LEGISLATIVE PROPOSALS REGARDING DERIVATIVES AND SEC ECONOMIC ANALYSIS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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WITNESSES

THURSDAY, APRIL 11, 2013

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

LEGISLATIVE PROPOSALS REGARDING DERIVATIVES AND SEC ECONOMIC ANALYSIS

Thursday, April 11, 2013

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

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Bachus, Royce, Lucas, Neugebauer, Huizenga, Grimm, Stivers, Fincher, Mulvaney, Hultgren, Ross, Wagner; Maloney, Sherman, Scott, Himes, Peters, Foster, Carney, Sewell, and Kildee.

Ex officio present: Representatives Hensarling and Waters.

Chairman GARRETT. Good morning. Today's hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order. Today's hearing is entitled, "Legislative Proposals Regarding Derivatives and SEC Economic Analysis."

I want to thank the members of the panel for the testimony that you are about to give.

We will begin today's hearing with opening statements, and I will now recognize myself for 3 minutes.

Today's hearing will examine seven specific legislative proposals to ensure an appropriate and thorough regulatory regime for the U.S. swaps market, and codify a good government regulatory approval process for the SEC.

Let me begin with the legislative proposals addressing Title VII of the Dodd-Frank Act. All six of these proposals are common-sense and bipartisan approaches to provide clear rules of the road for the market participants, while ensuring a robust regulatory regime exists over the marketplace. Many of these proposals—including the end-user, the inter-affiliate, and indemnification bills—actually passed the full House by large margins last year. And I hope we do that again this year.

I also want to begin to thank a lot of folks on both sides of the aisle who worked on all of these bills. I also commend Mr. Hultgren and Mr. Himes on their bipartisanship and bicameral work on the new version of the so-called "swaps push-out" legislation. I believe that the legislation changes made here were very appropriate. I look forward to having this legislation signed into law this year.

Next, I would like to thank Mr. Fincher for bipartisan legislation requiring that FSOC to study implementation of the derivatives

Credit Valuation Adjustment (CVA). Capital adjustments is a very good idea. I look forward to its swift passage, as well.

Regarding the new version of the cross-border legislation, I wanted to start by complimenting—and I don't see either of them here—Mr. Carney and Mr. Scott for their bipartisan work on this legislation. In drafting this legislation, we decided to take a different approach than last time in attacking a very complicated problem of regulating swap transactions between U.S. and non-U.S. persons.

Instead of drafting the exact legislation into legislation, what we did here is to allow the regulators to continue to have discretion and flexibility on how to implement the rules. I note there has been some confusion by some commentators on the impact of this legislation, so I would like to make certain everyone understands exactly what it does and the effect it will have. So, I will spend a moment on this.

First and foremost, the legislation specifically requires the SEC and the CFTC to have identical cross-border rules. I think it is difficult, if not impossible, for anyone to suggest that it is appropriate for two domestic regulatory bodies to have different standards governing very similar parts of the market. By simply requiring the agencies to have identical rules, the bill will limit any potential opportunities between market participants by ensuring that we have a standard, identical regulatory regime for all types of the swap markets.

First, there is a great deal of ongoing discussion about how to limit regulatory opportunities to market participants, as some of the past witnesses and the witnesses here today have noted in testimony, as well. And actually, we heard this last year, as well. Under this new regime, the most difficult, glaring area of this is if the SEC and the CFTC have different rules.

Second, the legislation requires that formal rules be issued. Currently, the CFTC is moving down a path of instituting a form of amorphous guidance, if you will, which has questionable legal authority. And without a formal rule in place that carries the force of law, there is a valid concern that some of the entities won't feel the need to abide by the guidance—whatever that is—if challenged by a court of law. And the guidance might carry less weight. So by requiring a formal rule instead of guidance, the bill ensures that the force of law will not be in question.

And finally, the legislation specifically authorizes the SEC and the CFTC to regulate swap transactions between U.S. and foreign entities if the regulators are concerned about the importation of systemic risk. Under current law, it is questionable what authority the agencies actually have to regulate potential transactions between them.

If the regulator is concerned about any foreign country not living up to the Obama Administration's G-20 commitments established back in 2009, then those regulators will be specifically authorized to act. Now, the House Agriculture Committee has already passed this bill by a unanimous vote, and I hope this committee will do so the same.

The last bill up for discussion today is the FCC Regulatory Accountability Act. It is similar to legislation which passed the full House last year. The House Agriculture Committee passed the

identical bill for the CFTC and they did so in a bipartisan manner. And I look forward to working closely with my colleagues on both sides to do the same thing here.

So, I thank the members of the panel. And I thank the members of this committee, on both sides of the aisle, for all of these pieces of legislation that we have been able to move forward in a bipartisan manner.

And with that, I will recognize Mrs. Maloney for 3 minutes.

Mrs. MALONEY. Thank you very much, Mr. Chairman.

I am delighted to be at this hearing where we are reviewing several bills that have already passed the Agriculture Committee. Many have passed the House and this committee in the last Congress. There is one new bill. And some of them are working or directed at preempting the regulation of derivatives.

We certainly do not in any way want to weaken Dodd-Frank, the transparency, the oversight, and the accountability which was put in place with that important bill. But I think it is important to review these bills now in light of the progress and steps that the SEC and the CFTC have made, in addition to some of the improvements that Members of Congress have put in place.

It is important not only to uphold Dodd-Frank and the oversight and transparency and accountability, but it is important that we get it right and make sure that it works for our markets and helps our country remain competitive in the global economy.

There is one new bill, H.R. 1341, which requires a study on FSOC on capital surcharges that were placed on derivatives. The E.U. apparently has exempted their banks, and the study will look at what impact this has on our financial institutions.

I look forward to the hearing, and to hearing from our distinguished panelists. I yield back.

Chairman GARRETT. The gentlelady yields back.

Mr. Huizenga for 1½ minutes.

Mr. HUIZENGA. Thank you, Chairman Garrett, and Ranking Member Maloney. I appreciate you holding this hearing today to discuss these various issues. And I am happy to work with my colleague from Wisconsin, Gwen Moore, on this, as well as with some friends from the Agriculture Committee.

Thousands of companies, big and small, across the State of Michigan as well as the whole United States utilize derivatives to better manage the risks that they face every day. The use of these derivatives to hedge risks benefits the global economy by allowing for a range of businesses from manufacturing to health care to agriculture to improve their planning and forecasting and offer more stable prices to their customers as they are managing those dips.

By imposing undue regulatory burdens on end-users, this could increase costs and reduce liquidity, and it would prevent end-users from using these markets efficiently and effectively. That is why I am a proud co-sponsor of H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013. We have to come up with better names than these, I think sometimes.

But this bipartisan legislation would remove that requirement imposed on foreign regulators by the Dodd-Frank Act as a condition of obtaining data repositories. The legislative solution is a small technical fix, but it is desperately needed, as we know. And

it is vital to maintaining the integrity of our domestic and global derivatives markets.

I look forward to hearing from the distinguished panel on this as we are moving forward.

So with that, I yield back, Mr. Chairman.

Chairman GARRETT. Thank you. The gentleman yields back.

We now go to the ranking member of the full Financial Services Committee, the gentlelady from California, Ms. Waters, for 3 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman, for having this hearing today. This is a very important hearing and I look forward to hearing more from our witnesses about today's bills before the committee and their thoughts on how to best implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

But before we consider these modifications to the Act, I think it is important to remember what necessitated the legislation in the first place. I think there is consensus that the over-the-counter derivatives market proved to be a tremendous source of systemic risk during the last crisis. While many firms historically used derivatives like insurance or as a tool to manage their risks, some of our largest financial institutions constructed highly leveraged and opaque positions in the mark-to-market in the lead-up to 2008's financial collapse.

As a result, we were all put in the terrible position of needing to provide government support to private institutions, or else potentially witness the collapse of a $600 trillion market.

The Wall Street Reform Act seeks to ensure that we are never again put in that terrible position by remaking the OTC derivatives market via transparent trading on exchanges and swap execution facilities, and lowering risk through centralized clearing, as well as regulation of swap dealers and major swap participants and public reporting of swap prices and trading volumes.

Though it has been 3 years since the crisis, we still await final regulations on about two-thirds of the provisions requiring rulemaking. And while I remain open to changing the Act to respond to legitimate concerns, I am very nervous about potentially undermining our reforms or otherwise tying the hands of regulators before they have had a chance to finish their work. So, I will closely scrutinize each bill before us today, and consider each one both individually and cumulatively.

Finally, I will add that I am very concerned about the continued push from the Majority on this committee on cost-benefit analysis. The SEC is already subject to an onerous requirement in this regard, and I feel that the Majority is trying to tip the scales in the agency's rulemaking in order to favor the interests of business over the interests of investors. In fact, it could be said that this is really a back-door way of repealing some of the most crucial provisions in Wall Street reform.

