markets and for agency-backed securities in the mortgage backed securities markets.

Thus, DTCC, through its subsidiaries, processes huge volumes of transactions – more than 30 billion a year – on an at-cost basis.

Overview of the Trade Information Warehouse

Since 2003, DTCC has been working with the industry—and with regulators—to automate the trade confirmation process for CDS, essentially replacing the manual error prone process where virtually none of the CDS trades were matched in an automated environment with a process where virtually all CDS trades are matched through a system that DTCC launched in 2004. The automated capture of initial trade details associated with a CDS contract or assignment was critical to the eventual creation of DTCC's Trade Information Warehouse.

In November 2006, at the initiative of swap market participants, DTCC expanded further to launch the TIW to operate and maintain the centralized global electronic database for virtually all position data on CDS contracts outstanding in the marketplace. Since the life cycle for CDS contracts can extend over five years, in 2007, DTCC "back-loaded" records in the Warehouse with information on over 2.2 million outstanding CDS contracts effected prior to the November 2006 date in which the Warehouse started collecting CDS data. As stated above, the Warehouse database currently represents about 98% of all credit derivative transactions in the global marketplace; constituting approximately 2.3 million contracts with a notional value of $29 trillion ($25.3 trillion electronically confirmed "gold" records and $3.7 trillion paper-confirmed "copper" records).

In addition to repository services, which include the acceptance and dissemination of data reported by reporting counterparties, the Warehouse provides legal recordkeeping and central life cycle event processing for swaps registered therein. By agreement with its 17,000+ users worldwide, the Warehouse maintains the most current CDS contract details on the official legal or "gold" record for both cleared and bilaterally-executed CDS transactions. The repository also stores key information on market participants' more customized CDS swap contracts, in the form of single-sided, non-legally binding or "copper" records for these transactions, to help regulators and market participants gain a more clear and complete snapshot of the market's overall risk exposure to OTC credit derivatives instruments.

DTCC's Warehouse is also the first and only centralized global provider of life cycle event processing for OTC credit derivatives contract positions throughout their multi-year terms. Various routine events, such as calculating payments due under contracts, bilaterally netting and settling those payments and less-common events, such as credit events, early terminations and company name changes and reorganizations, may occur, all requiring action on behalf of the parties to such CDS contracts. DTCC's Warehouse is equipped to automate the processing associated with those events and related actions. The performance of these functions by the Warehouse distinguishes it from any swap data repository that merely accepts and stores swap data information.

The Indemnification Provision and Its Impact

Consistent with our discussion about the need for global regulatory cooperation in ensuring access to the data necessary to protect against systemic risk, DTCC is deeply concerned about the indemnification provisions in Sections 728 and 763 of the Dodd-Frank Act, and we have expressed these concerns throughout the regulatory process. The Dodd-Frank Act requires that repositories obtain indemnifications from foreign regulators before sharing information with them. There was no legislative history behind this provision, which was incorporated late in the legislative process, without having been considered in the hearing process. As a result, it was not subject to extensive discussion and consideration prior to the enactment of the Dodd-Frank Act, and its negative consequences must not have been clear to legislators or the relevant regulatory bodies. DTCC believes that the indemnification provision will significantly impede global regulatory cooperation.

Foreign regulators are not likely to grant DCOs or SDRs indemnification in exchange for access to information. Accordingly, regulators may be less willing to access the aggregated market data, resulting in a reduction of information consumption, domestically and internationally, which jeopardizes market stability.

This provision has the unintended consequence of giving foreign jurisdictions an incentive to create their own local repositories in order to avoid indemnification. Proliferation of local "national" repositories around the world would make it very difficult to obtain a full picture of a particular asset class, impair market and regulatory oversight, create inconsistencies in data, frustrate data analysis and increase systemic risk.

Further, the provision could have an immediate negative impact on the ability of U.S. regulators to obtain information from repositories located in foreign countries should reciprocal indemnification provisions be enacted in foreign laws. U.S. regulators, like foreign regulators, might be legally or practically precluded from signing such agreements.

Preventing the exchange of information between regulators will frustrate efforts to mitigate international financial risk and fragment regulatory oversight on a jurisdiction-by-jurisdiction basis.

In light of the existing indemnification requirement, this Committee should encourage regulators to waive indemnification in situations where foreign regulators are carrying out their regulatory responsibilities *in a manner consistent with international agreements*, which includes maintaining the confidentiality of data.

Alternatively, removing this provision of the Dodd-Frank Act in technical corrections bill may be appropriate in order to avoid undermining the ability of U.S. regulators to obtain information in derivatives markets on a global basis.

Regulatory Status of Trade Repositories – Global Cooperation

Derivatives markets are inherently cross-border, as participants in a transaction are often located in more than one jurisdiction. From the outset, DTCC has understood that the TIW serves a global function, and the information held by the Warehouse is relevant to regulators in many locations. DTCC believes it is important to support regulators around the world and has effectively done so since the end of 2008.

The SDR regime established under the Dodd-Frank Act must recognize the global characteristics of OTC derivatives markets. For that reason, Congress rightly directed regulators to undertake international harmonization, a requirement that should apply fully to the SDR system and individual SDRs. DTCC has worked closely with the ODRF and, with DTCC's support, the group agreed to criteria for the sharing of data, recognizing the need to have critical data on CDS accessible across geographic boundaries and regulatory jurisdictions. DTCC has implemented regulatory disclosure processes using those criteria and urges the same approach for other asset classes going forward.

DTCC anticipates that global regulators will increasingly recognize the overwhelming advantage of understanding risks globally from a central vantage point, thereby avoiding data fragmentation, which critically detracts from the management of systemic risk. As the system for the use of repositories is developed internationally, it is very important for the U.S. to facilitate a result that will place U.S. regulators and foreign regulators on an equal footing in their ability to obtain information from repositories quickly and without barriers. Currently, the international perception is that there is inequality as the indemnity provisions, notification and direct access to all data by the Commission distort this.

To promote global market transparency, in implementing the Dodd-Frank Act, U.S. standards should be developed to be compatible with those standards still under development in other countries, meeting the needs of both U.S. and foreign regulators. Given that risks to the U.S. financial system can be impacted by transactions occurring virtually anywhere in the world, it is essential that the SEC and CFTC's final regulations create SDRs that meet the immediate needs of U.S. regulators and the long-term need of harmonization with the requirements of regulators in Europe and other major financial markets. This will ensure that meaningful international data continues to be available to U.S. regulators.

One philosophical and pragmatic question that arises with respect to global cooperation is whether market data should be collected and held by the private sector and made available to regulators on a pro-active and as-requested basis or, alternatively, whether governments themselves should collect the data and disseminate under treaty and information-sharing agreements.

The model of each government collecting the data will lack some of the efficiencies of a private sector offering. The private sector solution, for cost and customer connectivity reasons, will be driven to standardize across jurisdictions and share infrastructure to the maximum extent possible. These are not inconsiderable undertakings (for example the SEC estimate of costs for the industry in the first year was in excess of $1 billion). This standardization and sharing of infrastructure is positive from a public policy perspective as it will also support the aggregation of data for public and regulator use.

In contrast, the governmental approach is likely to be focused on a jurisdictional implementation that will be less able to benefit from existing or related commercial business processes that can deliver high quality information to SDRs. Clearly the U.S. is a very significant market with scale, but such action also creates a precedent for elsewhere, and to obtain the data in the current TIW over 50 jurisdictions would have to implement such governmental solutions.

The TIW has shown that global offerings can be developed in the corporate sector, providing cost advantages to customers from a connectivity and common infrastructure perspective, across jurisdictions, in this global market. Additionally, key to this model is a sense of international co-operation and equal footing for all regulators with respect to the data needed directly in relation to areas of their regulatory responsibility.

Repositories' Role in Promoting Transparency and Reducing Systemic Risk

By aggregating information, repositories collect and compile all relevant data in order to assure appropriate market transparency and effective monitoring of systemic risk. Global repositories have been, or are being, established for each OTC derivatives asset class, which can provide regulators in the U.S. and around the world real-time access to the data necessary to monitor and safeguard financial markets.

The Dodd-Frank Act has identified SDRs as central to helping U.S. regulators maintain the safety and soundness of derivatives markets. DTCC has urged regulators, and urges this Committee, to focus on three objectives in moving forward with regulations covering SDRs:

1) Enhancing market transparency for regulators and market participants;
2) Reducing systemic risk by ensuring regulators can determine a firm's underlying position and exposure in an integrated fashion; and
3) Promoting coordination and efficiency in the supervision of global capital markets.

DTCC urges Congress, as well as regulators, to think carefully about the implications of fragmenting information on outstanding contracts into different repositories, in different countries, on different continents.

If German regulators have to examine a dozen different trade repositories to determine the positions of different types of credit default swap contracts that may be outstanding on German companies, they may never find all of the contracts, certainly not quickly. Contract records could be scattered across repositories in the U.S., in Europe, in Japan, in Dubai, in Hong Kong and elsewhere. Nor is it likely to be apparent to the regulators what they are looking for, since the offsets to contracts residing in one database might be residing elsewhere. A contract could easily have been written between a Swiss financial institution and an Australian financial institution on an underlying German entity, only to be sold or assigned to another party located in Brazil. Even if all of the data is eventually located, a system to aggregate, omit duplicate records, verify and analyze it would still be required.

All of the information detailed above is currently collected in the Warehouse globally. Data is published weekly on all of the contracts held, including a breakdown by currency. Moreover, DTCC has consistently stated that all interested regulators should have access to the data they need. Accordingly, for approximately the past year, DTCC has made such data available as appropriate to the regulators involved in accordance with the global criteria adopted by the ODRF. All of this functional transparency will be undermined if regulators move forward with an approach that does not provide for globally consolidated data.

Global regulators need consolidated reporting across international markets. International regulatory guidance for derivatives regulation has recognized that aggregated data is vital to provide a comprehensive view of derivatives markets. For example, last October, the Financial Stability Board suggested that a beneficial solution to the needs of regulators throughout the world would be the establishment of "a single global data source to aggregate the information from [SDRs]."

A system for SDR reporting around the world should be implemented promptly – but it must contain mechanisms to facilitate prompt consolidation and to avoid fragmentation if it is be effective in providing meaningful market surveillance for regulators and risk surveillance for markets.

The Rule-Making Process

The regulatory implementation of Title VII has been extremely demanding, both on regulators and on market participants. DTCC has filed comments on a number of proposed new rules governing SDRs. Copies of DTCC's comments filed to date are appended to this testimony. I request that they be entered in full into the hearing record, as they address many technical issues in detail that goes well beyond what is appropriate to cover in this statement.[2] I will cover the highlights of our comments on the major issues that DTCC believes are most likely to be of interest to this Committee, beginning with proposed standards for repositories.

Proposed Standards for Swap Data Repositories

DTCC has recommended that the regulations implementing Title VII set high standards for SDRs to meet the needs of regulators and the markets, serving as an industry utility for both. DTCC also recommends that the rules be refined to only cover entities that are actually acting as repositories, rather than entities merely providing ancillary functions. Some of the major principles include:

> *Neutrality*. DTCC urges regulators to adopt standards for SDRs that foster neutrality and "open access" to all market participants. Regulators must ensure that the public utility function of SDRs is separated from potential commercial uses of the data. SDRs should operate objectively and impartially, with an arms-length and non-discriminatory relationship to any and all clearing, confirmation and execution facilities, affiliated or otherwise.

[2] They include comments on the CFTC's Interim Final Rule for Reporting Pre-Enactment Swap Transactions; the CFTC/SEC request for general comments on SDRs and mitigation of conflicts of interest; the CFTC Proposed Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest; the SEC's Proposed Rule on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC; the SEC's Interim Final Rule on the Reporting of Security-Based Swap Transaction Data; the SEC Proposed Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information; the FSOC Advance Notice of Proposed Rulemaking Regarding Authority to Designate Financial Market Utilities as Systematically Important; the SEC's Proposed Regulation on Security-Based Swap Repository Regulation, Duties and Core Principles; the OFR Statement on Legal Entity Identification for Financial Contracts; the CFTC Proposed Regulation on Real-time Public Reporting of Swap Transaction Data; the CFTC Proposed Regulation of Swap Data Recordkeeping and Reporting Requirements; and the CFTC Proposed Regulation of Swap Data Repositories.

Round-the Clock Operations. Markets never sleep and neither should repositories. Regulators should require every SDR to operate on a 24/6 basis, process transactions in real-time and maintain redundancy.

Real-Time Processing. Market participants and regulators need repositories to perform their functions without delay in order to facilitate accuracy and the completeness of market information.

At-Cost Fee Structures. Because SDRs operate as utilities, they should be required to maintain non-profit fee structures, with at-cost operating budgets, rather than providing sources of revenue for commercial enterprises.

Redundancy. It is a material weakness for any SDR to fail to maintain adequate redundancy sufficient to protect databases in light of catastrophic events. Significant and extensive requirements for redundancy for every SDR, consistent with long-established U.S. and global standards for business continuity and resilience, are essential for proper function and mitigation of systemic risk.

No Reductions in Registration Requirements or Performance Requirements. SDRs should be required to meet proposed standards fully, even during the temporary registration phase. The proposed regulations allow for temporary registration for SDRs while regulators assess an SDR's capabilities. To protect safety and soundness, DTCC recommends that appropriate due diligence be conducted during the temporary registration process to ensure that new entrants have adequate operational capabilities, including 24/6 operation, real-time processing, multiple redundancy and robust information security controls.

Phase-In for Existing Repositories. Existing repositories, such as the TIW, already provide important transparency to regulators and markets. Final regulations need to ensure that the existing operations of any entity that intends to register as an SDR are not interrupted through the registration process. This can be achieved with phase-in transition arrangements for existing repositories whose services need to be amended to conform to final rules and the effective date of the Dodd-Frank Act.

Regulatory Harmonization. While comprehensive and thoughtful, proposed CFTC and SEC regulations governing repositories are not identical and, in some areas, differ materially. To avoid creating conflicting standards and imposing unnecessary costs, Congress should urge regulators to harmonize the regulations overseeing SDRs.

Implementation Issues

The proposed regulations issued under the Dodd-Frank Act place substantial demands on existing repositories, and those substantial demands apply to anyone who seeks to become a repository.

DTCC recommends that appropriate transitional arrangements be made to avoid market disruption in the implementation process of the proposed regulations. This can be done through a phase-in period for existing service providers like the Warehouse and by allowing a longer period for registration of new service providers who wish to become repositories, enabling them to put in place adequate systems and appropriate controls to meet the Dodd-Frank Act standards.

The implementation of the Dodd-Frank Act also places a significant burden on regulatory agencies. DTCC is merely one participant among a great number of entities consulting regularly with the CFTC and the SEC as these regulators seek to carry out their statutory mission. In meeting with these regulators, it is clear that they feel heavily burdened and are doing their best to meet the demands placed on them by the implementation of this monumental legislation.

Conclusion

Generally, the Dodd-Frank Act established an appropriate framework for the further development and use of repositories in the United States and internationally. DTCC does, however, recommend that Congress review the Act's indemnification requirement. As contemplated, the indemnification requirement could create substantial problems for U.S. regulators by giving foreign jurisdictions the incentive to establish separate repositories that operate on a local or national basis, rather than an international standard.

International coordination is critical to achieving the level of transparency necessary to mitigate systemic risk in swaps markets. DTCC also urges that legislators and regulators focus on the use of consolidated repositories, or single repositories by asset class, to counter the risk of fragmentation. Finally, it is critical that in implementing the Dodd-Frank Act, regulators build on existing systems and processes to address the policy goals of the Act. Building on existing systems will result in the most cost-efficient, effective and immediate solutions.

As I stated at the beginning of my testimony, risk mitigation is central to DTCC's mission. As regulators and legislators across the globe write the rules under which the OTC derivatives markets will operate, DTCC is actively engaged in the dialogue. DTCC has a unique perspective to share and appreciates the opportunity to testify before you today.

I look forward to answering any questions the Committee may have.

QUESTIONS AND ANSWERS

MARCH 3, 2011

Senate Committee on Agriculture, Nutrition & Forestry
Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act
Questions for the Record
Mr. Steven M. Bunkin
Thursday, March 3, 2011

Senator Pat Roberts

1) Congress explicitly omitted provisions that would have established a fiduciary duty for swap dealers for their transactions with special entities like pension funds. However, as you mention in your testimony, some of CFTC's proposed business conduct rules may have created a new "fiduciary-like" standard that would have the same effect. If so, how would this impact the ability of these special entities to hedge their risks with you?

Response: As the proposed CFTC business conduct rules are currently drafted, we believe that few, if any, swap dealers/MSPs would risk entering into swaps with pensions, endowments or subject governmental entities (so-called "special entities"), making it difficult if not impossible for these special entities to use swaps to hedge their risks.

As noted in your question, Congress considered and decided to omit a provision that would have imposed a fiduciary duty on swap dealers or major swap participants ("MSP") that enter or offer to enter into swaps with special entities. Instead, Congress adopted a two-step approach applicable to swaps with special entities. First, the swap dealer/MSP must have a reasonable basis to believe that the special entity has a qualified representative that is independent of the swap dealer/MSP. Second, only where the swap dealer/MSP provides "advice" to the special entity with respect to a swap, the swap dealer/MSP must act in the "best interest" of the special entity. In reviewing the statutory language, many lawyers who typically deal with ERISA-covered pension plans and other special entities advised that there would be few circumstances where a swap dealer/MSP would or could provide advice to a special entity about a swap it proposed to enter into with that special entity.

In its proposed rules to implement the second provision, the CFTC broadly defined "advice" as the provision of ***any*** tailored information with respect to a swap. First, as a practical matter, we believe it will be difficult for a swap dealer to assure that it provides no tailored information about a swap to a potential swap counterparty (and we would expect most special entities would expect to get at least some tailored information so that they could assess the swap). Moreover, the proposed rule ***requires*** swap dealers/MSPs to provide swap specific tailored information in many instances, which means that in order to comply with the proposed rules, a swap dealer/MSP would be required to provide "advice." While there is a carve-out for general information provided in response to a competitive bid request, that carve-out is very narrow and would not apply in most cases. Accordingly, as a result of the extremely broad definition of "advice" in most, if not all, cases, a swap dealer/MSP will be deemed to be providing "advice" to any special entity with which it offers to enter into a swap.

Once a swap dealer/MSP provides "advice" to a special entity, it is required to act in the special entity's "best interest." Although the proposed rule does not provide detailed guidance regarding what it means to act in a special entity's "best interest," it indicates the CFTC will look to "existing principles in case law" to inform the meaning on a case-by-case basis. The proposed rule specifically refers to ERISA's fiduciary duties as an area of law to which the CFTC might look in interpreting the duties owed to a special entity under the "best interest" standard. Of course, ERISA requires a fiduciary of a plan at all times to act ***solely*** in the interest of that plan and in any case prohibits outright a fiduciary of an ERISA plan with respect to a swap from acting as the counterparty with respect to that swap. It is of little consolation that the proposed rule refers to informal consultations with the Department of Labor, which advised that the determination of a dealer's status under the proposed rule is "separate and distinct" from a fiduciary determination under ERISA.

Even outside of ERISA, where there are strict "prohibited transaction" rules that impose a right of rescission and severe penalties where fiduciaries enter into potentially self dealing types of transactions, common law fiduciary principles raise similar conflicts of interest concerns where a fiduciary advises and acts as a counterparty with respect to the same transaction.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act
Questions for the Record
Mr. Terrence A. Duffy
Thursday, March 3, 2011

Senator Pat Roberts

1) Please comment briefly on the timing, sequencing, and analysis of the SEC and CFTC proposed rulemakings. Do you think the timeframe in the proposed rules for centrally-cleared swaps is realistic?

Section 712 of Title VII of Dodd-Frank says the CFTC and SEC have 360 days from the date of enactment (*i.e.*, July 15, 2011) to promulgate the rules and regulations "required" by the title. Our review of Title VII reveals that there are fewer than 15 rulemakings *required* by the CFTC. The CFTC, however, has proposed over 50 rulemakings to date. Most of these proposals are not required by Title VII, and many are aimed to restructuring the regulatory regime for the regulated futures market, which was not the objective of Title VII.

While the financial crisis focused well-warranted attention on the lack of regulation of OTC financial markets, and Congress crafted legislation that, we hope, reduces the likelihood of a repetition of that near disaster, it is important to emphasize that regulated futures markets and futures clearing houses did not contribute to that crisis. Indeed, CFTC-regulated futures exchanges and clearing houses operated flawlessly, performing all of their essential functions without interruption. Significantly, while large financial firms regulated by other oversight agencies failed, 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.

The CFTC's proposed rulemakings in this regard, if adopted, would convert the regulatory system for the futures markets from the highly successful and cost-effective principles-based regime that has permitted U.S. futures markets to prosper as an engine of economic growth for this nation and which Congress chose to replicate for swap execution facilities and swap data repositories, to a restrictive, rules-based regime that will stifle growth and innovation. The proposals containing these rules lack meaningful analysis as to whether the proposed rules are necessary or appropriate or whether they are justifiable from a cost benefit perspective. Indeed, in our view, the CFTC has not performed an adequate cost benefit analysis in conjunction with proposed rulemakings, an analysis they are required by the Administrative Procedure Act to share with the public so that the public has an opportunity to comment on that analysis during the rulemaking process.

Rather than waste scarce resources to impose non-required regulations and duplicate the oversight of self-regulatory organizations ("SROs") subject to its jurisdiction, the CFTC should, instead, focus on the rules that Dodd-Frank requires the agency to adopt no later than July 15, 2011, and those necessary to ensure that Dodd-Frank's objectives of reducing systemic risk and increasing transparency in the previously un-regulated swaps markets are met. In this regard, the CFTC has yet to propose rules that would address critical definitions that are the foundation of Dodd-Frank's regulatory reforms. For example, the CFTC has not yet proposed a definition for "swap," a term which needs to be further defined no later than July 15, 2011, not only because the law requires it, but because market participants will be unable to determine whether they can lawfully execute any "swap" transaction other than on or subject to the rules of a designated contract market. Without final rules defining these terms, market participants will not know what their legal and regulatory obligation are under Title VII.

Chairman Gensler recently announced his agenda for the sequencing and timing of rulemaking under Dodd-Frank. He was not explicit about the time frame for any particular rules, however, he grouped the rulemakings into three categories, which he labeled "early," "middle," and "late." CME Group recommends that the CFTC reprioritize its rulemaking efforts to focus in the early and middle phases on getting the critical definitions in place as quickly as possible and also on adopting those rules which it is required by law to adopt to bring the previously un-regulated swaps market into a well-developed regulatory framework. To this end, rules proposed by the CFTC should be clear and thorough and contain a supporting analysis that allows the public to have an opportunity to provide meaningful comment prior to the close of the comment period. We recommend that the Commission leave for the late phase those rulemakings which are not critical to the creation of the regulatory regime that will govern the newly regulated swaps market. In proposing these rules, the CFTC also should perform an adequate cost benefit analysis to ensure that the rules, as proposed, are necessary and appropriate for carrying out Congress' intent.

2) How do you think market liquidity may be affected by the proposed position limits?

The proposed position limits proposal will have a material adverse impact on market liquidity. The CFTC's proposal will limit both speculative trading and trading that had been properly classified by the CFTC as appropriate hedging. The CFTC offers no evidence or economic theory to sustain the restrictions it proposes to impose other than an FTC report from 1926. The trading that the CFTC seeks to restrict is essential to the orderly functioning of futures markets; it provides market liquidity, which promotes more effective commodity price discovery and allows for the efficient transfer of price risk. In Section 3(a) of the Commodity Exchange Act ("CEA"), Congress itself has found that speculators serve the national public interest by "assuming risks, discovering prices, or disseminating pricing information" through trading in "liquid, fair and financially secure trading facilities." Artificially constraining speculative trading and financially based hedges will decrease liquidity in the affected markets, which in turn will likely increase price volatility and the cost of hedging especially in deferred months. Price volatility and increased hedging costs ultimately get passed on to consumers in the form of higher commodity prices. Position limits are not a costless palliative. On the contrary, they stand to harm markets and the very the group of people the CFTC's seeks to protect, the American consumer.

3) Have you done any estimates of what Dodd-Frank compliance will cost you? What happens to these costs?

Any reasonably accurate estimate of industry compliance costs would be nearly impossible to obtain at this time. While the CFTC has thus far published for comment over 50 proposed rulemakings, we do not yet have any sense of what the regulatory landscape will look like next year. Many of the proposed rulemakings are vague or incomplete making it difficult to determine our compliance obligations. In short, the breadth of the CFTC's rulemaking and its lack of a meaningful cost-benefit analysis has resulted in insufficient information to afford the public and market participants with a meaningful opportunity to comment, making it virtually impossible for us to perform this important task. It is clear, however, that the rules as proposed would result in significant compliance costs for all market participants without an equal or corresponding regulatory or public benefit.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act
Questions for the Record
Chairman Gary Gensler
Thursday, March 3, 2011

Chairwoman Debbie Stabenow

1) As you know, Dodd-Frank did not include a mandate for ownership limits, but provided discretion to impose limitations on the control by certain individual entities. The CFTC proposed a rule that would apply these limits not only to the individual members of these regulated entities, but also in some cases to apply limits collectively to the group of enumerated entities. Could you expand on how the CFTC determined that these aggregate limits are necessary?

The Commission's proposed rule on governance for DCOs, DCMs and SEFs implements Section 726 of the Dodd-Frank Act, which requires the Commission to mitigate conflicts of interest in the operation of certain DCOs, DCMs and SEFs. It is designed to advance the goals of the Dodd-Frank Act that clearinghouses and trading platforms have open decision-making and that their governance be protected from potential conflicts of interest. Such conflicts may arise with respect to determinations regarding the clearing and trading of swaps; access to such clearing and trading; and in the responsibilities of registrants for overseeing their members for compliance. Open governance is important to promoting competition amongst trading platforms as well as to lowering risk to the American public by ensuring that as many standardized swaps are cleared as possible.

Section 726(a) of the Dodd-Frank Act authorizes "numerical limits...on control" or "voting rights" that enumerated entities may hold with respect to such DCOs, DCMs, and SEFs. Enumerated entities include: (i) bank holding companies with more than $50,000,000,000 in total consolidated assets; (ii) nonbank financial companies supervised by the Board of Governors of the Federal Reserve System; (iii) affiliates of (i) or (ii); (iv) swap dealers; (v) major swap participants; or (vi) associated persons of (iv) or (v).

Section 726(b) of the Dodd-Frank Act directs the Commission to adopt rules determined to be necessary or appropriate to improve the governance of certain DCOs, DCMs or SEFs or to mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants, on the one hand, and such DCOs, DCMs and SEFs.

Section 726(c) of the Dodd-Frank Act directs the Commission to consider the manner in which its rules address conflicts of interest in the abovementioned interaction arising from equity ownership, voting structure or other governance arrangements of the relevant DCOs, DCMs and SEFs.

The CFTC proposal has two important components. One is with regard to the functioning of the boards of directors and the inclusion of a sufficient number of public directors.

The second component is related to possible limits to the voting control of trading platforms and clearinghouses. The proposal recommends no aggregate limits on such voting control of trading platforms but does propose a limit of 20 percent on any individual member. With regard to clearinghouses, the proposal would set an aggregate limit of 40 percent of voting control for certain entities, but it also has another option: placing no aggregate limit if the voting ownership is more diverse, with no one member or named entity holding more than 5 percent. Importantly, the proposal also recommends that the Commission retain the authority in certain circumstances to grant exemptions to ownership limits.

The Commission has received extensive public comment with regard to the proposed rule and will summarize and consider those comments before proceeding to consider a final rule.

2) Definition of 'SWAP'—Exclusions: Before Dodd-Frank, physical forward commodity contracts and commercial options were excluded from CFTC regulation. It was Congressional intent to preserve a regulatory exclusion for forward contracts from the definition of swap. While we are all waiting on the CFTC's proposed product definitions, I would like to ask if you believe there should be exclusions from the definition of "swap" for commercial commodity contracts -- such as forward contracts for physical power, natural gas, coal and other fuels, and for commercial options, such as capacity contracts, reserve sharing agreements, and all-requirements contracts?

Under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, there has been a series of orders, interpretations and cases upon which market participants have come to rely regarding the exception from futures regulation for forwards and forwards with embedded options. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." The SEC-CFTC joint proposed rule regarding the definition of swap interprets that exclusion in a manner that is consistent with the CFTC's previous history of the forward exclusion from futures regulation.

3) Implementation and Transition Periods: Increased transparency was a cornerstone of Dodd-Frank and it contains robust reporting requirements. The law put the onus of reporting on swap dealers and major swap participants, but for those transactions involving only end users,

reporting obligations will fall on the end users, and often smaller entities like coops. These reporting obligations could require significant system changes and more administrative staffing. Will the CFTC require each end user to keep electronic records and report their transactions to the Commission? In end user-to-end user transactions, has the Commission considered ways to help end-users meet the new requirements?

The proposed Swap Data Recordkeeping and Reporting Requirements rule distinguishes between swap dealers, major swap participants and end-users in terms of data recordkeeping and reporting requirements. The rule requested comment concerning whether the Commission should adopt a phase-in approach to requirements for end-users and whether the time within which reporting is required should differ according to whether the reporting counterparty is an end-user or a dealer or major swap participant. The Commission received comments regarding the appropriate phase-in approach and appropriate reporting time requirements and is evaluating these comments as it prepares the final rule.

4) In the Dodd-Frank Act, Congress made a clear decision to exempt regulated lenders from being classified as a swaps dealer based solely on the swaps they enter into with customers in connection with making a loan to those customers. CFTC's recently proposed rule defining "swaps dealer" limited this exemption to insured depository institutions. In the final rule, will the CFTC treat all federally regulated lenders equally, including Farm Credit System institutions?

The Dodd-Frank Act's definition of the term "swap dealer" provides that an insured depository institution is not to be considered a swap dealer "to the extent if offers to enter into a swap with a customer in connection with originating a loan with that customer" But does not apply that treatment to FCS institutions The Commission is consulting with the Farm Credit Administration regarding its rules and FCS institutions. It is also reviewing public comments regarding the treatment of FCS institutions. The Commission will summarize and consider those comments before proceeding to consider final rules.

5) Given the increased open interest in futures trading, especially in agricultural commodities why did the Commission choose to base its proposed Position Limits rule on 2004 open interest levels, and not replace those levels based on more current market conditions?

The Commission's position limit rulemaking proposes to retain certain agricultural position limits. At the same time, the proposal requests comment on whether these limits should be higher or based on open interest levels on a forward looking basis. The proposal to retain the current limits, along with the request for comment on other approaches, gives the Commission the flexibility to retain currently effective position

limits or adopt different limits, including those based on open interest levels on a forward looking basis.

6) As you probably know, swap dealers operating in the United States have different business models whereby some dealers are owned by U.S. companies while others are owned by foreign companies. How will the CFTC ensure that all swap dealers are treated on an equal basis so that neither model is advantaged or disadvantaged?

In implementing the Dodd-Frank Act, the Commission has sought to obtain the views of the entire spectrum of market participants and regulators. The Commission and its staff have worked extensively with fellow domestic and foreign regulators to ensure coordination and cooperation to the maximum degree practical. In proposing a swap dealer regulatory regime to protect the American public, Congress also gave the Commission the flexibility needed to address various situations. The Commission will carefully review and respond to public comments and the views of fellow regulators as it proceeds to final rules.

7) In many sections of the Dodd-Frank Act, the CFTC is required to assess the impact on liquidity of its proposals. Has the CFTC reviewed how its proposals will affect market liquidity? If so, what are the general results of that review?

In its proposed rulemakings, the CFTC considered how the rule proposals might affect liquidity in the swap markets through discussions with market participants, domestic and international regulators and other interested parties. The CFTC addressed those issues in the rulemakings. In addition, the Commission has sought public comment specifically with regard to expected liquidity impacts. The Commission will thoroughly and carefully review public comments before proceeding to consider final rules.

<u>Senator Pat Roberts</u>

1) End users are concerned that their hedging costs may indirectly go up if their counterparties are ultimately subjected to higher capital and margin requirements on end-user exempt transactions. Please tell me how increased margin requirements on counterparties with respect to end-user exempt transactions will contribute to overall decreased risk in our financial system. Also please tell me how requiring end users to devote more working capital to risk management margin will help contribute to economic growth and job creation.

To ensure the financial integrity of swap dealers and security-based swap dealers, Congress directed that prudential regulators, the SEC and the CFTC establish capital and margin requirements. The CFTC's proposed rule would not require margin for

uncleared swaps to be paid or collected on transactions involving non-financial end-users hedging or mitigating commercial risk.

2) Under Dodd-Frank the CFTC will set minimum capital requirements for non-bank swap dealers and MSPs. There is concern that your regulations on capital may make OTC derivatives trading cost prohibitive in the US if the Commission does not adopt a risk based capital approach consistent with Basel standards. What is the CFTC doing to ensure that non-bank swap dealers and MSPs are treated on an equal basis and can compute capital using a risk-based approach like banks?

The CFTC proposed rule to establish capital requirements for nonbank swap dealers and major swap participants was published in the Federal Register on May 12, 2011. The proposal fulfills the Dodd-Frank Act's mandate in Section 731 to establish capital rules for all registered swap dealers and major swap participants that are not banks, including nonbank subsidiaries of bank holding companies.