Thank you, Mr. Chairman, and I yield back my time.

Chairman GARRETT. And the gentlelady yields back.

Mr. Stivers is recognized for 1 minute.

Mr. STIVERS. Thank you. I will be brief.

I want to thank my co-sponsors—Ms. Fudge, Ms. Moore, and Mr. Gibson—for working with me to introduce this important legislation. I also want to thank Ms. Waters and the members of the minority for working on this bill. Last Congress, as you may remember, it got 357 votes on the House Floor.

This bill clarifies that Dodd-Frank is not related to inter-affiliate swaps. The charges and the restrictions should not be required on the accounting end of those transactions. We shouldn't charge companies 2 to 3 times more for managing their risk in a centralized way, in a more advanced way, and in a smarter way.

I look forward to working with the members of this committee and the whole House to see that these important clarifications get passed. And I want to thank the chairman for this hearing, and for his attention to these important matters.

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

Chairman GARRETT. The gentleman yields back.

Mr. Scott is recognized for 2 minutes.

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

As a long-time member of both the Agriculture Committee and the Financial Services Committee, I have had a great amount of time to study the intricacies of the issues presented by these pieces of legislation that we are reviewing here today. So it is not without deep examination and a keen eye on maintaining the effectiveness of Dodd-Frank that I am in a position to support the majority of these bills before us.

And I should mention that the majority of these bills do have broad bipartisan support. Two of the more controversial ones, I might add, that I am a co-sponsor on, the cross-border, for example, as well as the push-out provision, are both supported by our Federal Reserve Chairman, Ben Bernanke, our former FDIC Chairman, Sheila Bair, and our good friend and former chairman of this committee, and one of the authors of this bill, Mr. Barney Frank.

But it goes without saying that some of this legislation is indeed controversial. And I think the opposition to some of these bills stems from well-founded and very respectful fears of repeating some of the mistakes that in the past led to lax regulation, poor oversight, and eventually economic turmoil.

However, I feel that these bills before us today are not a radical departure from the necessary and proper reforms that are laid out in Dodd-Frank. They will not blow a hole in the bottom of Dodd-Frank, as has been suggested. They will not lead to more Enron loopholes or London loopholes or London Whales.

They are, I firmly believe, corrections to portions of Title VII that are not going to work and have unintended consequences as they are proposed. And not only just for us and our markets, but for foreign markets. And we must remember that we deal in a worldwide market. Our regulations here are basically for us. But we cannot and we must not put our financial institutions in a weakened competitive position.

So I am very sympathetic to the concerns of those who feel this legislation tilts a little bit back towards Wall Street's favor, but I must respectfully disagree with this sentiment. None of the bills we are considering today drastically alters margin or clearing require-

ments, nor do they undermine transparency by lessening the share of trading data.

And I should also mention that none of the bills before us today does anything to alter even in the slightest the Volcker Rule, which once implemented will be a key protection both for the economy and for the taxpayers against high-risk proprietary trading.

So, Mr. Chairman, again, I want to add my voice to the support for these bills and I yield back my time.

Chairman GARRETT. The gentleman yields back.

Mr. Fincher is recognized for 1½ minutes.

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

A lot of folks believe Democrats and Republicans can't agree on anything. However, the bills we are considering this morning are examples of two parties coming together for good governance. I am pleased that we are considering H.R. 1341, the Financial Competitive Act of 2013, which I introduced last month. Mr. Scott, the gentleman from Georgia, and I are working to move this forward to ensure America remains competitive in the global marketplace.

My bill simply requires FSOC to conduct a study of the impacts that implementing the credit valuation adjustment capital requirement, or CVA, will have on U.S. consumers, end-users, and U.S. financial institutions. European Basel III rules are being finalized and would provide a significant exemption from the CVA market for risk-weighted assets for European banks. Transactions with sovereign pension funds and corporate counterparties, which are also exempt from clearing obligations, will be exempted from CVA risk-weighted assets.

I have some serious questions about the impact the European exemption will have on U.S. financial institutions and the larger U.S. economy. To me, this exemption will provide a significant financial business advantage to European banks, European customers, and European end-users at the expense of American businesses, banks, and end-users.

I am not alone. Canada recently announced it will delay its CVA capital requirement for 1 year, even though it implemented the rest of the Basel III package on schedule. Canada's decision to delay implementation of the CVA requirement was simple. It was driven by the concern that Canadian banks would be at a competitive disadvantage because of the European CVA exemption.

Mr. Chairman, the U.S. economy is in a fragile state. Any additional hurdles, fees, or foreign advantage will cost the U.S. economy valuable jobs. I look forward to hearing the testimony of the panel today, and I appreciate Mr. Scott for co-sponsoring.

I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Peters for 2 minutes.

Mr. PETERS. Thank you, Mr. Chairman.

Good morning. I would like to thank our witnesses for being here today, and I look forward to your testimony.

I would like to spend a moment discussing one of the bills we are examining today, H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013. I co-authored this bipartisan legislation, which would help protect businesses that rely on derivatives to responsibly manage risk, with Mr. Grimm.

Derivative end-users represent a broad cross-section of U.S. production, from farmers worried about the price of fertilizer, to manufacturers that are concerned about fluctuating interest rates. Businesses in all of our districts use derivatives to ensure they pay a reasonable price for the products they need, and keep consumer prices stable no matter what happens in the financial markets.

During the consideration of the Dodd-Frank Act, there was a bipartisan recognition that regulations to curb excessive risk-taking in the financial sector should not stifle job creation in the agriculture or manufacturing industries. Michigan is a State that builds and grows things. And let me be clear: The Dodd-Frank Act was not written to hinder the hardworking folks building autos or growing apples.

End-users, companies that use derivative contracts to offset legitimate business risk, were specifically exempted from the clearing requirements, and Congress did not specifically direct regulators to require end-users to post margin. Our bipartisan bill simply clarifies that non-financial end-users are exempt from the Dodd-Frank margin requirements. Forcing non-financial end-users to post margin could have several negative consequences by unnecessarily increasing prices for consumers across a range of goods, slowing job growth here in the United States, and driving businesses to foreign, less transparent derivatives markets.

Our bill passed the House last year with overwhelming bipartisan support, because it is both about protecting jobs and clarifying congressional intent. Having served on the Dodd-Frank conference committee, I can say that this bill will ensure congressional intent to protect our manufacturing and agricultural interests are carried out.

And I will continue to work with Mr. Grimm to get H.R. 634 signed into law to protect jobs across our country and help our economy continue to grow.

I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

Let's turn now to Mr. Grimm for 1½ minutes.

Mr. GRIMM. Thank you, Chairman Garrett. I appreciate it.

I would also like to thank the witnesses for testifying today.

I, too, would like to focus on H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013. As we just heard, this is truly a bipartisan piece of legislation that myself and my friend from Michigan, Mr. Peters, introduced.

In the 112th Congress, H.R. 634 received a tremendous amount of support. It passed the House 370 to 24. And as Mr. Peters said, it is very common-sense, basic legislation which will simply ensure that non-financial commercial end-users of over-the-counter derivatives are not subject to margin requirements which Congress—and that is the key part—never intended. And it ensures that regulators do not attempt to exercise authorities that they were not granted by Congress in ways that would harm the economy by diverting working capital from productive uses, such as promoting economic growth and job creation.

A lack of such an exemption could lead to regulatory arbitrage, increases in consumer prices, as we just heard, and some firms

could abandon hedging altogether, or a loss of jobs as vital working capital is tied up in margin accounts with financial institutions.

So I think we have said enough about it. I am now interested in hearing what the witnesses' thoughts are on this common-sense bipartisan legislation.

And with that, I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

And for the final word, Mr. Hultgren for 1½ minutes.

Mr. HULTGREN. Thank you, Chairman Garrett, not just for holding this hearing today but also for your leadership on these important issues. I greatly appreciate the opportunity to have a role in this important bill, and I am optimistic, as you said, Mr. Chairman, that we can get it passed and signed into law.

H.R. 992, the Swaps Regulatory Improvement Act, does two basic things: one, it will allow depository institutions to continue providing a spectrum of client services and products that would otherwise be unnecessarily prohibited; and two, our bill will clarify one of the unintended consequences of Dodd-Frank, the complete prohibition on swaps trading applied to foreign banks operating in the United States. Section 716 sponsor Senator Lincoln acknowledged this significant oversight, saying, "This double standard was not intended." You can't get much clearer than that.

It is also hard to find such a clear example of potential arbitrage as Section 716 and the unilateral prohibition it imposes on American businesses. Foreign jurisdictions have not followed suit, and there is a clear possibility of market share being pushed overseas because our banks can't provide the same products and services.

Furthermore, multiple regulators have highlighted that spinning off swaps trades may actually increase systemic risk. Affiliates that will house these pushed out swaps trades will be less supervised and not as well-capitalized as the banks which currently engage in these trades.