The proposed rule addresses capital requirements for swap dealers and major swap participants in three different categories: 1) if they are futures commission merchants (FCMs); 2) if they are subsidiaries of bank holding companies or systemically important financial institutions; or 3) if they are not in either category.

With regard to dealers that also are FCMs, generally speaking, the Commission's existing capital rules for FCMs would apply. This is to ensure that FCMs have sufficient capital to continue to carry and clear customer swaps and futures transactions cleared by a DCO.

The proposed rule would require dealers that are subsidiaries of bank holding companies or that have been designated as systemically important financial institutions by the Financial Stability Oversight Council (FSOC) to follow the rules set by the prudential regulators. For instance, a subsidiary of a U.S. bank holding company would have to comply with the capital requirements set by the Federal Reserve Board as if the subsidiary itself were a U.S. bank holding company. This is intended to prevent regulatory arbitrage and ensure consistency among capital regimes for those entities that are regulated by prudential regulators.

For those swap dealers and major swap participants that are not regulated for capital by a prudential regulator and are not FCMs, part of bank holding companies or systemically important financial institutions, the proposed rule departs from bank capital rules. It takes into consideration that these dealers are likely to have different balance sheets from those financial institutions that traditionally have been subject to prudential supervision. Such entities would be required to maintain a minimum level of tangible net equity greater than $20 million plus a measurement for market risk and a measurement for credit risk. This market risk and credit risk would be scaled to the dealers' activities and

be measured based upon swaps activity and related hedges. The proposal would allow such firms to recognize as part of their capital fixed assets and other assets that traditionally have not been recognized by prudential regulators.

The Commission has received public comment with regard to the proposed rule and will summarize and consider those comments before proceeding to consider a final rule

3) During the formulation of Dodd-Frank, you seemed to think there would be a couple dozen swap dealers. Now, apparently you believe there will be a couple hundred swap dealers. However, if the CFTC uses the "de minimus" exception that Congress included, then the number of entities designated as dealers will likely be closer to your estimate from last year. My question is: for these end-users that have a small amount of derivatives business, what reductions in systemic financial risk would you be achieving by designating them as swaps dealers, and have you performed any cost benefit analysis showing benefits exceeding costs?

In the joint rulemaking to further define the term "swap dealer," the SEC and the CFTC proposed factors for the de minimis exemption based on the aggregate effective notional amount of an entity's trades, its level of trading activity with special entities, the number of counterparties it transacts with and the number of swaps it trades. The Commissions specifically requested that the public provide comments regarding the proposal with respect to the de minimis exemption. Pursuant to section 15(a) of the CEA, the Commission considered the benefits and costs of the proposed rule's de minimis exemption. Public comment also was specifically requested with respect to costs and benefits.

4) The CFTC proposed rules for public reporting define what is a block trade based on the futures markets and set the reporting delay based on the corporate bond markets. Why do you believe it was appropriate to base these rules on the futures and bond markets when Dodd-Frank specifically tells the CFTC to set its rules based on particular swap markets? What is the CFTC doing to ensure that its final rules are based on the empirical analysis of the swap markets required by Dodd-Frank?

While the Commission examined the futures markets and the corporate bond markets, it also considered discussions with market participants, including swap dealers and end-users, in developing its proposal for block trades. The proposed block trade rules specified two tests for determining the appropriate minimum block size – the distribution test, which is analogous to a criterion used to set block sizes on futures markets, and the social size multiplier test, which is not used to determine block sizes in either the futures or bond markets. Under the proposed rules, the appropriate minimum block size would be the larger of these two tests. In this regard, the appropriate minimum block size would be dependent on observed transaction sizes in the swap market and would be consistent with former Agriculture Committee Chairwoman Blanche Lincoln's statement that "the

guiding principal in setting appropriate block trade levels should be that the vast majority of swap transactions should be exposed to the public through exchange trading."

The Commission sought comments from the public regarding the proposed block trade rules. The Commission will address the issue after taking into account comments received.

5) Many commenters have suggested that your proposed rule on block trades will be largely ineffective because it will not apply to more than 15 percent of what is currently being traded. What is your rationale for having such a restrictive view of block trades?

The proposed rule is designed to fulfill Congress's direction to bring public transparency to the entire swaps market, including both standardized and customized swaps. This post-trade transparency will enhance price discovery and liquidity while ensuring anonymity and protection for large trades in appropriate cases. Per Congress's direction, the proposal requires real time reporting for swap transaction and pricing data to occur as soon as technologically practicable for trades other than trades of large notional size (block trades). Congress mandated that these trades be reported without delay regardless of whether they are standardized or customized.

With regard to block trades or trades of large notional size, the proposed rule includes two important features: a time delay and a method to report the large sizes. With regard to the delay, the proposed rule includes a 15-minute delay on standardized blocks. This compares to the futures marketplace, which currently has a five-minute delay for blocks, and the equities marketplace, which has an even shorter delay. With regard to customized trades of large notional size, the proposal asks a series of questions as to whether a similar delay of 15 minutes would be appropriate for interest rate, currency and other financial swaps and what delays may be appropriate for customized large trades referencing physical commodities. The second important feature with regard to block trades or trades of large notional size is a reporting method that transactions greater than $250 million notional amount – even the very largest of trades – will just be reported as being greater than $250 million. This will protect anonymity and promote the liquidity of these large trades.

The proposal on real time reporting includes the methods by which to calculate what a block trade is across the market for various swap instruments. This will be based on data collected by the swap data repositories in each of the asset classes. Lastly, the proposal includes an initial implementation date of January 2012 to provide time for the initial setting of block sizes based on market data and time for market participants to prepare for such real time reporting requirements.

The transparency afforded through real time post-trade reporting will increase liquidity and enhance the price discover function of the market.

The Commission has received extensive public comment with regard to the proposed rule and will summarize and consider those comments before proceeding to consider a final rule.

6) As Commissioner Dunn has said, "To date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate or that position limits will prevent excessive speculation. The task then is for the CFTC staff to determine whether position limits are appropriate. With such a lack of concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does." Is the CFTC currently collecting data and performing any analyses that would shed light on this situation? If so, will it be completed in a timeframe that is meaningful to the current proposed rulemaking?

The Commission's proposed rule on position limits is designed to implement Congress' direction in the Dodd-Frank Act to ensure that the markets for physical commodities are made up of a broad group of market participants with a diversity of views. The Commission does obtain comprehensive data on futures markets participants through its large trader reporting system. The Commission's proposed rule on large swap trader reporting, once finalized, will provided data needed to effectively establish comprehensive, aggregate position limits.

7) I am concerned that many CFTC proposed rules will continue to erode the current principles-based regulatory structure for our futures exchanges by going back to the pre-CFMA days with prescriptive rules. The DCO and DCM core principles have been adequate to guide the operation of exchanges and clearing houses, allowing flexibility that permitted exchanges and clearing houses to operate successfully and without failure during the financial crisis. Given your budget constraints and the unlikelihood of it getting any better in the short term, how are you going to prioritize? Are you going to focus on bringing more transparency to the previously-unregulated OTC swaps market, or are you going to be spending resources making changes—that were not required by Dodd-Frank—to currently-regulated futures markets? If you intend to continue with these proposed changes to core principles for DCMs and DCOs, please provide me with the analyses and/or market failures that currently exist that are the basis for your continuation of DCO and DCM core principle changes.

The Commission's proposed rulemakings with regard to DCMs and DCOs are generally designed to bring Commission regulations in line with the Dodd-Frank Act's updates to the statutory core principles. For example, in the case of DCMs, the Act increased the number of core principles to 23 and modified existing core principles. As the Dodd-Frank Act allows DCMs to – for the first time – offer swaps in addition to futures and

commodity options, the proposal also is meant to account for that change. It is likewise important to update the rules and guidance for DCMs in light of the fact that the Commission also is promulgating rules and guidance for swap execution facilities, and many of the core principles are similar.

The Commission has received a number of comments on these proposed rulemakings and intends to take all those comments into consideration in determining whether to adopt specific rules, guidance and acceptable practices appropriate to particular situations.

8) The CFTC business conduct proposal would impose more restrictions on swaps than even those that exist in the retail futures and securities markets, and would transform dealers from counterparties to advisors even though Congress wanted to draw a clear distinction between the two. I also understand that these requirements would basically shut pension plans and municipalities out of the swap markets. What are you doing to address these issues?

The Commission's proposed rules on business conduct standards for swap dealers and major swap participants would implement the Dodd-Frank Act's requirements that they deal fairly with customers, provide balanced communications and disclose conflicts of interest and material incentives before entering into swaps. The proposed rule also would implement the Dodd-Frank Act's heightened duties on swap dealers and major swap participants when they deal with certain entities, such as pension plans, governmental entities and endowments. The Commission is working closely with the SEC and the Department of Labor (DOL) in an effort to address the concerns that have been raised regarding possible conflicts between the DOL's pension rules and the statutory requirements of Dodd-Frank. In addition, the Commission is reviewing public comments in connection with its proposed rule.

9) In testimony last month a number of market participants have expressed concerns related to the implementation of Title VII rules. Many experts have suggested that lack of logical order to the rulemaking process makes the July deadline simply too soon to finalize all of the new rules required by Dodd Frank and the establishment of what is essentially a new market. Indeed, Commissioner O'Malia recently wrote an article in the WSJ (February 26th) that recommended that the CFTC not vote on any final rules until the commission settles on an implementation strategy and a timeline that are realistic. Can you update the Committee on how you are going to sequence these rules so that the market can adjust to these changes? Given the significance of derivatives markets and the important risk management function they perform for the U.S. economy would a delay or statutory extension of Dodd-Frank assist your agency to propose effective rules and to achieve greater harmonization with other regulators?

To address these issues, the Commission re-opened most of its comment periods that had closed and extended some existing comment periods so that the public could provide comments in the context of the entire mosaic of proposed rules. That extended comment

period closed on June 3, 2011. In addition, on May 2 and 3, 2011, CFTC and SEC staff held roundtable sessions to obtain views of the public with regard to implementation dates of the various rulemakings. Prior to the roundtable, on April 29, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. The Commission is also receiving written comments on that subject. Since the beginning of the rulemaking process, the Commission has worked closely with Federal regulators and will continue to do so.

10) Given that the rulemaking timeframe in Dodd-Frank is problematic, do you believe it is important to provide affected parties additional time to institute the required IT and operational infrastructure for compliance with what is essentially a completely new regulatory regime for trading OTC derivatives?

The Dodd-Frank Act provides the Commission with ample flexibility to phase in implementation of requirements. In part, the purpose of the staff roundtables held by SEC and CFTC staff on May 2 and 3, 2011 and of the ongoing solicitation of written comments was to obtain information regarding such concerns to inform the final rulemaking process.

11) What thought has the Commission given to risks arising from US implementation of Dodd-Frank prior to finalization and implementation of derivatives regulation in other G20 regimes?

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

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

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

Through consultation, regulators are working to bring consistency to oversight of the swaps markets. In September of last year, the European Commission released its swaps proposal. The European Council and the European Parliament are now considering the proposal. Similar to the Dodd-Frank Act, the European Commission proposal covers the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. It is important that all standardized swaps – including exchange-traded swaps – are subject to mandatory central clearing. The proposal includes requirements for central clearing of swaps, robust oversight of central counterparties and reporting of all swaps to a trade repository.

The E.C. also is considering revisions to its existing Markets in Financial Instruments Directive (MiFID), which includes a trade execution requirement, the creation of a report with aggregate data on the markets similar to the CFTC's Commitments of Traders reports and accountability levels or position limits on various commodity markets.

12) In many sections of the statute (PTT, position limits, SEFs), the CFTC is required to assess the impact on liquidity of its proposals, and in none of the relevant notices of proposed rulemakings is there any discussion of the impact on liquidity. Has the CFTC reviewed how its PTT, SEF (including block trade definition) and position limit proposals will affect market liquidity? If so, what are the results of that review? If not, why not?

In its proposed rulemakings, the CFTC considered how the rule proposals might affect liquidity in the swap markets through discussions with market participants, domestic and international regulators and other interested parties. The CFTC addressed those issues in the rulemakings. In addition, the Commission has sought public comment specifically with regard to expected liquidity impacts. The CFTC will continue to analyze and study the effects of increased transparency on liquidity and will thoroughly and carefully review submitted public comments before proceeding to final rules.

13) The proposed rule on swap dealers would likely capture a number of farmer cooperatives, based on a cooperative doing such things as offering a local elevator a swap to offset the risk of that elevator offering forward contracting with farmers. If those cooperatives are considered dealers, increased regulatory costs will significantly curtail their ability to offer farmers and ranchers risk management tools such as forward contracts. Is it your intention to classify these cooperatives as dealers?

14) There are also several other agriculturally-oriented businesses who do essentially the same kinds of activities as farmer cooperatives, but are simply organized differently. Is it your

intention to distinguish between farmer cooperatives versus other kinds of agricultural businesses that all engage in essentially the same kinds of swaps activities with customers?

Response to 13 and 14: The Dodd-Frank Act includes a definition of the term swap dealer and also requires that the CFTC and the SEC jointly adopt rules further defining the term. The joint proposed rulemaking specifically requests that commenters inform the Commissions of their views regarding the appropriate treatment of agricultural cooperatives and of other dealers that limit their dealing activity primarily to swaps in agricultural commodities. The Commission will review, analyze and consider all public comments submitted in connection with this rulemaking before proceeding to issue a final rule.

15) Title VIII of Dodd-Frank tasked the Financial Stability Oversight Council (FSOC) with designating certain clearinghouses as "Systemically Important Financial Market Utilities." The designated clearinghouses will be "subject to enhanced examination, supervision, enforcement and reporting standards and requirements." An Advanced Notice of Proposed Rulemaking (ANPR) was released on this issue late last year. What is the FSOC's timeline for designating financial market utilities as Systemically Important? What issues have commenters identified in their responses to the ANPR?

The FSOC's proposed rule was published on March 28, 2011, and described the framework that the Council would use to determine whether a financial market utility should be designated as systemically important. The comment period closed on May 27. The FSOC will summarize and consider public comments before proceeding.

16) In the proposed definition of "swap dealer" the CFTC and the SEC have taken different approaches as to recognizing the difference between a "dealer" in a financial product and a "trader" in such product. Do the SEC and CFTC intend to ensure that there is ultimately single definition before promulgating a final rule?

In December 2010, the CFTC and the SEC jointly issued a proposed rule to further define the terms "swap dealer" and "security-based swap dealer." In the joint proposal, the CFTC and the SEC "recognize that the principles relevant to identifying dealing activity involving swaps can differ from comparable principles associated with security-based swaps. These differences are due, in part, to differences in how those instruments are used. For example, because security-based swaps may be used to hedge or gain economic exposure to underlying securities, there is a basis to build upon the same principles that are presently used to identify dealers for other types of securities."

Because security-based swaps are related to securities, the CFTC and SEC agreed that the dealer-trader distinction (which refers to the SEC's interpretation of aspects of the Securities Exchange Act of 1934) is "an important analytical tool to assist in determining whether a person is a 'security-based swap dealer.'" Swaps, unlike security-based swaps, are related to financial and non-financial commodities such as interest rates, currencies, agricultural commodities, energy commodities and metals.

The CFTC and the SEC agreed that it would not necessarily be appropriate to use principles developed to determine if a person is a securities dealer to determine if a person is a dealer in commodity swaps. The proposal requested comment on this interpretive approach. To date, there are more than 180 comments responding to the proposal. The use of the dealer-trader distinction will be addressed in the final rules relating to the swap dealer and security-based swap dealer definitions, after taking the comments into account.

17) We understand the agencies are struggling to cope with resource shortages. The Commissioners and staff deserve enormous credit for their efforts; however, Dodd-Frank is a wasteful and inefficient regime for taxpayers and U.S. businesses. Proposed rules would require banks to be regulated by at least three regulators and individual lines of business will be regulated by both the SEC and the CFTC with respect to essentially the same activity (e.g., index vs. single name CDS). Have you actively sought opportunities to coordinate and harmonize rules with the Fed and each other to leverage resources and eliminate wasteful duplication of rule making?

Yes. The CFTC, the SEC, other Federal regulators and their staffs are and have been in frequent contact throughout the process of implementing the reforms of the Dodd-Frank Act.

18) Financial entities – including banks and thrifts – generally do not qualify as end users under DFA. However, DFA requires both the CFTC and the SEC to consider whether small banks and thrifts with total assets of $10 billion or less should be eligible for treatment as end users. The CFTC and the SEC have issued proposed rules on the end-user exception to mandatory clearing--The SEC's rule proposal includes would explicitly allow banks and thrifts with total assets of $10 billion or less to qualify as end users. And also "preliminarily believes" that it would be appropriate to provide this end user exemption because it believes that small banks and thrifts do small volumes; the CFTC's rule proposal does not propose specific language and simply asks for comments about a possible end-user exemption for small banks and thrifts. What are the implications for these smaller banks and thrifts if the CFTC chooses not to implement an exemption analogous to that proposed by the SEC?

If not exempted from the definition of "financial entity," smaller banks and thrifts would, like other financial entities, be subject to the clearing and trade execution requirements to

the extent they engage in swaps to which those requirements apply. As you noted, the Commission specifically requested that commenters address the question of the exemption and of any requirements that should apply to small banks, savings associations, farm credit system institutions and credit union that, if permitted, elect to use the clearing exception. The Commission looks forward to reviewing comments in this area.

19) There are several sections of Dodd-Frank that require the SEC to work jointly with the CFTC on issues of importance. It is clear that Congress would like the CFTC and SEC to work more closely together and try, for lack of a better term, to get along. Specifically, Section 713 requires the SEC and CFTC to work together to issue rules related to portfolio margining, which reduces systemic risk by combining potentially offsetting positions in securities and futures products into a single portfolio for margin and settlement purposes. Please describe the efforts you and your staff have undertaken to work with your counterparts in order to issue rules related to portfolio margining.

The SEC and the CFTC are working well and cooperatively together. The Commissions have worked together to propose joint rules further defining entities (swap dealers, security-based swap dealers, major swap participants, major security-based swap participants and eligible contract participants) and further defining products covered under title VII of the Dodd-Frank Act. In other areas where rules are not being written on a joint basis, there is a great deal of shared communication. Staffs from the two Commissions meet frequently on related rules and share draft term sheets, memos and other work product. Staffs of the two agencies have jointly hosted seven public roundtables to further public discussion regarding particular aspects of Dodd-Frank implementation. The joint roundtables have served as opportunities to discuss governance and conflicts of interest in the clearing and listing of swaps, swap data, swap data repositories and real time reporting, swap execution facilities and security-based swap execution facilities, credit default swaps, capital and margin for swaps and security-based swaps and implementation schedules for the various rules.

Towards meeting statutory goals regarding portfolio margining, the CFTC's proposed rule on general requirements for DCOs addresses procedures for approval. Any DCO seeking to provide clearing and settlement services for a futures portfolio margining account would submit its proposal to the Commission for approval. Further consultation between the CFTC and SEC, as well as industry views, will inform the Commission on strategies to facilitate the implementation of such programs for qualified participants.

Senator Patrick Leahy

1) As you noted in your testimony, Congress recognized the difference in the levels of risk posed by transactions between financial entities and transactions between non-financial entities. Our intent was to impose strict margin requirements on financial entities, while protecting

designated end-users that rely on the underlying commodities, such as gas or oil, to operate their businesses by enabling them to continue to hedge their business risks without such margin requirements.

I am concerned that the U.S. Commodity Futures Trading Commission ("CFTC") is positioning itself to impose margin requirements on counterparties to these designated transactions, which will result in higher costs to end users. If our commercial end-user transactions, for example those by our public power utilities, are required to post collateral to engage in derivatives trading it could severely limit and possibly eliminate the use of such risk protection tools and result in higher costs or greater price volatility for consumers.

Can you explain to me how the CFTC will strictly follow the Congressional intent for the end-user exemption?

In keeping with Congressional intent, the Commission's proposed rule on margin for swap dealers and major swap participants would not require margin to be paid or collected on transactions involving non-financial end-users hedging or mitigating commercial risk.

2) As you discuss in your testimony, the derivatives industry is a vital component of the United States financial system. There is little doubt that a lack of oversight in this industry contributed significantly to our country's 2008 financial crisis. For this reason, I am encouraged that the CFTC's proposed rulemaking to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") includes rules designed to increase oversight of the derivatives market.

Certain of these proposed rules are designed to ensure accountability by also promoting competition in the derivatives market. Pursuant to Section 726 of the Dodd-Frank Act, the CFTC's proposed rules impose certain ownership limits on Designated Contract Markets ("DCM") and Swap Execution Facilities ("SEF"). However, the Justice Department expressed concern in its written comments that these rules may still provide an opportunity for anticompetitive conduct where a group of powerful entities owns a controlling share of a DCM or SEF.

Did the CFTC consider including an aggregate dealer ownership cap for DCMs or SEFs?

Why does the CFTC's proposed rulemaking not provide some aggregate cap for dealer ownership of DCMs and SEFs?

The Commission's proposed rule on governance for DCOs, DCMs and SEFs is designed to advance the goals of the Dodd-Frank Act that clearinghouses and trading platforms have open decision-making and that their governance be protected from potential conflicts of interest. Such conflicts may arise with respect to determinations regarding the clearing and trading of swaps; access to such clearing and trading; and in the responsibilities of registrants for overseeing their members for compliance. Open

governance is important to promoting competition amongst trading platforms as well as to lowering risk to the American public by ensuring that as many standardized swaps are cleared as are appropriate.

The CFTC proposal has two important components. One is with regard to the functioning of the boards of directors and the inclusion of a sufficient number of public directors.

The second component is related to possible limits to the voting control of clearinghouses and exchanges. The proposal recommends no aggregate limits on such voting control of trading platforms but does propose a limit of 20 percent on any individual member. With regard to clearinghouses, the proposal would set an aggregate limit of 40 percent of voting control for certain entities, but also has another option. The second option places no aggregate limit if the voting ownership is more diverse, with no one member or named entity holding more than 5 percent. The proposed rule's development was informed by preliminary public comment – including comment provided through a joint SEC/CFTC staff roundtable – and designed to address the conflicts of interest identified in the Dodd-Frank Act. The Commission and staff stressed the desire for additional public comment in preparation for a final rule.
The Commission has received extensive public comment with regard in response to the proposed rule and will summarize and consider those comments before proceeding to consider a final rule.

3) I have long been a supporter of the whistleblower provisions of the False Claims Act as an important tool to leverage government resources in the investigation and prosecution of fraud. The Department of Justice has worked closely with whistleblowers in using that statute to recover more than $27 billion since the Act was strengthened in 1986. Due in part to the Department of Justice's great success working with whistleblowers, I worked to see similar provisions included in the Dodd-Frank Act.

   Given its significant experience working with whistleblowers, to what extent and in what ways are you consulting with the Department of Justice as you establish the CFTC whistleblower program?

   Prior to developing a proposed rule, CFTC staff met with Department of Justice officials who provided valuable consultation in advance of the Commission's action.

<u>Senator Tom Harkin</u>

1) <u>Excessive Speculation and Position Limits</u>
   The Dodd-Frank Act provides clear direction and authority for the CFTC to issue rules to prevent excessive speculation and its consequences. There are a good number of very knowledgeable, smart people who are convinced that the CFTC needs to have strong

regulations to guard against excessive speculation, and I called upon the Commission to move ahead and issue a proposed rule for consideration, as it has done. Now, I acknowledge there is a lot of disagreement with respect to the concept of excessive speculation and steps to deal with it. But surely there is a way to devise reasonable rules that will allow the markets to function, allow traders and investors to participate in markets, but that will protect consumers and our overall economy against the negative consequences of excessive speculation in the commodity markets. Can I have your assurance that you are going to push ahead aggressively to deliver a final rule that is workable yet that also has real teeth in it?

It is essential to complete the task of implementing the aggregate position limits regime that Congress mandated to guard against the burdens of excessive speculation. The Commission is in the final stage of the position limits rulemaking process. As part of the process, the Commission has received many comments, including comments from market participants, public interest groups and individuals. The Commission will thoroughly review these comments and will adjust the proposed rulemaking to craft reasonable and robust final rules.

2) End Users and Margin:
Since the enactment of Dodd-Frank, much has been made over the issue of margin, particularly the impact on commercial end-users that are exempt from the clearing requirement. Margin, which is the cash that parties to derivatives contracts have to put forward in order to cover their positions as the market moves one way or the other, is essential to ensuring there is enough capital in the system to cover the risks of contract. In simpler terms, margin is designed to compensate for counterparty credit risk. The Dodd-Frank Act requires the posting of margin by swap dealers and major swap participants, including as to derivative contracts that are otherwise exempt from the clearing requirement. I have two questions about this issue.

First, I have heard from a number of firms who argue that if they are required to post margin on their derivative contract positions they will be tying up excess capital that they could otherwise use to expand lending and credit to businesses. How do the Commissions view that position?

Second, I am also interested in this issue as it relates to the pricing of derivatives contracts. Prior to the reforms of Dodd-Frank swaps dealers often did not require their counterparties to post significant margin, if any at all. However, they certainly had to account for their counterparty's credit risk or at least should have, and it seems that the dealer would account for risk by increasing the price of those derivatives contracts according to the risk the dealer was taking on. Now, however, with margin explicitly required under Dodd-Frank for swap dealers and major swap participants, it seems that counterparty credit risk no longer needs to be priced implicitly into the contract but instead can be pulled out of the contract's price and transparently addressed through the setting of margin under the margin requirements. That should make the price of these contracts go down for non-financial end-users, assuming that they generally pose less counter-party risk. Do you agree with that analysis? If not, why not?

To ensure the financial integrity of swap dealers and security-based swap dealers, Congress directed that prudential regulators, the SEC and the CFTC establish capital and margin requirements. The CFTC's proposed rule would not require margin for uncleared swaps to be paid or collected on transactions involving non-financial end-users hedging or mitigating commercial risk. 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, and the proposed rule is meant to be consistent with Congressional intent in that regard. It is true, however, that, where margin arrangements between a swap dealer and another party are not explicit, the strength of the counterparty's credit will affect the swap's pricing. It is perfectly reasonable to assume that where margin is posted as collateral to account for credit risk, the pricing on the swap will be adjusted as well.

3) Data Collection and Swap Data Repositories:
One of the key issues facing the Commissions going forward concerns Swap Data Repositories. Indeed, the ability to collect trade level data with unique identifiers is essential to enforcing the Act's reforms, including the Volcker Rule. What steps are the Commissions taking to gather trade-by-trade level data? In addition, what data do the Commissions believe they can collect for each trade? How do the Commissions intend to identify currently existing contracts that are required to be reported to the Commissions under the terms of the Act?

Working closely with the SEC, other regulators and market participants, CFTC staff is proceeding diligently on this matter. Staff has focused its efforts on implementing systems of identifying both swap counterparties with Legal Entity Identifiers (LEI) and swaps products with Unique Product Identifiers (UPI). Significant progress was reached in the area of LEI and work is underway to implement this system as a cooperative project between regulators and the industry. Specifically with regard to swap product classification and identification, Commission staff is actively involved in the coordination of various efforts where the purpose is to achieve a universally-applicable method. Implementation of a universal system of swap product classification and identification will facilitate the efficient fulfillment of Dodd-Frank Act regulatory protections. In addition to engaging in numerous meetings with industry and the public, CFTC staff held a roundtable on June 8, 2011, to engage more broadly in public discussion.

4) Governance, Conflicts of Interest, and Ownership Shares:
I was pleased to see both Commissions promptly put forward proposed rules to implement Sections 726 and 765 of the Dodd-Frank Act, which place certain requirements on Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities to mitigate conflicts of interest. Last year, I submitted comments to both Commissions to express

my concern that these proposed rules did not go far enough toward including an aggregate ownership cap on large market participants. As I wrote to the Commissions:

"Spreading ownership between multiple enumerated entities through an aggregate cap will force large entities to invest in multiple SEFs and DCMs, helping to increase liquidity and enhance price transparency. In addition, diverse ownership will help encourage innovation in this area, enhancing market efficiency and transparency. An aggregate cap on ownership will help to ensure these outcomes. "

I was also interested to see the Department of Justice's comment that the lack of an aggregate ownership cap on major derivatives dealers "may not sufficiently protect and promote competition in the industry."

What steps are the Commissions taking to address these concerns relating to governance, conflicts of interest, and ownership shares as you move toward issuing final rules and when do you expect these rules to be finalized?

The Dodd-Frank Act directs the Commission to adopt rules to mitigate conflicts of interest and provides that the rules may include "numerical limits…on control" or "voting rights" that bank holding companies, swap dealers and other specified entities may hold with respect to DCOs, DCMs and SEFs.

The Act also directs the Commission to adopt rules determined to be necessary or appropriate to improve the governance, mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants, on the one hand, and DCOs, DCMs and SEFs on the other.

The Commission is directed to consider the manner in which its rules address conflicts of interest in the interaction arising from equity ownership, voting structure or other governance arrangements of the relevant DCOs, DCMs and SEFs.

The Commission's proposed rule on governance for DCOs, DCMs and SEFs is designed to advance the goals of open decision-making and prevention of potential conflicts of interest. Such conflicts may arise with respect to determinations regarding the clearing and trading of swaps; access to such clearing and trading; and in the responsibilities of registrants oversee their members for compliance. Open governance is important to promoting competition amongst trading platforms as well as to lowering risk to the American public by ensuring that as many standardized swaps are cleared as is appropriate.

The CFTC proposal has two main components. One is with regard to the functioning of the boards of directors and the inclusion of a sufficient number of public directors.

The second component relates to limiting the voting control of clearinghouses and exchanges. The proposal recommends no aggregate limits on such voting control of trading platforms but does propose a limit of 20 percent on any individual member. With regard to clearinghouses, the proposal would set an aggregate limit of 40 percent of voting control for certain entities, but also has another option. The second option places no aggregate limit if the voting ownership is more diverse, with no one member or named entity holding more than 5 percent. Importantly, the proposal also recommends that the Commission retain the authority in certain circumstances to grant exemptions to ownership limits.

The Commission has received extensive public comment with regard to the proposed rule and will summarize and consider those comments before proceeding to consider a final rule.

Senator Ben Nelson

1) Recordkeeping and Reporting: As you know, commercial end-users will be able to except their swaps from the new clearing and exchange-trading requirements under Dodd-Frank if they are using the swaps to hedge "commercial risk" – something you discussed in the recent House Agriculture Committee hearing. The rural electric cooperatives in my state and across the country would like to continue their commercial risk management and public service activities with the fewest possible changes to the way they've done business safely and reliably for more than 70 years. If end-users are merely using swaps to hedge risk, then why subject them to more than the absolute minimum necessary CFTC jurisdiction – such as once-a-year filings or "CFTC-lite" regulations?

In passing the Dodd-Frank Act, Congress recognized the different levels of risk posed by transactions between financial entities and those that involve non-financial entities, as reflected in the non-financial end-user exception to clearing. The CFTC also has recognized this, for example, in its proposed rule regarding margin requirements for swap dealers and major swap participants. For any transaction involving a non-financial end-user engaged in hedging or mitigating commercial risk, neither party is required to post margin.

Before the Commission proceeds to final rules, Commission staff will read and summarize all submitted public comments, and Commissioners will have the opportunity to review comments and provide feedback.

2) Implementation and Transition Periods: If the CFTC requires each end-user that wants to hedge its risk of future power price volatility (using real financial swaps, or simply buying power or natural gas forwards or commercial options) to keep electronic records like a financial trading house, and report in seconds or minutes like it was trading credit, currency or other exotic financial instruments – the costs of system changes and administrative staffing will be significant. Given that the vast majority of transactions in the electric utility arena are end user to end user, even extended transition periods for end users may not suffice if counterparties cannot "trade" with our members until we are transitioned. End users -- especially those with public service obligations to deliver energy like the rural electric co-ops -- don't have the option to just stop hedging risk until they're ready to comply with CFTC regulation. How will the CFTC deal with the fact that end users need to be able to continue their commercial business and risk management activities?

The proposed Real Time Public Reporting rules require swap participants to report swap transaction and pricing data as soon as technologically practicable but recognizes that what is technologically practicable will vary depending on the reporting entity. The proposed rules also specify that reporting parties, swap markets and registered SDRs retain reportable swap data for a period of five years so that transactions can be re-created for trade practice surveillance and compliance. The Commission received comments on the proposed recordkeeping requirements and is evaluating those comments.

Senator Kirsten Gillibrand

1) As you know, implementing the requirements of the Dodd Frank Act will require the participants in the derivatives markets as well as the CFTC and the SEC to develop, assemble, test and implement a complex technology infrastructure. Could you give us your views on what new technologies will need to be developed and how long you expect will be required for these technologies to be fully functioning, in each case for the industry participants and for your two agencies?

Full implementation of the Dodd-Frank regulatory structure for the swaps markets will involve the employment by industry of the newest technologies available. Both the need for an efficient market and the demands on regulatory agencies will require that technology be fully exploited. As one example, the swap data repositories that will collect and store transaction data will need to have up-to-date systems. As the regulators are to also have direct access to SDR data, we too will need to ensure that our systems are compatible with those of the SDRs and are up-to-date.