H.R. 992 will strengthen regulatory oversight, it will preserve U.S. competitiveness, and as we will hear today, it will protect end-users from higher costs and more counterparty risk.

Finally, I want to thank my co-sponsor and teammate, Mr. Himes, for his leadership on this issue. I look forward to working with him again, and with all of my colleagues on both sides of the aisle to improve Title VII where we can.

With that, I yield back.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

We will now turn to the panel. And again, we welcome the panel to the hearing today.

Without objection, your entire written statements will be made a part of the record today. For those of you who have not been here before, we will recognize each of you for 5 minutes. The light in front of you will turn yellow when you have 1 minute remaining to wrap up, and it will turn red when your time has expired.

We will now turn to Mr. Bentsen from SIFMA.

Thank you for being with us today, and you are recognized for 5 minutes.

STATEMENT OF THE HONORABLE KENNETH E. BENTSEN, JR., ACTING PRESIDENT AND CEO, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. BENTSEN. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

On behalf of SIFMA and its member firms, I appreciate the opportunity to testify on several of these important pieces of legislation which would modify Title VII of the Dodd-Frank Act.

As you know, the Dodd-Frank Act created a broad new regulatory regime for derivatives products, commonly referred to as swaps. Specifically, the Act seeks to reduce systemic risk by mandating central clearing for standardized swaps through clearing houses, imposing capital requirements in collection of margin for uncleared swaps, affecting customers through business conduct requirements to promote transparency—

Chairman GARRETT. Excuse me. Can you please pull the microphone a little bit closer to you?

Mr. BENTSEN. No problem, sir.

Let me just say, SIFMA strongly supports the intent of many of these reforms. And I think it is important to note that many of these reforms are actually moving into implementation at this point in time, be it central clearing, data reporting, or even registration. And the firms are taking steps to put these reforms into place.

However, if Title VII is implemented incorrectly, reforms may cause more harm than good. We believe that the appropriate sequencing and coordination of the rules will be critical to the successful implementation of the Act. In addition, we encourage the regulators to harmonize their rules so that similar products will be subject to similar rules.

Given the focus of today's hearing, I would like to offer SIFMA's views on several pieces of the legislation, as well as one or two other issues I would like to bring to your attention. In particular, the swaps push-out rule was added in the Senate in the final stages of the legislative process and never debated in the House. As you know, it would force banks to push out certain swap activities into separately capitalized affiliates or subsidiaries.

The push-out rule, as has been noted today, was opposed by senior prudential regulators, including Fed Chairman Bernanke and former FDIC Chairman Bair. The push-out will increase systemic risk and significantly increase the costs to banks in providing customers with the tools that they need to manage risk. As a result, end-users will pay a higher cost. We appreciate the work of Congressmen Hultgren and Himes in introducing bipartisan legislation to deal with this issue.

Another concern as it relates to our members is the cross-border application of derivatives rules. Neither the SEC nor the CFTC has finished their work and they are doing it in apparently differing ways, with the SEC having not even proposed a rule, and the CFTC doing so by guidance. We think what the CFTC has proposed is unworkable, and it could result in an uneven playing field across global markets that would be to the detriment of U.S. financial markets.

We are encouraged by the bill that the committee is considering today to bring harmonization to this, which frankly is equivalent with what the original statute did with respect to product definitions and registration, which required a joint rulemaking. And we believe that should apply in this case to cross-border application.

In addition, we think that the issue that was raised with respect to the CVA that Congressman Fincher has talked about today is of critical importance. We are seeing a growing trend of diversion from the G-20 principles of harmonization, of implementation of reforms, in particular as it relates to Basel capital standards. And the action by the European Union with respect to CVA creates a very unlevel playing field, but also is incongruous to what the G-20 was trying to accomplish. So we think it is entirely appropriate for the FSOC to look at this.

Congressman Fincher made the point about the Canadians and what they are doing. And while there are clearly problems with the CVA calibration—every market participant agrees with that—exemption from rules and diversion from uniform application is counterproductive and will lead to greater systemic risk.

I would like to mention something which is not before the committee today, but has been before the committee in the past, and that is the question of swap execution facilities. I would encourage the committee to take this issue up, because we believe again you have diversion between the CFTC on this.

And I might mention our buy-side members, who are supposed to be beneficiaries of the swap execution facility proposal, are the ones who have the biggest concerns because of a minimum mandatory request for quote model that they believe will impede best execution for the benefit of their customers. So, this committee has worked on this before, and we would encourage you to do it again.

On the inter-affiliate swaps bill, we think that this is a step in the right direction, and while I will acknowledge that the CFTC recently took exemptive action to address this, it doesn't go far enough and it is frankly onerous in its application. So we think the legislation is the appropriate step to take to do something that we believe Congress intended all along.

Finally, let me just talk about cost-benefit analysis. I know there is a lot of discussion and concern about it, but I might note that President Obama, following on actions by President Clinton through Executive Order, brought about the imposition of cost-benefit analysis in non-Executive-Branch agencies. And we think it is entirely appropriate that non-Executive-Branch agencies, independent agencies as created by Congress, should have similar cost-benefit analysis requirements, as President Obama and President Clinton have proposed before.

Thank you, Mr. Chairman, and I look forward to answering your questions.

[The prepared statement of Mr. Bentsen can be found on page 45 of the appendix.]

Chairman GARRETT. Great. Thank you very much.

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

STATEMENT OF CHRISTOPHER CHILDS, MANAGING DIRECTOR AND CHIEF EXECUTIVE OFFICER, THE DEPOSITORY TRUST & CLEARING CORPORATION (DTCC) DATA REPOSITORY (U.S.)

Mr. CHILDS. Thank you, Mr. Chairman.

I am Chris Childs, chief executive officer of the DTCC Data Repository, or DDR, which is DTCC's U.S. swap data repository. DTCC is a participant-owned and governed cooperative that serves as a critical financial market infrastructure for the U.S. and global financial markets. DTCC strongly supports H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013. I want to thank Congressman Huizenga and Congresswoman Moore for their leadership on this issue.

I would like to focus on three points today. First, I will briefly introduce DTCC's role in the swaps market. Second, I will explain the indemnification provision in Dodd-Frank and the problem it poses for swap sharing and systemic risk oversight. And third, I will discuss why a legislative remedy is needed to resolve this matter.

Let me begin with my first point. DTCC has a long history in the over-the-counter swaps market as a trade repository going back to 2005. Today, a swap data repository is provisionally registered with the CFTC under Dodd-Frank, and is the only registered SDR to offer trade repository and public reporting access across all five asset classes.

In addition, the DTCC SDR was the first registered swap data repository to publish real-time price information. As you know, yesterday was the CFTC deadline for certain end-users to begin reporting trade data to SDRs. DTCC has been working with market participants to help them meet their reporting obligations, and I am pleased to report that end-user information is now being transmitted into our repository and made publicly available on our Web site.

In addition to our work in the United States, DTCC provides trade repository services in the United Kingdom, Singapore, and the Netherlands. And we are the first organization to receive regulatory approval in Japan to establish a trade repository. As derivative trading is a global business, it is critical that regulators worldwide have access to a complete data set for systemic risk oversight.

So let me turn to my second point and explain how the indemnification provision in Dodd-Frank has the potential to inhibit the ability of regulators to fully understand market exposures. The indemnification provision requires a registered SDR as a condition to sharing information with an entity like a foreign regulator to receive a written agreement that the regulator will abide by certain confidentiality requirements and indemnify the SDR for any expense arising from litigation relating to the information provided.

We believe these provisions are complicated and unworkable. Many foreign countries and their legal systems do not recognize the concept of indemnification. Even where they do, many foreign governments cannot or will not agree to indemnify foreign private third parties, such as U.S.-registered SDRs, or foreign governments.

In order to access the necessary information without indemnification, each jurisdiction may have to establish a local trade repository. And a proliferation of local trade repositories would undermine the ability of regulators to obtain timely, consolidated, and accurate view of the global marketplace.

For nearly 3 years, regulators globally have followed OTC derivatives regulatory forum guidelines to access the information they need for systemic risk oversight. It is the standard that the DTCC uses to provide regulators around the world with access to global credit default and interest rate swap data in its voluntary trade repositories, and it has worked well to date.

The Dodd-Frank indemnification requirement has not been copied by regulators overseas. In fact, the European market infrastructure regulation, known as EMIR, considered and rejected an indemnification requirement.

Turning to my final point, let me discuss potential remedies to indemnification. During the 112th Congress, a bipartisan coalition of more than 40 lawmakers in the House signed on as co-sponsors of legislation identical to H.R. 742. The SEC testified in support of such legislation and former SEC Chairman Elisse Walter reaffirmed this position earlier this week.