Senator Saxby Chambliss

1) The Dodd-Frank Act provided the CFTC with discretionary authority to implement a registration requirement for foreign boards of trade. While the registration was not required by the Act, the Commission has chosen to exercise this authority and therefore the Act does require you to consider any previous findings that a foreign board of trade is subject to comparable regulation in their home jurisdiction. There are several such foreign boards of trade that have been operating in the US for many years based upon the CFTC staff finding that they are comparably regulated. Why now would these boards of trade be required to resubmit their documentation to prove that their regulations are comparable? And given the limited resources at the CFTC how many staff are going to be devoted to reviewing this information which they may in fact have already reviewed previously?

The foreign board of trade (FBOT) registration system will replace the CFTC's current practice of issuing no-action letters to such FBOTs. Importantly, a registration structure will bring consistency and transparency to the Commission's oversight of such entities. The Commission's proposed rule also would provide that FBOTs subject to comparable and comprehensive supervision and regulation in their home country and that meet conditions outlined in the proposal would be allowed to make available swaps contracts through direct access to U.S. market participants. The President's Budget request for FY 2012 estimates that the CFTC requires four additional FTEs to carry out the FBOT registration provisions. We look forward to reviewing public comments on this issue.

2) As you know, the original House-passed bill contained a provision to limit ownership interest in regulated entities – both individual and aggregate ownership limits – the so called "Lynch Amendment"; the Senate bill contained no such provision; and the final Conference agreement also contained no mandate for such limits. However, the Commission has now proposed ownership restrictions on both clearinghouses and exchanges within their conflicts of interest rule. What led the Commission to determine such restrictions are necessary, particularly given the fact that Congress made a very conscious effort to strip this requirement from the final conference report and replaced it with a discretionary allowance?

The Commission's proposed rule on governance for DCOs, DCMs and SEFs implements Section 726 of the Dodd-Frank Act, which requires the Commission to mitigate conflicts of interest in the operation of certain DCOs, DCMs and SEFs. It is designed to advance the goals of the Dodd-Frank Act that clearinghouses and trading platforms have open decision-making and that their governance be protected from potential conflicts of interest. Such conflicts may arise with respect to determinations regarding the clearing and trading of swaps; access to such clearing and trading; and in the responsibilities of registrants for overseeing their members for compliance. Open governance is important to promoting competition amongst trading platforms as well as to lowering risk to the American public by ensuring that as many standardized swaps are cleared as possible.

Specifically, Section 726(a) of the Dodd-Frank Act expressly empowers the Commission to adopt "numerical limits…on control" or "voting rights" that enumerated entities may hold with respect to such DCOs, DCMs, and SEFs. Enumerated entities include: (i) bank holding companies with more than $50,000,000,000 in total consolidated assets; (ii) nonbank financial companies supervised by the Board of Governors of the Federal Reserve System; (iii) affiliates of (i) or (ii); (iv) swap dealers; (v) major swap participants; or (vi) associated persons of (iv) or (v).

Section 726(b) of the Dodd-Frank Act directs the Commission to adopt rules determined to be necessary or appropriate to improve the governance of certain DCOs, DCMs or SEFs or to mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with the interaction between swap dealers and major swap participants, on the one hand, and such DCOs, DCMs and SEFs.

Section 726(c) of the Dodd-Frank Act directs the Commission to consider the manner in which its rules address conflicts of interest in the abovementioned interaction arising from equity ownership, voting structure or other governance arrangements of the relevant DCOs, DCMs and SEFs.

The CFTC proposal has two important components. One is with regard to the functioning of the boards of directors and the inclusion of a sufficient number of public directors.

The second component is related to possible limits to the voting control of trading platforms and clearinghouses. The proposal recommends no aggregate limits on such voting control of trading platforms but does propose a limit of 20 percent on any individual member. With regard to clearinghouses, the proposal would set an aggregate limit of 40 percent of voting control for certain entities, but it also has another option: placing no aggregate limit if the voting ownership is more diverse, with no one member or named entity holding more than 5 percent. Importantly, the proposal also recommends that the Commission retain the authority in certain circumstances to grant exemptions to ownership limits.

The Commission has received extensive public comment with regard to the proposed rule and will summarize and consider those comments before proceeding to consider a final rule.

3) The Dodd-Frank Act requires both the SEC and the CFTC to create rules to implement whistleblower programs. The SEC and the CFTC have separately issued proposed rules. Some companies will be subject to both sets of rules. Is there anything about the types of products that the SEC and CFTC regulate that should result in differences under a whistleblower program? Can you please describe the steps the SEC and CFTC have taken to ensure that the rules are similar, and do not impose unnecessary compliance burdens on companies by

requiring different standards? Are there any areas or compelling reasons why the two sets of rules should not be identical?

CFTC staff has consulted with SEC staff regarding drafting of rules to implement the agencies' respective Dodd-Frank Act whistleblower provisions. The CFTC's proposed rulemaking is not expected to impose any regulatory burden on companies that would logically require any change to their compliance systems.

Due to factors unrelated to the differences between the products the CFTC and SEC regulate, the CFTC's and SEC's proposed rulemakings are similar but not identical. While similar, the statutory provisions governing the two regimes are not identical. In addition, some terms of the SEC's statutory provision are defined under the Securities Exchange Act of 1934 or are terms of art under SEC case law, and there is no comparable CFTC precedent. Another factor leading to differences is that the SEC has an existing whistleblower program for insider trading violations and existing obligations for certain persons to report violations to it.

4) In granting the CFTC the authority to set position limits to prevent excessive speculation, Congress also granted the CFTC the authority to exempt certain types of traders and swaps. Under the proposed rule issued in January, however, the CFTC grants no exemptions from position limits, essentially ignoring the fundamental differences between futures market participants, mostly notably placing investors in mutual funds in the same category as market speculators. CFTC Commissioner Sommers has expressed her concern that the proposed rule fails to consider imposing different limits on different groups or classes of traders, as contemplated by Dodd-Frank. During your recent testimony before the House Financial Services Committee, you stated you were keeping an "open mind" on the matter. Under what conditions is the CFTC prepared to use its exemptive authority under Dodd-Frank to ensure that the final rules promulgated are appropriately and narrowly tailored to achieve their objectives without causing unintended harm to the markets or ordinary investors such as those who hold mutual funds?

As noted, the Dodd-Frank Act provides the Commission with the authority to exempt persons or transactions from any position limits it establishes. The Commission is in the final stage of its position limits rulemaking process. As part of the process, the Commission has received more than 12,000 comments, including comments from market participants, public interest groups and individuals. The Commission will thoroughly review these comments and will respond to them in developing a final rule.

5) Dodd-Frank directs the CFTC to adopt position limits "as appropriate." Given that the CFTC does not currently have comprehensive data for the swap markets, how does it intend to ensure that the formulas it uses to set limits will be appropriate - particularly for non-spot months for which there is less trading data currently available? Isn't there a real danger that the CFTC will set position limits prematurely, impeding the liquidity of the U.S. futures markets and perhaps

driving business out of the U.S. onto foreign boards of trade? CFTC Commissioner Sommers and O'Malia have noted that imposing position limits without a thorough understanding of these markets is a flawed approach. Given this lack of data and the fact that the CFTC does not currently even know the size of the commodity swap market, shouldn't the CFTC wait to implement Phase Two of the position limit proposal until it has more information?

The Commission's proposed rule establishes position limits in agriculture, energy and metals markets. It includes one position limits regime for the spot month and another regime for single-month and all-months combined limits. It would implement spot-month limits, which are currently set in agriculture, energy and metals markets, sooner than the single-month or all-months-combined limits. Single-month and all-months-combined limits, which currently are only set for certain agricultural contracts, would be re-established in the energy and metals markets and be extended to certain swaps. Under the proposed rule, these limits would be set using a formula based on data on the total size of the swaps and futures market collected through the position reporting rule. Those limits depend on the Commission's obtaining additional information regarding the market.

<u>Senator Thad Cochran</u>

1) I am concerned that the CFTC's current budget constraints, combined with the significant increase in its regulation proposals for the OTC market, will result in a lack of available resources to regulate the futures market and create an unnecessary burden on the competitiveness and innovation of the well-functioning futures market. How will you ensure that your regulatory efforts in the OTC market will not be excessive to the point of causing collateral damage to the futures market?

The President's Budget proposes that $308 million be appropriated for the CFTC for FY 2012. This funding level would enable the agency to perform its responsibilities both in the oversight of commodity futures markets and in beginning to oversee the swaps markets.

In 2008, both the financial system and the financial regulatory system failed the test for the American public. Though there were many causes to the crisis, the unregulated swaps market played a central role. The President's budget request asks for $140 million more than our FY 2010 funding level because the 2008 financial crisis was very real, and Congress mandated that regulation be brought to the swaps market.

The CFTC is a good investment for the American public, overseeing vast markets with a relatively small staff. At its core, the mission of the CFTC is to ensure the integrity and transparency of derivatives markets so that hedgers and investors may use them with

confidence. Derivatives emerged as tools to allow producers and merchants to be certain of the prices of commodities that they planned to use or sell in the future. Derivatives markets are used to hedge risk and discover prices and work best when they are transparent and free from fraud and manipulation.

2) Chairman Gensler, at this point, given what you know about the substantive and procedural difficulties involved in moving all those regulatory actions, as well as the limited financial and personnel resources the agency has available to accomplish all that activity, do you believe that Congress should extend the deadlines for CFTC to meet all its obligations under Dodd-Frank? Would extending those deadlines allow CFTC to produce a better, more thoughtful set of regulations?

   The Dodd-Frank Act has a deadline of 360 days after enactment for completion of the bulk of our rulemakings – July 16, 2011. The Dodd-Frank Act and the Commodity Exchange Act give the CFTC the flexibility and authority needed to address the issues relating to the effective dates of Title VII. The Commission scheduled public meetings in July and August to begin considering final rules under Dodd-Frank, and we envision having more meetings in September and into the fall to take up final rules.

   The Commission is taking sufficient time to carefully prepare its rulemakings and to take full advantage of the more than 20,000 public comments that have been submitted in connection with 51 proposed rules issued to implement the Dodd-Frank Act.

3) The CFTC is in the process of imposing position limits that have been promulgated without first making the findings required by Dodd-Frank. As CFTC Commissioner Mike Dunn has stated publicly, none of the CFTC's internal reports and none of the responsible economic studies demonstrate that excessive speculation has caused abnormal price movements. Even Nobel Prize winning economist Paul Krugman has written that recent increases in commodities prices have more to do with supply and demand rather than speculation. Shouldn't the CFTC provide a rigorous economic analysis of the costs, benefits, and regulatory impact of its position limits rule before finalizing its proposed position limits rule, which could have a significant impact on the markets and the broader economy?

   Since 1936, the Commodity Exchange Act has prescribed position limits to protect against the burdens of excessive speculation, including those caused by large concentrated positions. Between the CFTC and the futures exchanges, there are currently position limits in the spot month on physical delivery contracts in the agricultural, energy and metals markets. There also are position limits in a number of financial contracts.

   In addition to these spot month limits, between Federally-set position limits and those set by exchanges, there also are a number of agricultural contracts that have single-month and all-months-combined position limits. The exchanges had set all-months-combined

limits in energy markets until 2001 and in metals markets earlier, after which the limits were replaced with position accountability regimes.

The Commission has significant historical experience in the administration of position limit requirements. In January, pursuant to the requirements of the Dodd-Frank Act, the Commission proposed a position limit regime for energy, metal and agricultural contracts. More than 12,000 comments have been submitted and will ensure that the Commission is fully informed by a range of views with respect to the rulemaking. The Commission will move forward to consideration of a final rule after staff can analyze, summarize and consider comments, and after the Commissioners are able to discuss the comments and provide feedback to staff.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act
Questions for the Record
Ms. Jill Harlan
Thursday, March 3, 2011

Senator Pat Roberts

1) Please comment briefly on the timing, sequencing, and analysis of the SEC and CFTC proposed rulemakings. In particular, are the proposed rules providing people with enough certainty about regulatory requirements; are they providing people with enough analysis about the rationale for the rules; and are they allowing adequate time for people to comment? Do you think the agencies will meet the 1-year deadline, or even should meet the 1-year deadline? We think it would be extremely helpful to have the definitions (e.g. swap, swap dealer, commercial risk etc.) completed and a ruling from the Treasury Secretary regarding the exclusion/inclusion of foreign exchange swaps and forwards before other rules are finalized. It is difficult for market participants to provide comments without clear direction regarding their status based on the definitions. We don't believe the agency will or should meet the one-year deadline and, indeed, believe that the deadline for promulgating final rules should be extended. The quality of the rules should take precedence over a hurried timeline. We are still very concerned about the damage of unintended consequences. We also believe that the CFTC should conduct more thorough cost-benefit analyses of the rules it is proposing. We know that many of these rules will impose costs on end-users, yet we have seen no analysis of how those costs balance against benefits that the rules are likely to achieve.

2) How would a retroactive margin requirement impact the standing agreements you have with your counterparties? What would be the impact on liquidity for end-users? While there would be an administrative burden to adjust our agreements, our main concern is the liquidity issue. If required to post margin, especially retroactively, we would be forced to either post the margin, which would reduce other uses for cash flow, including investments and capital expenditures or offset outstanding contracts and add the foreign exchange, interest rate and commodity risk back to our corporate results. We note that we have not conducted a legal analysis of how a retroactive requirement would affect existing contracts, including rights and responsibilities thereunder.

3) Do you agree with the idea that clearing and exchange trading are better for end-users, because it prevents dealers from charging them high prices? No. We believe the counterparties, who in our case are corporate banks, should have the right to differentiate price based on their assessment of the end-users risk and considering their overall business relationship with an end-user, just as end-users have the right to choose among potential counterparties. When we enter into a transaction, we normally obtain multiple bids and have real time access to market prices.

4) How do you deal with counterparty risk in your OTC transactions today? We set credit limits for each of our counterparties and regularly measure the amount of capacity utilized. If a limit is reached, we diversify to other counterparties.

Senate Committee on Agriculture, Nutrition & Forestry
Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act
Questions for the Record
Chairman Mary Schapiro
Thursday, March 3, 2011

Chairwoman Debbie Stabenow

Question 1: The Federal Reserve published a study on risk retention that recommended that regulators should recognize that "one size does not fit all." Given the proven track record of current auto ABS practices on risk retention – and the fact there is a cost penalty associated with holding a vertical slice – how seriously are you looking at the Fed's study in the risk retention area?

Answer: In making recommendations for proposed rules to the Commission, the staff closely analyzed the Federal Reserve Board's "Report to the Congress on Risk Retention," released October 2010. As you may know, the Commission and other regulators jointly proposed rules regarding risk retention at the end of March 2011. In this regard, the joint proposed regulation takes into account the diversity of assets that are securitized, the structures historically used in securitizations, and the manner in which securitizers may have historically retained exposure to the credit risk of the assets they securitize. For example, the proposed rules provide several options a securitizer may choose among to meet risk retention obligations under section 15G of the Securities Exchange Act of 1934, including, among other options, retention of a five percent "vertical" slice of each class of interests issued in the securitization or retention of a five percent "horizontal" first-loss interest in the securitization. The proposal takes into account the manners in which risk retention often have occurred in ABS backed by credit card receivables, automobile loan and lease securitizations, as well as other asset classes.

Question 2: I have heard from some Michigan companies that the horizontal slice approach actually provides greater investor protection in the auto ABS sector because it will require the issuer to fully absorb losses first, do you agree?

Answer: As noted above, the jointly proposed rules provide several options a securitizer may choose among to meet its risk retention obligations under section 15G of the Securities Exchange Act of 1934. The proposal is designed so that each of the various options for allowed risk retention meet the statute's goal of better underwriting and alignment of interest. The proposed rules issued jointly by the Commission and other regulators at the end of March 2011 include a horizontal slice approach as an option that would be an acceptable form of risk retention for all types of asset classes, including auto ABS. Specifically, as proposed, a sponsor would be permitted to satisfy its risk retention obligations by retaining a horizontal residual interest in the issuing entity in an amount that is equal to at least five percent of the par value of all interests in the issuing entity that are issued as part of the securitization. Because it is possible to structure ABS so that horizontal retention is negated, the proposed rules include conditions governing the horizontal slice option intended to make the option meet the objectives of the statute. I look forward to reviewing the public comments on this proposed approach.

Question 3: As you know, protecting consumer privacy was central to the Dodd-Frank legislation. How do you intend to address consumer privacy issues with regards to loan level disclosure rules?