In addition, three of the five CFTC Commissioners publicly endorsed the need for legislation to clarify this provision of Dodd-Frank. Last month, the House Agriculture Committee held a hearing on various legislative proposals, including H.R. 742. No opposition was expressed at the hearing.

Soon after, H.R. 742 was approved unanimously by the committee. We urge this committee to approve H.R. 742 to make technical corrections to this provision of Dodd-Frank, and ensure regulatory comity with international counterparts. The legislation will help provide the proper environment for the development of a global trade repository system to support the goals of Congress and regulators in creating a more stable and secure financial system.

Thank you.

[The prepared statement of Mr. Childs can be found on page 53 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Deas, welcome, and you are recognized for 5 minutes.

STATEMENT OF THOMAS C. DEAS, JR., VICE PRESIDENT AND TREASURER, FMC CORPORATON

Mr. DEAS. Thank you, sir.

Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

I am Tom Deas, vice president and treasurer of FMC Corporation, and I am also chairman of the National Association of Corporate Treasurers (NACT). FMC and NACT are also part of the Coalition for Derivatives End-Users.

As you oversee the implementation of the Dodd-Frank Act, I want to assure you that end-users comprising less than 10 percent of the derivatives market were not and are not engaging in the kind of risky, speculative trading activity that became evident in 2008. We use derivatives to hedge risks in our day-to-day business

activity. We are offsetting risk with derivatives, not creating new risks.

We believe it is sound policy and consistent with the law to exempt end-users from provisions intended to reduce the inherent riskiness of swap dealers' activities. However, at this point, 2½ years after passage of the Act, there are several areas where continuing regulatory uncertainty compels end-users to appeal for legislative relief.

Among several areas of concern, I would like to invite your attention to three. First, in regard to the margining of derivatives. FMC Corporation, an innovator in the chemical industry, was founded almost 130 years ago. This is our 82nd year of listing on the New York Stock Exchange. In 1931, the NYSE was the largest pool of capital to grow our business.

Today, using derivatives, we have an additional market that is the cheapest and most flexible way for us to hedge business risks every day, to cover foreign exchange movements, changes in interest rates, global energy, and commodity prices. Our banks do not require FMC to post cash margin to secure mark-to-market fluctuation in the value of our derivatives.

But instead, price the overall transaction to take this risk into account. This structure gives us certainty, so that we never have to post cash margin while the derivative is outstanding. To do so would divert cash from funds we would otherwise invest in our business.

The proposals by the banking regulators mandating collection of margin from end-users are out of sync, not only with the CFTC, but with the European regulators as well. We believe end-users and their swap dealers should remain as they have been since the inception of the derivatives market, free to negotiate mutually acceptable margin agreements, instead of having regulators impose mandatory daily margining with its uncertain liquidity requirements. The coalition commends your bipartisan efforts to redress this through H.R. 634.

Next, in our affiliate derivative transaction. The coalition recognizes the efforts of the CFTC to provide relief on inter-affiliated use, but we still have concerns. For example, end-users have long used widely accepted risk reduction techniques to net exposures within their corporate groups so that they can reduce the derivatives they do with banks.

However, the internal central Treasury units they use run the risk of being designated as financial entities subject to mandatory clearing and margining, even though they are acting on behalf of non-financial end-user companies otherwise eligible for relief from these burdens. We support H.R. 677 as a straightforward and necessary remedy for this and related problems.

Finally, capital requirements for derivative transactions. With your help, end-users could successfully navigate the complex regulatory issues I have described today, only to find that the unclear OTC derivatives we seek to continue using have become too costly because of much higher capital requirements imposed on our banks. The bank regulators have proposed a new credit valuation adjustment, significantly increasing capital requirements on all derivatives.

However, European regulators have concluded endusers' hedging activities are in fact reducing risk and should attract less capital than swap dealers' trades. They propose to exempt non-financial end-users from these capital requirements. This would put FMC and other American companies at an economic disadvantage compared to our European competitors. The coalition supports legislation such as H.R. 1341 directing FSOC to study this problem and report on the consequences for American competitiveness.

A related issue is the swaps push-out provision of Section 716 of the Act, which would require that banks contribute additional capital to establish separate subsidiaries by this July to conduct much of their derivatives activity.

Although I have focused here on a few main concerns, end-users are very concerned about the web of, at times, conflicting rules from U.S. as well as foreign regulators that will determine whether we can continue to manage business risk through derivatives. The clear end-user exemption we thought would apply is still uncertain, confronting us with the risk of foreign regulatory arbitrage and potential competitive burdens that could limit growth and ultimately our ability to sustain and we hope grow jobs.

Thank you again for your attention to the needs of end-user companies.

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

Chairman GARRETT. And I thank you as well.

Dr. Parsons, from MIT, welcome to the panel. You are recognized for 5 minutes.

STATEMENT OF JOHN E. PARSONS, SENIOR LECTURER, FINANCE GROUP, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. PARSONS. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee for giving me the opportunity to testify here today.

It has been nearly 3 years since the passage of the Dodd-Frank Act, and many of its derivative market reforms are still not fully implemented. Americans remain threatened by the same dangers that exploded on the country in 2008. Congress should consider ways to encourage and enable the full implementation of the Dodd-Frank derivative reforms.

Instead, five of the seven legislative proposals before the subcommittee today take us in the opposite direction. They reverse key elements of the reform. They resurrect the old system in which major segments of the derivatives markets are off limits to the cop on the beat. They reinstate the old system in which the cop's discretion and authority is severely limited, while at the same time financial players are given greater license and more loopholes.

These pieces of legislation in their style highlight the stark differences between parts of the OTC derivative markets, which operate on two very different business models. The first business model is organized around the unique services that OTC swaps can offer to American and international businesses. It was the model that was responsible for the origin of swaps at the end of the 1970s.

The swaps marketplace is uniquely positioned to offer customized as well as less liquid derivatives complementing the standardized derivatives offered for trade on futures exchanges, and the swaps marketplace provides an alternative for competition in standardizable derivatives, too.

In serving these needs, the swaps market provides a real service to the economy, and it can be supported in this by a proper regulatory framework like Title VII of the Dodd-Frank Act. Unfortunately, before the financial crisis, the OTC swaps marketplace also had a second business model, organized around the lack of regulation. It valued operating in dark markets and the ability to evade supervision. It warehoused growing volumes of credit risks on the balance sheets of derivative dealers. It does not provide any unique service to the economy. It undermines the economy's stability.

Growth in this trade was a classic case of regulatory arbitrage. This arbitraged trade did not have an interest in sound and stable markets, because its very existence relied on the lack of regulation and oversight. This arbitraged trade did not advocate wise regulation. It fought hard for no regulation.

This is best epitomized by the legislative fight over the now-infamous Commodity Futures Modernization Act of 2000. Full implementation of the Dodd-Frank Act's derivative reforms to this arbitraged trade and push the OTC swaps industry to focus on the truly productive business model.

Unfortunately, a large portion of the industry remains wedded to the regulatory arbitrage model. It constantly turns to Congress, and returns again and again, in a bid to repeat the success it had before the financial crisis in blocking sound and universal standards for market conduct.

Much of the legislation at hand in today's hearing supports the bad business model of the arbitrage trade. The legislation is animated by the private benefits of loopholes for select constituencies and overlooks the value of universal standards that benefit the U.S. economy.

What the country needs is good regulation that supports sound and stable derivative markets providing real services to America's businesses. What the country needs is to finish the implementation of the Dodd-Frank derivative reforms. As of today, this job is not yet done and that is where Congress should focus its attention.

Thank you.

[The prepared statement of Dr. Parsons can be found on page 66 of the appendix.]

Chairman GARRETT. Again, I thank you.

At this time, we will go to questioning, and I will yield myself 5 minutes.

I will start with Mr. Deas. First, you did discuss this, but maybe I will just give you a moment to elaborate on the economic impact if traditional end-users were having to comply with a margin requirement?

Second, in your testimony you talked about how under the existing framework, the prior framework, end-users were not required to have margin requirements. But I think you used language as to the extent that the institutions would take this into account with regard to their pricing.

Could you just flesh that out a little bit?

Mr. DEAS. Yes, sir. Thank you for that question.

The coalition commissioned a study of the effect of having to post margin, and FMC participated in that study. We are a member of the Business Roundtable, and we surveyed the non-financial members of the Business Roundtable and found that on average, those members would have to set aside $269 million to margin their derivative positions.

And the effect of this, when we extrapolate it across the S&P 500, of which FMC is also a member, would be diverting cash from investment and expanding planned equipment, building inventory for higher sales, conducting research and development, and ultimately growing jobs. And the jobs effect across the S&P 500 was 100,000 to 120,000.

I think even Chairman Bernanke has said that he agrees with the concept that end-users should not be subject to margining, but he feels the legislation is ambiguous and requires the banks he regulates to collect that margin. But the effect on it would be to stifle growth.

Now, for the price that is built in, just to give you an example, my company hedges energy exposure. We produce chemicals, and energy is a large component of that. So we would buy over-the-counter derivative strips to hedge the price of natural gas for the future.

Today, you can buy that kind of locked-in protection for 2014, for let's say around $4 an MMBTu. And we estimate that the credit spread that is built into that by our banks that would cover a period of anywhere from 18 to 24 months and would be something like 2 cents out of that $4 an MMBTu.

Whereas, the fluctuations in the price of natural gas could be as much as 40 cents over that period, which would multiply times our consumption of eight million MMBTus, be a considerable amount of liquidity that we would have to hold in reserve, because failure to meet that margin—

Chairman GARRETT. So, would the argument be that 2 cents is or is not adequate then, versus the 40 cents fluctuation?

Mr. DEAS. Well, no, sir. I don't think there is an argument against it.

Chairman GARRETT. Okay.

Mr. DEAS. That is how the market conducts itself, and so all the end-users, FMC and all the other end-users I know have opted to pay that credit spread—

Chairman GARRETT. Right, right.

Mr. DEAS. —rather than to margin. And then, the extreme case would be if the regulators imposed daily margining which would introduce more volatility.

Chairman GARRETT. Okay, thanks.

I will jump over to Congressman Bentsen. I think you were the one who commented on the SEC requirement of doing economic analysis. I appreciate that. And I think you pointed out that cost-benefit analysis is just basically in keeping with what the Administration was trying to do elsewhere, right?

Mr. BENTSEN. That is correct. The Obama Administration issued an Executive Order, I think 2 years ago now, requiring a cost-ben-

efit analysis regime with independent agencies. They don't have the exact authority to do it. The SEC has weighed in on that and has been building it. But this legislation we see is in line with that, with the Obama Executive Order.

Chairman GARRETT. And isn't it also—my understanding of it—we had Chairman Schapiro here 27 times, I think she said. And she said that they are already doing it voluntarily; this would just basically codify it.

Mr. BENTSEN. I think that is right. If you talk—in our discussions with the SEC, they are building out a cost-benefit analysis regime. And that is evident in recent actions like the request for information regarding H.R. 913.

Chairman GARRETT. Thank you very much.

I appreciate the panel.

The gentlelady from New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you.

I want to welcome all the panelists, particularly my former colleague, Ken Bentsen. It is very good to see you.

And Mr. Childs, who is DTCC is in the district that I represent.

I do support H.R. 742, which would put us in line with the rest of the world. But in your testimony today, it is almost too good to believe when you say you can give on-time data on interest rates, credit default swaps, the overview of exposure trends.

Did you have this information before the financial crisis? Could you have prevented the financial crisis and notified regulators? It says you are in constant contact with them. Why was this information not used in a way that it could have alerted us to avert or take steps to avoid this financial crisis from which we are still recovering? Every economist tells us it is the only one we have had which we could have prevented with better financial oversight and regulation.

Mr. CHILDS. Thank you for that question. I think it is important to understand the development of how we got to where we got to. And it is true that from 2005 we have been collecting data, but not for the purpose necessarily of regulatory oversight. Obviously, the DTCC itself is not a regulator.

Actually, the trade information warehouse, which was the prerunner to the repositories that we are now building, was built so that we could better administer the operations of credit default swaps. Interestingly, when the crisis did hit, it was at that point where it became very clear that the data we held would be very useful.

And it was at the point that we actually started with the industry, on a voluntary basis, making that data available to regulators. And it was actually quite useful during the aftermath of the crisis to understand the true risks that were in, at least, the credit default swaps market.

In many respects, I think the repository we had drove a lot of the legislative response to the crisis. So it is true to say we had a lot of that data at the time of the crisis, but it wasn't necessarily, or it wasn't being used at that point from a regulatory oversight perspective.

Mrs. MALONEY. How can you be sure that your data is accurate if the industry we are trying to regulate is supplying the data to

you? So if a lot of the problems that we tried to correct with Sarbanes-Oxley and really the derivatives and other oversight is that the data that we were given—regulators were given—was inaccurate? So the data is coming to you from the industry we need to regulate. And so, how you be sure the data is accurate?

Mr. CHILDS. It is a good question in as much that a lot of this data is self-reported. Having said that, with the provisions of Dodd-Frank there is the need for both sides to the trade to verify their positions. So, there is not just one counterparty reporting. The other side should be looking at that data.

And when it is a trade between two swap dealers, as well, one of the important pieces of provision of data is the value of that trade. And so, both sides of the transaction are independently sending in to the swap data repository their own independent valuation of those OTC transactions. So right there, hopefully there is a check and balance.

I think the third thing is there is obviously now it is transforming into a highly regulated market, and the regulation itself should force the market participants to comply with their regulatory responsibilities.

As it relates to the data itself, there are also validation techniques that we use when we are receiving data to ensure that the trade information that is coming in meets the requirements that are set forth within the regulation.

Mrs. MALONEY. Okay.

I would like to ask Ken Bentsen on the extraterritoriality of the bill, H.R. 1256, how has the proposed bill changed from the bill that moved though Congress last time? And given the fact that we are in a global economy and that some trades executed overseas could have a direct impact, not only on our financial institutions, but on our overall economy, what are your thoughts about the new U.S. swaps regulations and how they apply to U.S. entities operating overseas?

Do you think that this addresses it? Could you expand on that?

Mr. BENTSEN. Thank you. I think what this bill attempts to do is to better coordinate the rulemaking, and do by rulemaking in terms of process what the cross-border regime should be for swap dealer registrants who are operating in the United States.

And the goal, from our standpoint, would be to have a uniform application in the United States in as uniform an application globally, because this is a global market.

So what we are concerned about with the process as it is gone so far is that we have a potential uneven application through the extraterritorial application of U.S. rules with an uncertain definition of who is a U.S. person and who is not. How that treats foreign branches and affiliates of U.S. swap dealers, and that affects the market back here; whether you have reundancy in regulation or duplication in regulation in foreign markets and whether you have equivalency in regulation.

We see the Europeans who are moving forward with EMIR and Mifid in implementing their rules. The various Asian jurisdictions are moving, at maybe not as fast of a pace. But there needs to be a level playing field across these markets. And it has to start with,

in our view, a joint or dual rulemaking between the U.S. regulators, and we haven't had that so far.

And I would just lastly say, we have seen because of the process that has gone forward with the CFTC getting too far out in front that they have had to backfill through exemptive relief and no-action letters beginning on October 12th, at the end of this year, at the end of March, and going—which will continue through this year, which has created uncertainty in the market and seen counterparties move away from U.S. swap deals—U.S.-registered swap deals.

Mrs. MALONEY. My time has expired.

Chairman GARRETT. Mr. Hurt is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. And I thank each of the panelists for being here and each of the patrons for bills that we are considering today. I commend Mr. Grimm and Mr. Peters, especially on the end-user bill.

I wanted to just follow up with Mr. Deas, a little bit. I come from a rural district in Virginia. We have a lot of farming—dairy, tobacco, beef, grain. And I was wondering, for my constituents who are maybe watching this hearing, maybe not, I was wondering if you could break it down a little bit more in terms of what the threat to their operations—these are folks who depend on fuel, stable prices for fuel, and they depend on credit.

If you could elaborate a little bit on the effect of increased capital requirements, and so forth, on end-users if this legislation is not adopted here, and very importantly, down the hall of the Senate, and made law.

Mr. DEAS. Yes, sir. Thank you for that question. FMC, as I mentioned, was founded 130 years ago, to make spray equipment for farmers. Today, we make and sell over $2 billion of agricultural chemicals to farmers. Your constituents depend on our products to make their living. And they expect not only innovation, but products at an effective cost.

So as I described in our manufacturing, we use natural gas, and we have other inputs, and we try to achieve that low cost and predictability through, in part, managing our costs with derivatives. And so one of the important members of our coalition for derivative end-users is the Agricultural Retailers Association. And they have seen the effect on people in your district who would be hedging what is in the silo or hedging their future fuel costs of one type or another and then having a network of suppliers who themselves depend on derivatives to hedge their costs and provide products to them.

Mr. HURT. Thank you. I also wanted to ask Mr. Bentsen about testimony that was submitted in writing, and he touched on it briefly in his oral testimony. But in talking about the swaps execution facilities and some of the requirements—the CFTC has proposed rules relating to the customers requiring at least five market participants for a request for quotes, and requiring SEFs to display quotes for a period of time.

In your testimony, your written testimony, you said this differs from current market practice and could have significant impact on the liquidity in the swap market. Could you talk a little bit more, elaborate a little bit more about the effects that would have, or

those two proposals and the rest of the things that are of concern in the CFTC proposal and the importance of making sure we getting that right?