Answer: Section 942(b) of the Dodd-Frank Act requires the SEC to adopt regulations requiring each issuer of an asset-backed security to disclose, at a minimum, asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence. In April 2010, prior to the enactment of the Dodd-Frank Act, the Commission proposed rules (the "2010 ABS Proposals") that would revise the disclosure, reporting and offering process for asset-backed securities.[1] The 2010 ABS Proposals would require issuers of any registered asset-backed security to provide loan-level disclosures at the time of securitization and on an ongoing basis.

The loan-level data would cover items such as the terms and underwriting of the loan, credit information about the borrower, and/or characteristics of the property securing the loan. As the Commission discussed in the 2010 ABS Proposing Release, we are sensitive to the possibility that certain asset-level disclosure may raise concerns about the personal privacy of the underlying obligors.[2] Information about location of the property, credit scores, employment status and income, for example, would permit investors to perform better credit analysis of the underlying assets. We noted, however, that requiring disclosure about the geographic location of the obligor, or the collateralized property, credit scores, income and debt may raise privacy concerns.

To address these privacy concerns, instead of proposing to require issuers to disclose a specific location, credit score, or exact income and debt amounts we proposed that issuers provide that information in categories or ranges. For instance, to designate geographic location of an obligor who is a person, instead of requiring, city state or zip code of the property, we proposed that issuers provide the broader geographic delineation of Metropolitan Statistical Area,

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1 *See* Asset Backed Securities, SEC Release No. 33-9117 (April 7, 2010) [75 FR 23328] (the "2010 ABS Proposing Release").

2 *See* 2010 ABS Proposing Release at 23357.

Micropolitan Statistical Area, or Metropolitan Division, as applicable [3] In addition, for disclosure of an obligor credit score and income amount, we proposed coded responses that represent ranges of credit scores and dollar amounts.

We requested comment regarding whether there are particular asset-level data points that give rise to privacy concerns and whether there are other ways we could provide investors with useful information and lessen privacy concerns. Staff is currently reviewing these comments for purposes of developing a recommendation for final rules.

Senator Pat Roberts

Question 1: In the proposed definition of "swap dealer" the CFTC and the SEC have taken different approaches as to recognizing the difference between a "dealer" in a financial product and a "trader" in such product. Does the SEC and CFTC intend to ensure that there is ultimately a single definition before promulgating a final rule?

Answer: The Commission and the CFTC have worked closely in developing rules and related interpretations regarding the definitions of "swap dealer" and "security-based swap dealer." In doing so, we have been mindful of practical differences between how "swaps" and "security-based swaps" are used and traded. These differences include the use of swaps for hedging purposes by "natural long" entities in the agricultural, energy and resource sectors, as well as the use of aggregators in the swaps markets.

I believe that the proposed interpretations of the "swap dealer" and the "security-based swap dealer" definitions were drafted to be parallel, while appropriately accounting for those differences between swaps and security-based swaps and reflecting the Commission's historic use of the "dealer-trader" distinction. I expect that the Commission will carefully consider commenters' views on the rules and interpretations regarding the dealer definitions.

Question 2: We understand the agencies are struggling to cope with resource shortages. The Commissioners and staff deserve enormous credit for their efforts; however, Dodd-Frank is a wasteful and inefficient regime for taxpayers and U.S. businesses. Proposed rules would require banks to be regulated by at least three regulators and individual lines of business will be regulated by both the SEC and the CFTC with respect to essentially the same activity (e.g., index vs single name CDS). Have you actively sought opportunities to coordinate and harmonize rules

3 Metropolitan and Micropolitan Statistical Areas are geographic areas, designated by a five-digit number, defined by the U.S. Office of Management and Budget (OMB) for use by Federal statistical agencies in collecting, tabulating, and publishing Federal statistics.

with the Fed and each other to leverage resources and eliminate wasteful duplication of rule making?

Answer: In implementing Title VII of the Dodd-Frank Act, our staff has consulted regularly with the staffs of the CFTC, Federal Reserve Board, and other financial regulators to discuss rulemakings. We have sought input on draft rule proposals from our fellow regulators before proposing them for comment, and will continue to coordinate closely with these regulators as we develop additional proposals and move toward taking final action on our outstanding proposals. We are also actively reviewing responses to our requests for comment regarding how our proposed rules relate to the rules proposed by the CFTC, in an effort to further align our proposed rules where appropriate. We believe that these efforts will help ensure that, when finally adopted, these rulemakings serve the broader objective of providing a workable framework that allows the OTC derivatives market to continue to develop in a more transparent, efficient, accessible, and competitive manner.

Question 3: Financial entities – including banks and thrifts – generally do not qualify as end users under DFA. However, DFA requires both the CFTC and the SEC to consider whether small banks and thrifts with total assets of $10 billion or less should be eligible for treatment as end users. The CFTC and the SEC have issued proposed rules on the end-user exception to mandatory clearing--The SEC's rule proposal includes would explicitly allow banks and thrifts with total assets of $10 billion or less to qualify as end users. And also "preliminarily believes" that it would be appropriate to provide this end user exemption because it believes that small banks and thrifts do small volumes; the CFTC's rule proposal does not propose specific language and simply asks for comments about a possible end-user exemption for small banks and thrifts. What are the implications for these smaller banks and thrifts if the CFTC chooses not to implement an exemption analogous to that proposed by the SEC?

Answer: When we proposed allowing small banks and other financial institutions to use the end-user exception to mandatory clearing, the Commission stated that the lack of an end-user exception could limit the availability, or raise associated initial costs, of security-based swaps used by those institutions to manage their commercial risks. The feedback we have received to date as a result of the comment process generally supports this view. The Commission has also received comments indicating that without such an exception small financial institutions could be placed at a competitive disadvantage relative to larger institutions when providing loans and other financial services. We will carefully consider these and other views of commenters with respect to the small bank exception as we move toward adoption. Additionally, we are closely coordinating with the CFTC on addressing comments and concerns.

Question 4: There are several sections of Dodd-Frank that require the SEC to work jointly with the CFTC on issues of importance. It is clear that Congress would like the CFTC and SEC to work more closely together and try, for lack of a better term, to get along. Specifically, Section 713 requires the SEC and CFTC to work together to issue rules related to portfolio margining, which reduces systemic risk by combining potentially offsetting positions in securities and futures products into a single portfolio for margin and settlement purposes. Please describe the efforts you and your staff have undertaken to work with your counterparts in order to issue rules related to portfolio margining.

Answer: Section 713 of the Dodd-Frank Act provided legal certainty to facilitate the development of portfolio margining programs by providing that collateral for securities and commodity futures and options could be held in both securities accounts under Section 15(c)(3) of the Exchange Act and futures accounts under Section 4d of the Commodity Exchange Act pursuant to portfolio margining programs approved by the Commission and the CFTC, respectively. The Commission staff remains committed to working with the CFTC staff on issues related to portfolio margining. The Commission has already approved securities self-regulatory organization ("SRO") portfolio margin rules, which permit all equity and equity-based products – securities futures, stock options, individual equities and OTC derivatives – to be margined in portfolio margin securities accounts. These SRO portfolio margin rules already permit futures to be held in a securities portfolio margin account. The Dodd-Frank Act extended SIPC protection to futures positions held in these accounts. With exemptive relief from the CFTC, futures could presently be accommodated in a securities portfolio margin account under current SRO rules, without the need for additional Commission rulemaking. The Commission staff is also committed to continuing to work with the CFTC staff on ways to accommodate portfolio margining in futures portfolio margin accounts.

In general, as you note, portfolio margining can result in increased efficiencies and reduced risk, but only to the extent that the margin methodology that is being used adequately captures the risk of the combined positions. Therefore, it is important for regulators to carefully review the portfolio margining methodology to be employed – whether by individual dealers or clearinghouses – to ensure that new risks are not being created.

In terms of our joint rulemaking efforts under the Dodd-Frank Act, staff is working with CFTC staff to determine how to extend portfolio margining to derivatives covered by the Act. For example, trading in cleared credit default swaps ("CDS") may benefit from portfolio margining as between single name and index CDS. Because the proprietary positions of dealers in CDS are already being cleared in significant volume, this is an area of focus for our work on this issue.

Senator Patrick Leahy

Question 1: I have heard from several constituents who have shared with me their concerns that their community's appointed utility board members may be considered a "municipal advisor" and be required to register as such at the SEC. Your January proposed rule on registration of municipal advisors excluded employees of a municipal entity, but only considered elected members of municipal governing body as 'municipal employees' – not appointed members of such a body.

Can you explain to me why an appointed board member for a public utility who makes various decisions on behalf of the utility and its customers would be treated the same as a financial firm who contracted primarily for financial advice?

Answer: As you know, on December 20, 2010, the Commission proposed for public comment rules that would govern the registration of municipal advisors and, among other things, proposed guidance and solicited comment on the appropriate treatment of appointed members of a governing body. Section 15B(e)(4)(a) of the Securities Exchange Act, as added by the Dodd-Frank Act, provides that the term "municipal advisor" includes a person (who is not a municipal entity or an employee of a municipal entity) that "*(i) provides advice to or on behalf of a municipal entity or obligated person with respect to a municipal financial product or the issuance of municipal securities ... or (ii) undertakes a solicitation of a municipal entity*" (emphasis added). Accordingly, our proposal would require non-employee appointed officials (such as board members of a public utility) to register *only* if they provide advice with respect to a municipal financial product or an issuance of municipal securities to or on behalf of a municipal entity or obligated person, or if they undertake a solicitation of a municipal entity. As such, under the proposed rules, registration would only be required if the appointed official was providing advice in a manner not unlike a financial firm contracted for financial advice.

We have received more than 800 comment letters on the proposal, including many that address the status of appointed officials, and we are reviewing them carefully. Public input is critically important to us in crafting a final rule, and I can assure you that the status of appointed officials will receive very careful consideration before a final rule is adopted.

Question 2: On December 15, 2010, the SEC issued a draft rule implementing Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), now contained in Section 13(q) of the Securities Exchange Act of 1934. Section 1504, which requires the disclosure of payments made by extractive industry companies to governments, is an important step forward in providing information to investors so they can accurately assess risks associated with political instability in extractive markets. To provide the accountability that makes this transparency valuable to investors and companies alike, it is crucial that the reports of these payments be filed. Your draft rule does not meet this standard when it allows companies to "furnish" the report to the SEC rather than "file."

Can you describe how the SEC process is following Congressional intent on all aspects of Section 1504 rulemaking, and in the particular, the expectation that these reports should be filed, rather than furnished? What are you and your staff doing to ensure that?

Answer: I have recused myself from this rulemaking, but I have asked the staff of the Division of Corporation Finance to respond to your question. I understand that their response will be attached at the end of this document.

Question 3: As you discuss in your testimony, the derivatives industry is a vital component of the United States financial system. There is little doubt that a lack of oversight in this industry contributed significantly to our country's 2008 financial crisis. For this reason, I am encouraged that the SEC proposed rulemaking to implement provisions of the Dodd-Frank Act includes rules designed to increase oversight of the derivatives market.

Certain of these proposed rules are also designed to ensure accountability by promoting competition in the derivatives market. Pursuant to Section 765 of the Dodd-Frank Act, the SEC's proposed rules impose certain ownership limits on Security-based Swap Execution Facilities ("SSEF") and other Exchanges that trade security-based swaps. These ownership restrictions are extremely important. However, the Department of Justice expressed concern in its written comments that these rules may still provide an opportunity for anticompetitive conduct where a group of powerful entities collectively owns a controlling share of a SSEF or Exchange.

Did the SEC consider including an aggregate dealer ownership cap for SSEFs or Exchanges?

Why does the SEC's proposed rulemaking not provide some aggregate cap for dealer ownership of SSEFs and Exchanges?

Answer: First, I note that developing a robust regulatory regime for SSEFs and SBS exchanges that promotes competition, mitigates conflicts of interest, and restricts anticompetitive conduct by the owners of these trading platforms is a key objective in implementing the OTC derivatives provisions of the Dodd-Frank Act.

When developing proposed Regulation MC to implement Section 765, the Commission considered whether to propose an aggregate voting interest limit on SSEF participants (with respect to SSEFs) and exchange members (with respect to SBS exchanges). However, our concerns with respect to concentration of ownership in security-based swap clearing agencies, for which an aggregate voting interest limit was proposed, and SSEFs and SBS exchanges, for which no aggregate limit was proposed, are informed by structural differences that currently exist with respect to the clearing and trading of securities. Our experience has been that the central clearing model in the securities markets historically has tended toward convergence to a single clearing agency for each type of cleared product, while the market structure for securities trading historically has tended toward a more competitive model.

That experience suggests that, among other considerations, there generally will be a lower barrier to entry with respect to trading platforms, in part because participants of a SSEF or members of an SBS exchange would not incur the guaranty fund or other obligations that members of a clearing agency would incur, and thus multiple venues for the trading of security-based swaps are more likely to emerge. In fact, several commenters on proposed Regulation MC have noted that they expect to register as a SSEF. That said, we requested broad comment on our approach to SSEFs under Regulation MC.

In addition, on February 2, 2011, the Commission separately proposed rules relating to the registration and regulation of SSEFs, which include rules designed, in part, to address conflicts of interest affecting SSEFs. Specifically, those rules – "Regulation SB SEF" – would, among other things:

- Require a SSEF to permit any security-based swap dealer, major security-based swap participant or broker to become a participant of the SSEF as long as specified objective criteria are met;
- Require a SSEF to establish fair, objective, and not unreasonably discriminatory standards for granting impartial access to trading on the facility;
- Specify that a SSEF may not unreasonably prohibit or limit any person with respect to access to the services offered by the SSEF by applying those standards in an unfair or unreasonably discriminatory manner;
- Require information on any grants, denials or limitations of access by the SSEF to be reported on the proposed registration form for SSEFs and in the required annual report of the SSEF's Chief Compliance Officer;
- Require a SSEF to establish a compositionally balanced swap review committee to determine the security-based swaps that would trade on the SSEF, as well as the security-based swaps that should no longer trade on the SSEF; and
- Require that no less than 20% of the total number of directors on the SSEF's board be representative of SSEF participants, and that at least one director on the SSEF's board be representative of investors.

The Commission reopened the comment period for proposed Regulation MC to invite further comment on the proposed ownership and governance limitations, including how the provisions of Regulation MC interact with the provisions of

Regulation SB SEF and to what extent revisions to the two proposals may be appropriate. The Commission will carefully review the comments received with respect to proposed Regulation MC and proposed Regulation SB SEF when determining the scope of any final rules to mitigate conflicts of interest at SSEFs and SBS exchanges under Section 765.

Question 4: I have long been a supporter of the whistleblower provisions of the False Claims Act as an important tool to leverage government resources in the investigation and prosecution of fraud. The Department of Justice has worked closely with whistleblowers in using that statute to recover more than $27 billion since the Act was strengthened in 1986. Due in part to the Department of Justice's great success working with whistleblowers, I worked to see similar provisions included in the Dodd-Frank Act and was encouraged to see that the President's fiscal year 2012 budget calls for 43 new positions within the SEC's whistleblower program to expand investigations of tips received from whistleblowers.

Given its significant experience working with whistleblowers, to what extent and in what ways are you consulting with the Department of Justice as you establish the SEC whistleblower program?

Answer: I was pleased that the Dodd-Frank Act provided the SEC with new whistleblower authority, which we believe can help maximize the agency's resources and effectiveness by increasing high quality tips we would not otherwise receive, thereby enhancing our ability to detect and prevent violations of the federal securities laws. Since passage of the Dodd-Frank Act, we have been working to establish our new whistleblower program. Last November, we proposed rules to implement the program. In addition, we recently announced the hiring of Sean McKessy, the first Chief of our new Office of the Whistleblower, who will oversee the program. Moreover, the whistleblower fund that will be used to pay awards to qualifying whistleblowers is fully funded.

In establishing our program, we consulted with several agencies and organizations, including the Department of Justice (DOJ), the Internal Revenue Service and others in an effort to learn about their programs, best practices, and policies and procedures. I agree that DOJ's experience is instructive given our programs' similarities and the success of the False Claims Act program. At the same time, we are mindful of the differences in our respective programs, including statutory differences and the different functions that the SEC and the Civil Frauds Section of the DOJ serve. Where our programs are similar, our discussions, which began in the early stages of the legislative process, have in many respects informed our decisions concerning our own program, and we are grateful to DOJ and the various other agencies for sharing their thoughts with us as we move forward with the implementation of our program. Given that DOJ is an important law enforcement partner generally and has much to teach us in light of where we are in the process of developing our new whistleblower office, I expect extensive additional coordination with DOJ in the months and years to come.