Mr. BENTSEN. Yes, Congressman, thank you. This is an issue which was part of the statute that requires, in lieu of an exchange trading, if you will, the ability to trade swaps through a swap execution facility. This is a new entity created by legislative fiat, so it doesn't exist today.

And both the SEC and the CFTC are required to create these under the Act for the swap markets that they have jurisdiction over. They have come out with different proposals where the SEC has proposed that it would be the—the customer can determine whether or not or ask whether or not they want multiple requests for quotes.

The CFTC has come out with a proposal requiring a mandatory minimum of five requests for quotes, along with a block trading exemption, so certain trades of a certain size are exempted from that. The problem—and this really comes from our buy side members, so our members who are mutual fund companies, asset managers, managers for pension accounts, whatever, and their concern is they do not want to have a requirement—they want to—they don't mind having the ability to ask for multiple quotes, and they are very sophisticated in the markets on a regular basis, but they don't want to have to have a mandatory requirement where they are effectively telegraphing to the market when they are making a transaction to rebalance a portfolio for liquidations, whatever the case may be.

And they are going to have to hedge that trade they are making in equities or bonds, whatever it may be, that they are telling the market what trade they are making. And that is going to impede best execution at the cost of their end-users and customers.

Mr. HURT. And will impact liquidity and—

Mr. BENTSEN. Absolutely. Yes, and so they are the ones that this is designed to help, and they are saying, "Stop, because this isn't going to help us. This is going to hurt us."

Mr. HURT. Thank you. I think my time has expired.

Chairman GARRETT. The gentleman yields back.

The gentlelady from California?

Ms. WATERS. Thank you very much, Mr. Chairman. I have a question for Mr. Deas, representing the Coalition for Derivatives End-Users. I thank you for your testimony, and I think you have clarified a number of things, but I would like you to comment on the fact that this week we learned that ICAP, the biggest broker of interest rate swaps between banks, is being probed by the CFTC on whether their brokers colluded with banks in fixing interest rate swap prices. In particular, the CFTC is investigating whether ICAP brokers colluded with dealers, who stand to profit from inaccurate quotes, including failing to update published swap prices on a trading screen until after the trades occur.

As I understand it, the ISDAfix prices that ICAP is being accused of manipulating or the—it is ISDAfix prices that ICAP is being accused of manipulating are used by many corporate treasurers to gauge their funding costs. I raise this point to ask a question. We are focusing quite a bit in this hearing about the cost of

Dodd-Frank to derivatives' end-users, which include major U.S. companies. But in the wake of this probe, along with instances of LIBOR manipulation, to what extent are derivatives' end-users concerned that the system is rigged and that we actually need enhanced enforcement to ensure that there is an even playing field in our derivatives markets?

Mr. DEAS. Ranking Member Waters, thank you very much for that question, and thank you for your support of and attention to end-user issues.

A derivative by its very nature is a financial instrument whose price is derived from an underlying instrument. When my company goes to issue a bond in the public debt market, perhaps we have chosen to make it a 10-year term, we will hedge the interest rate risk with a 10-year interest rate swap derivative, custom crafted to meet that, and the price of that derivative, we can determine independently by looking at the actually second-by-second movement of the associated 10-year U.S. Treasury note that would correspond to the maturity that we are issuing.

And so we have, through access to these sources, a ready way to check what we think the price is, and then what we do is bid that transaction to a group of our banks—sometimes three or four banks—and pick the winning bidder from that group. So we have an independent means to get in the neighborhood, and we have a competition that allows us to select the best price.

Now, the swap data repository will make that somewhat easier in that it will provide, to the extent that it has data for the term and the amount that we are specifically interested in, that is yet another cross-check, but we feel that we are—we have adequate means to assure that we are getting an appropriate deal for our shareholders, our employees, and to do a proper transaction for the company.

Ms. WATERS. I would like to go to Mr. Parsons now. If manipulation is allegedly occurring in the highly liquid interest rates swaps market, what does it say about the potential for a manipulation in less liquid markets? Does this underscore the imperative for the reforms in Dodd-Frank Act?

And while you are speaking on this, as I understand it, the ISDAfix is a benchmark for fixed rates on interest rate swaps. You did not speak to that, Mr. Deas, but I would ask Mr. Parsons to comment on that.

Mr. PARSONS. Thank you. Certainly, if you can fix the interest rate market, the largest market in which there are so many, many other players, you can fix all sorts of other more illiquid markets. I was a little startled by Mr. Deas' response to you. If he prices his bonds off of U.S. Treasury rates, he would be a very unusual corporate treasurer.

Typically, you would price your bonds off of the swap rate, which is at a differential to the Treasury rate, and the swap rate is sometimes at a higher differential, and sometimes a lower differential. While they may not be manipulating the Treasury rates, if they are manipulating the swap rate, the premium or discount that the company is getting on selling its bond has just been manipulated, and there is no way for Mr. Deas to verify that by looking at the Treasury bill.

We need supervision to assure that markets work well. That has to be true about all kinds of markets. And a non-transparent market is going to have problems.

Ms. WATERS. Thank you very much. I yield back.

Chairman GARRETT. Thank you. The gentlelady yields back.

Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

In March, the acting USTR sent a letter to the Speaker noting his intention to launch negotiations of an E.U.-U.S. trade deal. This is, I think, a very positive development. And I am hopeful that we have a permanent USTR that can be named expeditiously and that negotiations are going to be under way very quickly.

But the letter noted, as it relates to trade and services, that a deal should improve regulatory cooperation where appropriate. Clearly, financial services of securities, banking, and insurance are an area where improved cooperation and coordination would be more than appropriate.

And I was going to ask Mr. Bentsen, do you agree that renewed interest in an E.U.-U.S. trade deal can have a positive impact on the ongoing conversation related to derivatives regulations and other aspects of financial services regulation in the United States and Europe? And specifically, could the trade deal help facilitate a framework for developing recognition arrangements?

Mr. BENTSEN. Thank you, Mr. Royce. We completely agree with that sentiment. We have been outspoken about the fact that we think a U.S.-E.U. trade agreement is entirely appropriate. We are very supportive of it on the broad range, but we also believe that it should include a financial plank to accomplish exactly what you are talking about. You are talking about two of the most intertwined markets, and combined, the largest financial market where you have similar efforts and new financial reforms going on, and we believe this agreement could be a model for regulatory coordination across very similar markets.

We have seen this, as you know, in other agreements such as the U.S.-Australian free trade agreement, where there is a mutual recognition component. And obviously, there are mutual recognition components in other sectors in trade agreements, so we think it is entirely appropriate, and we have been advocating such to the Administration.

Mr. ROYCE. Let me ask you another question. On the question of extraterritorial application of derivatives regulation, we have a problem where we need to ensure that we have similar regulation and similar enforcement by regulators, but there is also an important component that I think can't be understressed, and that is we have a problem of trust between nations which must withstand the pressures of crisis situations like the last financial crisis, and we need to build this trust.

In testimony before the House Agriculture Committee last December, the head of the European Commission's market infrastructure unit said that one consequence of the current rules under consideration in the United States is that, in his words, "Trades will not be able to clear and end-users will not hedge their risk or firms will hedge their risk, but they will only take place within one jurisdiction, which means that risk will be concentrated in one jurisdic-

tion. The consequence of that is a fragmented market and a significant concentration of financial risk in the U.S. system."

The regulations which have been imposed appear to have sort of the opposite of intended intent here. The consequence has been sort of the reciprocal. We wanted to decrease risk and increase global cooperation, but at least as perceived by Michel Barnier in that quote, he reached a different conclusion.

So what can you tell this committee about the coordination that you are seeing between U.S. and foreign regulators to ensure that there is a level playing field? And how do we avoid risk spilling over into the United States without adopting an overly strict extraterritorial regulation that appears to place distrust on the—in the part of our economic allies overseas?

Mr. BENTSEN. Mr. Royce, I think since that time, since the initial CFTC proposal and some of the push-back that has come not just from Europe but from various Asian jurisdictions, there has been increased dialogue through the IOSCO channel. And I think that is very positive. I think comments from former SEC Chairman Walter while she was in Australia about where the SEC may be heading with their proposed rule on cross-border are all positive steps.

But you are absolutely right. At the end of the day, there is a reason for the G-20 principles in uniform application, because you have—it is a global marketplace, and there has to be very good global coordination to make sure that we have a level playing field across the globe.

And, again, it goes back to your comments on trade. That is a perfect opportunity to create a protocol to address it.

Mr. ROYCE. If I could just close with Mr. Barnier's quote yesterday, he said, "It would be a great concern if duplicative rules were imposed in isolation, as it would start a process of costly replication worldwide, leading to capital and regulatory fragmentation." So, he is clearly still concerned.

Mr. ROYCE. Thank you.

Chairman GARRETT. Thank you.

Mr. Scott is recognized for 5 minutes, and a little extra.

Mr. SCOTT. Yes, okay. Thank you very much. I appreciate that. I have questions for Dr. Parsons and Mr. Childs and Mr. Bentsen.

First of all, Mr. Childs, I think the swaps data repository deal is very critical to smooth operations of our derivatives operation, but my understanding is that when a foreign regulator requests information from a U.S.-registered swap dealer repository, then that depository is required to receive a written agreement from the foreign regulator that it will abide by certain confidentiality requirements and that it will indemnify the SDR and its U.S. regulator for any expenses arising from litigation relating to inappropriate public release of information. Is that correct?

Mr. CHILDS. That is correct.

Mr. SCOTT. All right. And our bill, the bill before us, H.R. 742, would strike this indemnification requirement related to both the swap data gathered by the SDR and the data collected by the Commission.

So I think it is important for you if you can explain to us just in plain terms what is indemnification as a legal concept, both with

respect to domestic law, as well as the regulatory regime here and in foreign countries? And why would such a concept need to be included in the section of Dodd-Frank dealing with information sharing?

Mr. CHILDS. Thank you for the question. I think it is first—it is probably important to point out that I myself am not a lawyer, but I think that—or the concept here is that in a global market, data will be held in repositories. And under the legislation from Dodd-Frank, at this moment in time, if a foreign regulator needs to see any data that is held within that swap data repository, they would have to indemnify both the repository operator and the CFTC against any potential loss—litigation loss resulting from the use or misuse of that data. That concept, as I understand it, is not necessarily a concept which even exists in some foreign jurisdictions.

I think it is also important to note that in a reciprocal arrangement, it is unlikely that a U.S. regulator would be prepared to sign that indemnification language themselves.

Mr. SCOTT. So what sort of data protection procedures are in place in DTCC and in the industry as a whole that would make indemnification unnecessary, as this bill would do?

Mr. CHILDS. Again, a very good question. First of all, it is obviously important for the transparency of data for regulators around the world to get access to the data that they need so that they can fulfill their function on systemic risk oversight. But I think it is also important, in direct response to your question, to note that it doesn't mean that any regulator around the world can simply ask for all of the data within the swap data repository. There are very stringent controls that we would have in place and do, in fact, already have in place on the voluntary side of data provision, which ensures that regulators only get to see the data that they are entitled to see to perform their function.

Mr. SCOTT. All right. Dr. Parsons, I would like to turn to you for a moment and ask just a couple of quick questions about some things that have been in the news, and I think it is important that you comment on these, for example, the London Whale trades which continue to be in the news. Can you tell us very briefly, what was the nature of these trades? They were proprietary trades, were they not, rather than trades done on behalf of a customer of a bank?

And if they were proprietary trades, would they not be covered by the Volcker Rule? As I mentioned in my opening statement, none of the corrections to the portions of the Volcker Rule are in place just yet, but would you comment on that, please?

Mr. PARSONS. As I read the facts as they have come out from the investigations, that was prop trading, speculative trading. It would be prohibited by the Volcker Rule. Of course, there are people who want to broaden the definition about what portfolio hedging is in ways which I think would make it practically impossible to say that anything was not a portfolio hedge. And so, they would defend those trades that way.

But it seems to me that the regulations—the first drafts of the rules that the supervisors presented included a number of provisions to examine the activities in an institution like the CIO and

would have identified this as the kind of trade that is prohibited. But it wasn't yet in effect. The Volcker Rule is not yet in effect.

Mr. SCOTT. Thank you.

Mr. Bentsen, quickly, I know my time is pressing, but this pushout rule, the pushout rule results in pushing these swap activities out of the bank and into an area. And it is provided in Dodd-Frank that failure to do so then punishes or forfeits the bank from participating in the Fed's window, as well as FDIC insurance.

My concern is—and I would like for you to comment—does this weaken the situation more? Is this not—

Chairman GARRETT. If you can quickly respond, since we are over by 1½ minutes here.

Mr. SCOTT. All right. Thank you.

Mr. BENTSEN. I would say no, because the way the legislation is written, it doesn't open up the access to the payment system or to these particular swaps. And I think the reason why you have the prudential regulators, who didn't like this in the first place, is they don't like the idea of taking capital out of the bank and putting it in a separate affiliate, so they would rather keep it there where it is under their jurisdiction.

Mr. SCOTT. Okay, thanks.

Chairman GARRETT. Great. And thank you.

Mr. Huizenga, you are recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate that.

And somewhat following on what my colleague was talking about, Mr. Childs, if you don't mind, maybe expounding on this. I understand—I was not here when Dodd-Frank was created. But what I tell people is I am living with the echo effects of it, and we are trying to sort through and figure out how we make these things more manageable.

And my understanding is that this indemnification process was actually inserted during the conference committee. There weren't any hearings or discussions about it. And so, I think we are obviously dealing with some of those unintended consequences.

I am curious if you can give some perspective as to why foreign regulators have rejected the inclusion of these indemnification provisions in their derivatives reform legislation and why suddenly we think it is a good idea for us to be sort of an outlier or why some believe it is a good idea?

Mr. CHILDS. Yes, thank you. I think there are probably two reasons. One is, as I had mentioned, that indemnification is not even recognized in some jurisdictions. And the second reason, without talking on behalf of regulators and what they were really thinking, I think that it is generally accepted that in order to provide the right level of oversight and transparency, it is important that the data flows to where the data needs to be.

And the indemnification provisions would make that much more difficult, in some respects almost impossible. And, of course—

Mr. HUIZENGA. Specifically how?

Mr. CHILDS. Because if we as a swap data repository operator cannot provide the data without the indemnification, and if they cannot provide the indemnification, then the data cannot flow. And at that point, you don't have the transparency and the oversight

that you need. Obviously, it is even more important in times of crisis that data can flow quickly. Just the kind of paperwork—

Mr. HUIZENGA. An irresistible force moving an immovable object.

Mr. CHILDS. Right, exactly.

Mr. HUIZENGA. Okay.

Mr. CHILDS. So, it feels like a correction is required to bring the rules in line with what is being enacted elsewhere in the world to allow that transparency to occur.

Mr. HUIZENGA. And then who exactly determines what information is available and to whom? As you are dealing with these—I assume that data is available to those regulators, right?

Mr. CHILDS. Obviously, anything that is in the swap data repository at that moment in time is available and is provided already to the CFTC. If we get requests from—in fact, there is already a kind of voluntary regime which applies to credit default swaps and interest rate swaps, where the OTC Derivatives Regulatory Forum, which is around about 50 regulators, together with the industry agree the terms under which data can be provided, so we already do actually provide some data to foreign regulators, but under the voluntary regime that is in place as opposed to the legislative regime.

But, again, as I had mentioned earlier on, I think it is important to note that the rules around data and who gets to see what will always be pretty clear. And so, the swap data repository operators would provide the data underneath those rules. And it would provide data to regulators around the world based on the role that they perform in the world.

Mr. HUIZENGA. But in general, it is not available to the public?

Mr. CHILDS. Correct.

Mr. HUIZENGA. Okay. I appreciate that.

Mr. Chairman, I yield back.

Chairman GARRETT. Okay, the gentleman yields back.

The gentleman from California?

Mr. SHERMAN. Thank you.

I can understand the political reasons and the fairness reasons why we have exempted end-users from posting capital. My concern is that the financial institution that enters into an agreement with an end-user is thereby taking the counterparty risk. What do we have in the system to make sure that no one financial institution is taking too much counterparty risk dealing with end-users who are taking positions and may, when the market moves one way or another, be unable to come forward.

Yes, Mr. Bentsen?

Mr. BENTSEN. Mr. Sherman, we have a couple of things in the system that deal with that. For starters, we have existing capital standards that require financial institutions which are subject to that, so principally banks or any institutions that are subject to the Basel, that they have to put capital on a risk-weighted basis against various types of assets, including derivatives. So, there is that.

Second of all, under Section 165 of the Dodd-Frank Act, under enhanced prudential standards for systemically designated institutions and among banks under the statute, any commercial bank with $50 billion in assets or more is systemically designated by

statute, they are required—there is something known as single-counterparty credit limits. Now, that is still in the rulemaking process, and, to be fair, the initial proposal, in our view, was not as well done as it could be, but it is in the rulemaking process at the Fed right now, and that puts a further limitation that Congress imposed under Dodd-Frank on the level of concentration of risk that an institution can have with individual counterparties. And so, there are really two areas there where there is that requirement.

The last would be—and it is in process now, both in the United States and then through the BCBS–IOSCO working group—the capital and margin requirements for uncleared swaps. And that is in the proposal stage. Plus, you have the prudential regulators who have capital margin proposals out, as well as the SEC and the CFTC. The SEC just closed the books on their proposal about a month or so ago, and so there is a regime that is being established for uncleared swaps associated with that.

Mr. SHERMAN. Thank you for a comprehensive answer.