Senator Tom Harkin

Question 1: End Users and Margin: Since the enactment of Dodd-Frank, much has been made over the issue of margin, particularly the impact on commercial end-users that are exempt from the clearing requirement. Margin, which is the cash that parties to derivatives contracts have to put forward in order to cover their positions as the market moves one way or the other, is essential to ensuring there is enough capital in the system to cover the risks of contract. In simpler terms, margin is designed to compensate for counterparty credit risk. The Dodd-Frank Act requires the posting of margin by swap dealers and major swap participants, including as to derivative contracts that are otherwise exempt from the clearing requirement. I have two questions about this issue.

(a): First, I have heard from a number of firms who argue that if they are required to post margin on their derivative contract positions they will be tying up excess capital that they could otherwise use to expand lending and credit to businesses. How do the Commissions view that position?

Answer: The Commission has not yet proposed rules on margin for security-based swaps. In considering its approach to such proposed rules, as with any proposal, the Commission will be sensitive to the costs and benefits imposed by its rules. We will be mindful both of the importance of security-based swaps as hedging tools for commercial end users and the potential impact of using funds to post margin instead of for other business activities. At the same time, we are also mindful of the need to set prudent risk rules for dealers in these instruments. We discussed this issue, along with the end-user margin issue, with various stakeholders at a joint SEC-CFTC staff roundtable in December, and are taking the input we received at the roundtable and from other sources into account in writing proposed rules.

(b): Second, I am also interested in this issue as it relates to the pricing of derivatives contracts. Prior to the reforms of Dodd-Frank swaps dealers often did not require their counterparties to post significant margin, if any at all. However, they certainly had to account for their counterparty's credit risk or at least should have, and it seems that the dealer would account for risk by increasing the price of those derivatives contracts according to the risk the dealer was taking on. Now, however, with margin explicitly required under Dodd-Frank for swap dealers and major swap participants, it seems that counterparty credit risk no longer needs to be priced implicitly into the contract but instead can be pulled out of the contract's price and transparently addressed through the setting of margin under the margin requirements. That should make the price of these contracts go down for non-financial end-users, assuming that they generally pose less counter-party risk. Do you agree with that analysis? If not, why not?

Answer: In general, greater price transparency should have a positive impact on the markets. However, the Commission has not yet proposed rules on margin for security-based swaps. Moreover, there are multiple variables that affect derivatives pricing – including many new variables that will be introduced by the regulatory regime now being created, such as increased price transparency and greater use of clearing. Therefore, we cannot yet determine precisely what, if any, price impact there may be on derivatives contracts for market participants arising from margin requirements. The Commission is sensitive to the costs and benefits imposed by its rules and will consider comments received with respect to any proposed margin rules on market participants, including comments as to whether the price of derivatives contracts may increase or decrease as a result of any new requirements.

Question 2: Data Collection and Swap Data Repositories: One of the key issues facing the Commissions going forward concerns Swap Data Repositories. Indeed, the ability to collect trade level data with unique identifiers is essential to enforcing the Act's reforms, including the Volcker Rule. What steps are the Commissions taking to gather trade-by-trade level data? In addition, what data do the Commissions believe they can collect for each trade? How do the Commissions intend to identify currently existing contracts that are required to be reported to the Commissions under the terms of the Act?

Answer: To gather trade-by-trade level data on security-based swaps ("SBS"), the SEC has proposed Regulation SBSR which would, among other things, require that each SBS be reported to a registered security-based swap data repository ("SDR"). The proposed rules are designed to capture the full terms of each SBS transaction. Specifically, Regulation SBSR would require one of the counterparties to the SBS (the "reporting party") to provide the following data elements to the SDR: (1) the asset class of the SBS; (2) information that identifies the SBS instrument and the specific asset(s) or issuer(s) of any security on which the SBS is based; (3) the notional amount(s) and the currency(ies) in which the notional amount(s) is expressed; (4) the date and time (to the second) of execution; (5) the effective date; (6) the scheduled termination date; (7) the price; (8) the terms of any fixed or floating rate payments, and frequency of any payments; (9) whether or not the SBS will be cleared by a clearing agency and, if so, the name of the clearing agency; (10) if both counterparties to the SBS are SBS dealers, an indication to that effect; (11) if applicable, an indication that the transaction does not accurately reflect the market; (12) if applicable, an indication that the SBS is customized; (13) information that identifies the counterparties and others involved in the execution (such as any brokers, trading desks, or individual traders); (14) the amount(s) and currency(ies) of any up-front payment(s) and a description of the terms and contingencies of the payment streams of each counterparty to the other; (15) the title of any master agreement or any other agreement governing the transaction; (16) the data elements necessary for a person to determine the market value of the transaction; (17) if the SBS is not cleared, whether the end-user exception was invoked; (18) if the SBS is not cleared, a description of the settlement terms, including whether the SBS is cash-settled or physically settled, and the method for determining the settlement value; and (19) the venue where the SBS was executed.

With respect to existing SBS contracts, the Commission has adopted an interim final temporary rule that requires specified counterparties to report certain information regarding SBS that were entered into before the date of enactment of the Dodd-Frank Act and were still outstanding as of that date to an SDR or the Commission by the earlier of: (1) the compliance date to be established in proposed Regulation SBSR, or (2) within 60 days after an SDR commences operations to receive and maintain data regarding such SBS. These counterparties are also required to report information relating to pre-enactment SBS to the Commission upon request. The interim final temporary rule included an Interpretive Note requiring counterparties that may be required to report to the Commission to preserve information pertaining to the terms of these pre-enactment SBS. Subsequently, in proposed Regulation SBSR, the Commission proposed to require that pre-enactment SBS be reported to an SDR no later than January 12, 2012.

Proposed Regulation SBSR also would require counterparties that execute "transitional SBS" (*i.e.*, SBS executed after the date of enactment of the Dodd-Frank Act but before trade-by-trade reporting is required) to report all open positions in such transitional SBS to an appropriate SDR six months after the date on which such an SDR is registered (which should be before trade-by-trade reporting is required to commence). This requirement would permit the SDR and appropriate regulators to develop a complete picture of each counterparty's SBS exposures before trade-by-trade reporting begins.

Question 3: Governance, Conflicts of Interest, and Ownership Shares: I was pleased to see both Commissions promptly put forward proposed rules to implement Sections 726 and 765 of the Dodd-Frank Act, which place certain requirements on Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities to mitigate conflicts of interest. Last year, I submitted comments to both Commissions to express my concern that these proposed rules did not go far enough toward including an aggregate ownership cap on large market participants. As I wrote to the Commissions:

"Spreading ownership between multiple enumerated entities through an aggregate cap will force large entities to invest in multiple SEFs and DCMs, helping to increase liquidity and enhance price transparency. In addition, diverse ownership will help encourage innovation in this area, enhancing market efficiency and transparency. An aggregate cap on ownership will help to ensure these outcomes."

I was also interested to see the Department of Justice's comment that the lack of an aggregate ownership cap on major derivatives dealers "may not sufficiently protect and promote competition in the industry."

What steps are the Commissions taking to address these concerns relating to governance, conflicts of interest, and ownership shares as you move toward issuing final rules and when do you expect these rules to be finalized?

Answer: As you noted, on October 26, 2010, the Commission published for comment a proposal – "Regulation MC" – designed to mitigate conflicts of interest for security-based swap clearing agencies, security-based swap execution facilities ("SB SEFs") and security-based swap exchanges ("SBS exchanges"). The Commission proposed an ownership and voting limit of 20% and independent director and other governance requirements for SB SEFs and SBS exchanges. These proposed requirements were designed to strike an appropriate balance between the objectives of mitigating conflicts of interest and refraining from unnecessarily hindering the ability of entities to form new trading venues.
In addition, on February 2, 2011, the Commission proposed rules relating to the registration and regulation of SB SEFs, which include rules designed, in part, to address conflicts of interest affecting SB SEFs. Specifically, those rules – "Regulation SB SEF" – would, among other things:

- Require a SB SEF to permit any security-based swap dealer, major security-based swap participant or broker to become a participant of the SB SEF as long as specified objective criteria are met;
- Require a SB SEF to establish fair, objective, and not unreasonably discriminatory standards for granting impartial access to trading on the facility;
- Prohibit a SB SEF from unreasonably prohibiting or limiting any person with respect to access to the services offered by the SB SEF by applying those standards in an unfair or unreasonably discriminatory manner;
- Require information on any grants, denials or limitations of access by the SB SEF to be reported on the proposed registration form for SB SEFs and in the required annual report of the SB SEF's Chief Compliance Officer;
- Require a SB SEF to establish a compositionally balanced swap review committee to determine the security-based swaps that would trade on the SB SEF, as well as the security-based swaps that should no longer trade on the SB SEF; and
- Require that no less than 20% of the total number of directors on the SB SEF's board be representative of SB SEF participants, and that at least one director on the SB SEF's board be representative of investors.

The proposal seeks commenters' views regarding the interaction of proposed Regulation SB SEF with proposed Regulation MC, including whether the requirements contained in proposed Regulation SB SEF would appropriately address conflicts of interest concerns for SB SEFs or whether they should be revised either as unnecessary or insufficient to address such conflicts of interest. The SB SEF Proposing Release also asks commenters to provide their views on whether there are any redundancies or gaps for mitigating conflicts of interest for SB SEFs that should be addressed.

The Commission reopened the comment period for proposed Regulation MC to invite further comment on the proposed ownership and governance limitations, including how the provisions of Regulation MC interact with the provisions of Regulation SB SEF and to what extent revisions to the two proposals may be appropriate. The Commission will carefully review the comments received with respect to proposed Regulation MC and proposed Regulation SB SEF when determining the scope of any final rules to mitigate conflicts of interest at SSEFs and SBS exchanges.

There are a number of steps in the rulemaking process that have yet to be completed, including analyzing all comment letters that the Commission receives, before the Commission issues final rules relating to mitigation of conflicts at SB SEFs and SBS exchanges. Moreover, we expect to consult and coordinate, to the extent possible, with the CFTC before issuing any such final rules.

<u>Senator Kirsten Gillibrand</u>

Question 1: As you know, implementing the requirements of the Dodd Frank Act will require the participants in the derivatives markets as well as the CFTC and the SEC to develop, assemble, test and implement a complex technology infrastructure. Could you give us your views on what new technologies will need to be developed and how long you expect will be required for these technologies to be fully functioning, in each case for the industry participants and for your two agencies?

Answer: The technology and infrastructure changes that industry participants and the Commission will need to implement in order to meet the requirements of Dodd Frank are quite varied, and it is difficult at this relatively early stage to provide a full, accurate inventory of new technologies and implementation timetables. In particular, we use the comment process for our proposed rules to gain greater insight from market participants about, among other things, appropriate technological solutions for particular challenges, the extent to which existing platforms can be leveraged, and the costs and benefits of various approaches. Our rule proposals are also often themselves in part shaped by implementation considerations and current best practices by industry participants.

In many cases, preliminary discussions and comments have suggested that existing technology may be deployed for purposes of meeting new requirements under the Dodd-Frank Act. For example, our understanding is that many trading platforms, data repositories, and clearing agencies currently support systems and infrastructures that would be directly applicable for, or could be readily adapted to meet, the requirements of Dodd Frank. Similarly, it appears that existing Commission technology platforms, such as EDGAR, may offer solutions for certain implementation challenges that we face. In some circumstances, however, additional system technologies would need to be purpose-built by some firms or by the Commission. We believe that our ongoing dialogue with interested parties will help inform our final rules and facilitate the adoption of requirements that take into account the costs and benefits of various technological approaches, both for market participants and for the Commission.

Senator Saxby Chambliss

Question 1: David Becker, the SEC's General Counsel, recently gave a speech in London, England, in which he discussed the SEC's whistleblower rules. He acknowledged the significant amount of work required by public companies after Sarbanes-Oxley to develop whistleblower programs. In his speech, Mr. Becker stated that "[s]ome have asked us to require whistleblowers to go to corporations first, before coming to the Commission, in order to qualify for an award. It's not clear that the Commission could or should do that." What is your view about how to avoid undermining those programs at companies?

Answer: I understand the concern of the corporate community, and we received extensive public comment on this issue from a full range of perspectives. I believe there is great value in robust internal compliance programs as one mechanism to help detect and prevent fraud, and it is important for employees to report matters internally when appropriate. Our proposal for this new whistleblower provision was designed to avoid negatively undermining internal compliance programs. In addition, in some instances internal reporting may not be appropriate, and I believe it is important – consistent with the statute's language and our mission to protect investors – to ensure that whistleblowers can bring us their evidence of securities violations expeditiously.

I believe we can adopt rules which achieve a balance that preserves the important role that internal compliance programs play while remaining consistent with the statute's purpose of encouraging whistleblowers to come forward. The proposed rules include provisions that are intended to encourage, but not require, employees to continue to report potential violations through existing company processes in addition to making a whistleblower submission, and we are considering the many additional comments we have received on this issue.

Question 2: The Dodd-Frank Act requires both the SEC and the CFTC to create rules to implement whistleblower programs. The SEC and the CFTC have separately issued proposed rules. Some companies will be subject to both sets of rules. Is there anything about the types of products that the SEC and CFTC regulate that should result in differences under a whistleblower program? Can you please describe the steps the SEC and CFTC have taken to ensure that the rules are similar, and do not impose unnecessary compliance burdens on companies by requiring different standards? Are there any areas or compelling reasons why the two sets of rules should not be identical?

Answer: Section 922 of the Dodd-Frank Act establishes the legal framework under the Securities and Exchanges Act of 1934 for the implementation of the SEC's whistleblower program. Although certain of the provisions contained in Section 922 are similar to those set forth in Section 748 relating to the Commodity Exchange Act, the statutes each Commission administers contain material differences. Although the SEC and CFTC have separately proposed rules to implement the respective statutes, SEC staff has consulted extensively with the CFTC staff during the rulemaking process in order to share ideas and discuss potential implications of certain rule provisions on the various stakeholders, including whistleblowers, entities and our respective agencies. Ultimately, of course, the SEC and CFTC are separate regulatory agencies with unique responsibilities. The SEC's final rules should, I believe reflect what we believe is required for us to implement an effective program in light of the particulars of Section 922 and our agency's mission.

Senator Thad Cochran

Question 1: I am concerned that the CFTC's current budget constraints, combined with the significant increase in its regulation proposals for the OTC market, will result in a lack of available resources to regulate the futures market and create an unnecessary burden on the competitiveness and innovation of the well-functioning futures market. How will you ensure that your regulatory efforts in the OTC market will not be excessive to the point of causing collateral damage to the futures market?

Answer: With respect to the SEC and the securities markets, as I have explained in other testimony and public statements, the Dodd-Frank Act has added significantly to the Commission's workload. The Dodd-Frank Act requires the Commission to promulgate more than 100 new rules, create five new offices, produce more than 20 studies and reports, and to assume considerable new ongoing responsibilities that will have a significant long-term impact on the Commission's workload, including oversight of the OTC derivatives market and hedge fund advisers; registration of municipal advisors and security-based swap market participants; enhanced supervision of nationally recognized statistical rating organizations (NRSROs) and clearing agencies; heightened regulation of asset-backed securities (ABS); and creation of a new whistleblower program.

This workload comes in addition to the Commission's pre-Dodd-Frank Act responsibility for oversight of approximately 35,000 entities, including direct oversight of investment advisers, mutual funds, and broker-dealers; review of disclosures and financial statements of reporting companies; oversight of transfer agents, national securities exchanges, clearing agencies, and NRSROs; and oversight of the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC).

Absent additional funding and staffing, the demands placed on the Commission by the Dodd-Frank Act necessarily will reduce the Commission resources available for its traditional regulatory responsibilities, as well as for its ongoing responsibilities under the Dodd-Frank Act. Although this task is challenging, we are committed to fulfilling the objectives of the Act in a responsible and diligent manner, while seeking the broad public input and consultation needed to prevent unintended consequences for the markets.

Question 2: Chairman Schapiro, at this point, given what you know about the substantive and procedural difficulties involved in moving all those regulatory actions, as well as the limited financial and personnel resources the agency has available to accomplish all that activity, do you believe that Congress should extend the deadlines for CFTC to meet all its obligations under Dodd-Frank? Would extending those deadlines allow CFTC to produce a better, more thoughtful set of regulations?

Answer: With respect to the SEC, we continue to work towards completing the rulemaking proposal and adoption process under the Dodd-Frank Act. Given the complex issues raised by OTC derivatives, we are progressing at a deliberate pace, taking the time necessary to thoughtfully consider the issues before proposing specific rules, and we will continue to do so as we move toward adoption. We believe that this approach will help ensure that, when finally adopted, these rulemakings serve the broader objective of providing a workable framework that allows the OTC derivatives market to continue to develop in a more transparent, efficient, accessible, and competitive manner.

Question 3: The CFTC is in the process of imposing position limits that have been promulgated without first making the findings required by Dodd-Frank. As CFTC Commissioner Mike Dunn has stated publicly, none of the CFTC's internal reports and none of the responsible economic studies demonstrate that excessive speculation has caused abnormal price movements. Even Nobel Prize winning economist Paul Krugman has written that recent increases in commodities prices have more to do with supply and demand rather than speculation. Shouldn't the CFTC provide a rigorous economic analysis of the costs, benefits, and regulatory impact of its position limits rule before finalizing its proposed position limits rule, which could have a significant impact on the markets and the broader economy?

Answer: I am not familiar with the issues and considerations informing the CFTC's specific economic analyses with respect to its proposed position limits rule.

Senator Patrick Leahy
Response provided by the staff of the Division of Corporation Finance

Question 2: On December 15, 2010, the SEC issued a draft rule implementing Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), now contained in Section 13(q) of the Securities Exchange Act of 1934. Section 1504, which requires the disclosure of payments made by extractive industry companies to governments, is an important step forward in providing information to investors so they can accurately assess risks associated with political instability in extractive markets. To provide the accountability that makes this transparency valuable to investors and companies alike, it is crucial that the reports of these payments be filed. Your draft rule does not meet this standard when it allows companies to "furnish" the report to the SEC rather than "file."

Can you describe how the SEC process is following Congressional intent on all aspects of Section 1504 rulemaking, and in the particular, the expectation that these reports should be filed, rather than furnished? What are you and your staff doing to ensure that?

Answer: Section 1504 of the Dodd-Frank Act directs the Commission to issue rules requiring resource extraction issuers to include in an annual report information relating to any payment made by the issuer, a subsidiary, or an entity under the control of the issuer, to a foreign government or the federal government for the purpose of the commercial development of oil, natural gas, or minerals. Specifically, resource extraction issuers must provide information about the type and total amount of payments made for each project related to the commercial development of oil, natural gas, or minerals, and the type and total amount of payments made to each government. The statute specifies that, to the extent practicable, the rules should support international transparency promotion efforts.

As you noted, on December 15, 2010, the Commission published a rule proposal to implement Section 1504. The rule proposal is intended to be consistent with the statutory language in Section 1504. For example, consistent with the statute, the proposed rules would define a resource extraction issuer as an issuer that is required to file an annual report with the Commission and that engages in the commercial development of oil, natural gas, or minerals. As another example, the proposed disclosure requirements would apply to all issuers that meet the definition of resource extraction issuer – consistent with the statute, the proposed rules did not include an exemption for foreign issuers or smaller reporting companies. In addition, the proposed rules would define commercial development of oil, natural gas, or minerals to include exploration, extraction, processing, and export, or the acquisition of a license for any such activity.

The types of payments related to commercial development activities that must be disclosed under the proposal include:

- taxes;
- royalties;
- fees (including license fees);
- production entitlements; and
- bonuses.

These types of payments generally are consistent with the types of payments that the Extractive Industries Transparency Initiative, which was referenced in the statutory definition of "payment," suggests should be disclosed.

Section 1504 mandates that a resource extraction issuer provide the payment disclosure required by that section "in an annual report," but otherwise does not specify the location of the disclosure, either in terms of a specific form or in terms of location within a specific form. We proposed to require the disclosure to be provided in an annual report on Form 10-K, Form 20-F, or Form 40-F, as applicable and that the disclosure would be "furnished" rather than "filed." We requested comment on all aspects of the rule proposal, including this proposed requirement. This aspect of the rule proposal has generated interest from many commentators. The staff is currently considering all of the comments received on the rule proposal and is developing recommendations for the Commission.

Senate Committee on Agriculture, Nutrition & Forestry

Oversight Hearing:

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

Questions for the Record

Mr. Larry Thompson, Managing Director and General Counsel
The Depository Trust & Clearing Corporation

March 21, 2011

Chairwoman Debbie Stabenow

1) Dodd-Frank has an indemnification provision that is meant to protect proprietary information and hold foreign regulators accountable for proprietary or confidential information that is leaked to the market. Data security breaches could have a devastating impact on markets and certainly individual companies. There are recent examples of global data security breaches that are concerning and highlight this point. How do you guarantee the confidentiality of data in your system? How would you define a high standard in this industry? If we didn't have an indemnification provision, how could we hold entities responsible for protecting this kind of information?

Senator Pat Roberts

1) Your testimony mentions your concern about the indemnification provision that was in Dodd-Frank in regard to foreign regulators getting access to your swap trade data, noting that you think this isn't going to work. You suggest that either we should encourage the SEC and the CFTC to waive this provision, or delete it in a technical corrections bill. Can you tell me why this has become such an impediment? Why do you think it was included in the bill in the first place?

As both of Senator's Stabenow and Roberts questions above focus on a similar issue, the following response is intended to answer both in the following one section. Senator Roberts' additional question will be answered in the next section.

The risks posed to the safety and soundness of the global market infrastructure by fragmented data reporting were outlined in testimony by DTCC before this Committee on December 2, 2009. While not repeating that testimony, it is worth re-emphasizing that the OTC derivatives markets are global and it is not uncommon for counterparties located on two different continents to enter into a derivative contract relating to an underlying asset or security located on yet a third continent. As a result, regulators and other authorities located in many jurisdictions will generally have a material interest in the same transaction (albeit for different reasons). Without a consolidated global database, it will be extremely difficult to assure either that those regulators get a complete and accurate view of all the data in which they have a material interest or that public reporting of information relating to these global markets is complete and accurate.

Such a consolidated database exists today for the credit default swap ("CDS") market in the DTCC Trade Information Warehouse (the "TIW"). It is currently regulated by the Federal Reserve under a cooperative structure that can serve as an example of how global cooperation among regulators can make the markets safer and sounder for all. The TIW expects to register as a swap data repository ("SDR") and a security-based swap data repository. The TIW will also be regulated by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). To help assure global access, all of the data resident in the TIW is also resident in the DDR Ltd., located in London and regulated by the FSA. Additionally the London repository holds global equity derivative data not currently resident in the TIW, but which will be replicated in a U.S. repository.

At its core, any global repository must be absolutely secure. DTCC has over 30 years experience holding and protecting sensitive data of market participants. The basic information security infrastructure protects the security and confidentiality of the information through numerous technical and operational capabilities to analyze threat data to determine if adverse impacts have been observed. The central technical capability is based in an intricate Security Event Monitoring System, which experts use to review public and privately reported threat information, vulnerability measures and activity reports.

Real-time alerts and historical reports are reviewed by the Threat and Vulnerability Assessment team, which design and implement appropriate mitigation approaches, internal escalations and external notifications as required. For reasons the Committee can appreciate, DTCC cannot publish the details of the protective mechanisms, but the process is highly regulated (by the SEC, the CFTC, the Federal Reserve and the New York State Banking Department). A detailed briefing of DTCC's security protocols can be arranged at the pleasure of the Chair.

With respect to access to this central database by global regulators, the OTC Derivatives Regulators Forum (ODRF) – comprised of 42 regulators, central banks and other authorities around the world (including the SEC, CFTC and Federal Reserve), has provided written guidance to DTCC. This guidance has received full and formal assent from all 42 authorities comprising the ODRF and is set forth in an attachment to this submission. It was a significant achievement to obtain such unanimity of views across such a broad array of authorities and thus provides a solid basis on which to move forward in the area of global information sharing.

While the attached guidance speaks for itself, there are three key principles that merit emphasizing:

- First, the guidance generally provides for "direct and unfettered access" to information in which the regulator has a material interest, *regardless of whether or not jurisdictional limitations would in other contexts have made access difficult.* The guidance cites as an example that the SEC, as a market regulator, would be entitled to access "[t]ransaction level data for non U.S. participants bought/sold to non U.S. participants on U.S. reference entities." Neither the Dodd-Frank Act nor the proposed regulations thereunder would provide the SEC with access to that data if the trading took place outside of the U.S. (which would normally be the case in those circumstances).

  The agreements under which our over 17,000 users worldwide access our services specifically provide that their information can be provided to governmental authorities and thus affirmatively consents to SEC access to this data. Importantly, the guidance also provides that this access is limited by applicable data privacy and confidentiality laws.

- Second, the guidance requires that "[a]uthorities accessing data in the trade repository must have the legal right and ability to keep the data confidential." Authorities requesting data from DTCC have been willing to so certify, and have been ODRF members (or have received aggregate or anonymized data and been in close nexus to an ODRF member). In addition, DTCC has agreed with the ODRF in cases where there are concerns as to appropriateness of access, including with respect to authorities who are not

ODRF members, that these issues can be directly addressed at the ODRF. Such processes need limited further enhancement, but, formally linking to ODRF membership or using the status of signatory to the IOSCO MoU (which requires an ability to keep data confidential) may enhance this process and be an appropriate global solution for repositories.

- Third, the guidance provides that, while the primary regulator of any repository should not be restricted from doing what it needs to do to carry out its statutory oversight responsibilities, the "primary regulator would not generally access participant specific data for trades where both counterparties are outside of its supervisory jurisdiction." Thus, while a primary regulator in the U.S. might be able to access information about trades between non- U.S. counterparties on U.S. underlyings, it would not generally access information about trades between non- U.S. counterparties on non- U.S. underlyings.

  This "extra-territoriality" issue has recently been much discussed among European regulatory authorities and legislators. For U.S. authorities to have "unfettered access" to relevant extra jurisdictional trades (i.e., those executed outside the U.S. between non-U.S. counterparties, but on U.S. underlyings), U.S. authorities with primary regulatory responsibility over any global database need to commit not to access data with respect to trades that have no direct nexus to the U.S., either with respect to counterparties or underlying assets. The same would hold true of non- U.S. authorities primarily regulating a global database outside of the U.S.

DTCC has operated the TIW under these principles since June 2010, responding to over 100 requests from authorities around the world without incident. Recently, the TIW set up a global regulator portal that operates under these principles to permit, with appropriate certifications and documentation, global regulators to directly access relevant data through secure web interfaces. To date, 26 regulators and other authorities who are members of the ODRF have returned the relevant documentation and been set up on the system, and 16 have been using it to directly access information to which they are entitled under ODRF guidelines.

This major step forward increased the safety and soundness of OTC derivatives markets worldwide, and DTCC urges the Congress to take the necessary action to remove obstacles to the continued operation of automated data sharing, and the expansion thereof to other OTC derivative products. The critical issue among the competing topics for Congressional action is the elimination of the indemnification provisions of the Dodd-Frank Act as discussed in the testimony, as well as protecting extraterritorial data that may be resident on the same physical database as data required to be reported to SDRs.

Finally, it is important to consider the negative consequences of the failure to act. DTCC executive personnel have been briefed directly by many ODRF authorities that they do not view it as appropriate for governmental entities to indemnify private companies. Those regulators suggested that they would decline to provide such indemnification. In the reverse, the Committee should imagine U.S. authorities being asked to indemnify private, non U.S.

companies in order to receive data in which they have a material interest but not the jurisdictional reach to obtain otherwise.

The suggestion that U.S. authorities would be able to access completely extra-territorial trade information on a basis other than as set forth in the ODRF guidelines is equally problematic for the European authorities.

If these situations are not rectified and/or clarified, there is a significant risk that maintenance of swap data will become balkanized, with the immediate consequence that the data available to U.S. regulators will actually be reduced from what it is today under ODRF guidelines and that OTC derivative data made available to regulators and the public will generally be of questionable accuracy and/or completeness.

Senator Pat Roberts

1) It seems to me that clearinghouses – by nature of their function – already maintain much of the data or transaction records we're assuming an SDR would need to posses. Indeed, didn't Dodd-Frank contemplate this and to avoid duplicative reporting, only require regulatory reporting of non-cleared swap transactions to be sent to SDRs (Sec 729)?

   Wouldn't requiring a clearinghouse to send data (already reported to the CFTC) to a non-DCO SDR (or standalone SDR) be time-consuming, duplicative and costly? Wouldn't end users be made to bear these costs?

Requiring only non-cleared swap transactions to be reported to SDRs would:

1. significantly increase systemic risk,
2. significantly increase cost to the taxpayer
significantly increase costs to end users if they are required to report multiple trades to multiple repositories and exchanges.

DTCC believes that it is for these reasons, among others, that the Dodd-Frank Act specifically provides that "[e]ach swap, *whether cleared or uncleared*, shall be reported to a swap data repository." (Sec 727, emphasis added) Each issue is addressed below.

1. Reporting Only Non-Cleared Trades to SDRs will Increase Systemic Risk

While there remains on-going debate about the causes of the financial crisis of 2008, there is broad consensus that, to the extent OTC derivatives contributed to the crisis, it was due to (a) very large one-way positions that major counterparties, such as American International Group, Inc. ("AIG") took in mortgage-related CDSs, which threatened the continued viability of numerous systemically important firms and that activitywent unreported until it was too late; and (b) the general lack of understanding with respect to the extent of the exposures across all of the swap markets, which contributed to a lack of confidence in the creditworthiness of financial institutions at just the wrong time.

As noted in the response to the previous question, the infrastructure needed to protect against these types of situations has since been put in place for the global CDS market in the form of DTCC's Trade Information Warehouse ("TIW"), which provides complete and accurate information to regulators globally and to the public. However, it was not until July 2010 that the TIW gained access to all bespoke, less standardized contracts, such as those engaged in by AIG and its counterparties. All of that information is now a part of the TIW.

The experience through the credit crisis provides a very tangible and important lesson about the consequences of fragmented data. If regulators are only able to see the more standardized (and potentially clearable) transactions and not see in one place the entire risk exposure of the counterparties and entities involved in those transactions, including the bespoke, more unique trades, it would have indicated an incomplete picture and understate the extent of the risk to the stability of the financial system.

It is from this specific experience that DTCC approached the Dodd Frank regulatory reform process believing firmly that ensuring comprehensive data for all asset classes, both cleared and uncleared and for transactions occurring not only in the US but globally as well is the only way to ensure that the regulators have the information they need to see problems brewing *before* they get to crisis proportion.

With respect to public market transparency, the comprehensive global market information that the TIW is now able to publish includes, among other things, net market-wide exposures to each CDS index and index tranche, as well as net market-wide exposures to each of the top 1,000 individual corporate and governmental entities on which CDS are written (ranked by size of exposure), including in each case both cleared and uncleared trades.

With respect to more aggregated data, (e.g., overall exposure to sovereign debt, corporate debt and other broad categories), the published data also indicates which broad category of market participants holds what positions (these disclosures are made at this less granular level to protect the identity of the position holders). Had this information been available and published in the run-up to the 2008 crisis, much of the exposure uncertainty that contributed to market instability at the time, at least in the CDS market, could have been mitigated.

Having analyzed the effect of separate public reporting of both cleared and uncleared trades, DTCC can report that even with the most liquid instruments, separate reporting of these positions would have significantly overstated exposures, sometimes by an order of magnitude, thereby unnecessarily exacerbating public concern about such credit exposures during a time of market crisis.

Such a complete global data set (most of the systemically risky trades by counterparties like AIG were executed in London), would also have provided U.S. authorities with sufficient early warning of the build-up of risky positions like those with AIG to have enabled them to take corrective measures before the positions became so large that they threatened the fabric of the global financial system. On the other hand, if any of the AIG trades were deemed clearable and reported to multiple clearinghouses (as would have been likely to avoid concentration charges), some or all of which being located outside of the U.S., and the uncleared trades reported separately again, U.S. authorities would have had a difficult aggregation task to perform to understand the true exposure.

Regardless of one's view as to whether it is wise to rely solely on governments performing this task when it is already done very effectively by private organizations like the TIW that provide the relevant exposure reports to regulators, it is clear that it would require a significant outlay of taxpayer funds to have this task performed by governmental entities.

2. Reporting Only Non-Cleared Trades to SDRs will Increase Cost to the Taxpayer

As noted above, if SDRs do not serve as aggregators of trade data for the purpose of regulatory monitoring of systemic risk (and public reporting of market exposure data), the regulators will themselves be required to perform this aggregation in order to understand true exposure. Having built such a function, it is more complex than it may at first appear. In addition, as the CFTC has implicitly recognized in its proposed rules on swap data reporting, there are significant adverse economic incentives in not actually requiring SDRs to be able to accept reporting of all transactions in any asset class (it is a requirement of the CFTC proposed rules that SDRs at least have the ability to accept all such transactions). If clearing organizations are permitted to act as SDRs for their own cleared trades without being required to also accept complex uncleared trades, there may be no economically viable model for SDRs, whose function is solely to accept non-cleared trades, meaning that all such trades will be reported directly to regulators.

The likely consequence is a requirement that each regulatory or other authority will have to separately replicate the data collection and reporting infrastructure already built by DTCC and paid for primarily by the global swap dealers. The government should not spend taxpayer money building what the private sector has already built and serves the purposes of the Dodd-Frank Act extraordinarily well.

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