Dr. Parsons, back in November, Treasury issued a determination exempting certain foreign exchange swaps. I don't know if you are familiar with this. One situation would just be cash on the barrelhead literally, and one side delivers $1 billion worth of dollars, the other side delivers $1 billion worth of euros. The others could be that it is a transaction to be taken in the future. They bet on the movement of those currencies. Which of these does the Treasury exempt just the immediate delivery of currency from one to the other or, in effect, a bet on the future?

Mr. PARSONS. I have to say—

Mr. SHERMAN. And I am only asking you because Treasury is not here and—

Mr. PARSONS. I believe it includes bets on the future. But I have not investigated that exemption carefully. But my recollection was—

Mr. SHERMAN. Your colleague, Mr. Bentsen, did you have a comment?

Mr. BENTSEN. The Treasury exemption, which the Congress put in statute to allow Treasury to make this exemption, excludes all swaps and forwards for FX. And I think it does so importantly because of the tenor of the vast majority of swaps and forwards are less than 2 years, but there is a full—

Mr. SHERMAN. Currency can move a lot in 2 years. But whomever is on the losing side of that bet, then under this exemption, wouldn't have posted any capital. What risks are there to the financial institution that there is a 1-year bet on which way currency is going to move and the person on the losing side of that bet, or the company on the losing side of that bet doesn't have the funds to produce?

Mr. BENTSEN. Congressman Sherman, I would be happy to get back to you for the record, because I don't, off the top of my head, recall. But I would say, even within that 2-year tenor, the great—the vast—the majority within that is even in a much—below a year. So the way the FX market works is a very short-term market, and that is the reason Congress, we think appropriately at the time, recognized the monetary policy function of the FX market, the very short-term nature of the FX market, and designed the ex-

emption accordingly. And I would say, it is still—it still nonetheless is subject to the reporting requirements under Title VII.

Mr. SHERMAN. I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Fincher is recognized for 5 minutes.

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

There are a extraordinary number of moving regulatory reforms in a derivative space. People often forget about Basel and the layering effect that new capital mandates, along with these other reforms, will have on the real economy, and for job creators hedging risk and seeking access to credit to expand their business.

In my opening statement, I talked about European regulators creating an exemption from CVA, and they gave the exemption based on two things: concerns with Basel methodology; and the impact on end-users, which is critical to economic growth.

Mr. Bentsen, I think you alluded to this earlier: are you at all concerned about the different implementations of CVA? And wouldn't it be prudent for policymakers to examine the impact on U.S. financial institutions and end-users?

Mr. BENTSEN. Absolutely, Mr. Fincher. We think your bill is the right step to take. We have reached out to U.S. policymakers because of our concern, as I said before, this really is counter to the G-20 principles of uniform application of capital standards as proposed under Basel III.

As you pointed out, the Europeans provided this exemption because of their concerns. And to be fair, the proposed credit valuation adjustment—the methodology everyone believes is flawed and that should be reviewed. But if you start providing exemptions in one jurisdiction, you have the Canadian regulators who are now looking to see—again, they are very concerned about the CVA, as well, and how it will work and what the impact will be—you end up with a patchwork, and that doesn't do anyone any good and it results in an unlevel playing field that is unfair, frankly, commercially unfair to certain sectors.

So it is something that U.S. policymakers should, we believe very much, as well as we think other jurisdictions who aren't part of the E.U. should look in and also that the FSB and Basel should deal with.

Mr. FINCHER. Mr. Deas, would you like to comment on that, as well?

Mr. DEAS. We agree, sir, that if—I was commenting on the margin requirements for end-users, so it would require us to put capital aside, and this is a concern and there is actually a parallel effect here with requiring banks to separately capitalize a subsidiary to take their own capital.

What we know happens is that they are going to obtain a return on that capital and they are going to build a price into the swaps that they do with us. We are going to ultimately bear that, and that is going to just be a higher cost on the economy.

Mr. FINCHER. The second question is for Mr. Deas. Canadian regulators decided to finalize Basel III, but delay CVA, until both end-user cost and whether countries will implement it. Likewise, we are seeing similar concerns beyond Europe and Canada.

I actually have a quote here in an article in Risk magazine, which is entitled, "Asia Corporates Unfairly Penalized by CVA Capital." One European bank is quoted saying corporates shouldn't be penalized with higher prices because banks have to hold extra capital against these trades. Corporates don't pose a systemic risk, and their derivatives trades are used for hedging their real-world exposures. They are good for the economy.

Are you worried about, as the article reads, uncompetitive pricing which could spill over into the problems with the real economy? And couldn't progress—and Mr. Grimm's margin bill—be undermined by different capital treatments?

Mr. DEAS. Yes, sir. We have estimated as an example for my company, which is highly creditworthy and has access to the capital markets, that the swap spreads for my company could increase by a factor of three. And for less well-capitalized, less creditworthy companies, there would be potentially—actually, the way the formula works, it would be an exposure increase from that for less well-capitalized companies. And so, that cost would just be spread through the economy, and ultimately, we fear it would have an effect on jobs.

Mr. FINCHER. In wrapping up, Mr. Chairman, being a farmer, from 7 generations of cotton farmers, I am very familiar with FMC and the products that you make. And using derivatives, being able to hedge your positions and make the product affordable to the agricultural community and to other areas of the spectrum trickles all the way back down to the consumer in the end, because if we don't have your products, we can't grow the commodities that we produce for Americans and people all over the world to eat and to clothe themselves.

We have to be careful that this one-size-fits-all approach usually ends up not being the right fit, and just be careful as we proceed. So with that, Mr. Chairman, I yield back, and I thank the panel for the testimony.

Chairman GARRETT. The gentleman yields back.

Mr. Himes is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

I would like to thank the panel for participating today and for your insight. And I would like to start by noting that I think that Title VII of Dodd-Frank is one of the signal achievements of that legislation, remedying a wrong that many of you have talked about, which was of a very large and almost completely unregulated market, bringing derivatives into the light of day through clearinghouses, trading over exchanges, being subject to margin requirements, power for government regulators to step in and require additional margin to unwind businesses. I believe that this is a very important step forward within Dodd-Frank.

I also believe that as the work of mortals, it is not perfect and subject, therefore, to amendment to improve it. I find that this turns out to sometimes be a lonely point of view, as some of my friends—particularly on the other side—would suggest we should repeal the other thing, while others believe that any effort to amend or improve the legislation is the very work of Satan.

I find that the facts get lost in this. And now I turn to H.R. 992, which I have coauthored with Mr. Hultgren. There has been quite

a bit of press about it. I talked to reporters at the Huffington Post, at Mother Jones, to name two. After extension of interviews, I asked the reporters, and they had actually not bothered to read Section 716 or H.R. 992, as they did these interviews.

Americans for Financial Reform issued a letter on March 15th, critical of H.R. 992, which had a number of factual errors in it. When I called AFR to point out these factual errors, they issued a second letter on March 19th, interestingly back-dated to March 14th, showing that sometimes the facts get lost.

I want to turn, though, to the substance of the question of Section 716 and H.R. 992. It is puzzling. People like Sheila Bair and Ben Bernanke have suggested that Section 716 is problematic. Former Financial Services Committee Chairman Barney Frank made the statement that this provision, Section 716, added nothing in terms of protection. And so one asks, why is there such opposition to something that is bipartisan and supported by regulators?

The New York Times editorial board, and Americans for Financial Reform, their thesis is this: "A taxpayer backstop to derivative speculation is a bad idea. That is what H.R. 992 would permit." Now, H.R. 992, the idea is that the swaps that are not dangerous, the swaps that have always been in banks and that had nothing to do with what happened in 2008, the interest rate swaps, the currency swaps, the commodity swaps, not the structured asset-backed swaps, the CDOs, that they get to remain within banks while those more dangerous swaps, which, in fact, did have something to do with 2008, are pushed out.

What I want to focus on and bring the panel's attention to, though, is this premise put forward by the New York Times and by AFR that H.R. 992 opens up a taxpayer bailout or backstop. Let me read the very first line of Section 716, which is in no way altered or amended by H.R. 992: "Prohibition on Federal assistance. Notwithstanding any other provision of law, including regulations, no Federal assistance may be provided to any swaps entity with respect to any swap, security-based swap, or other activities of the swaps entity." Now, I am not a lawyer, but that looks to me to be a very clear prohibition on any Federal assistance associated with swaps activity.

So my question to the panel is—and anybody can answer it—can the fact of that very clear prohibition on any taxpayer bailout for swaps activity, is there any merit to the contention that H.R. 992—and, again, I quote the AFR letter—"opens us up to taxpayer backstop for derivatives activity?"

Yes, Dr. Parsons?

Mr. PARSONS. Yes, I think it does. I think it is very clear that we have too-big-to-fail banks. I think no matter what first line you write in a piece of legislation that says, "We will never, ever bail them out," the day that the dominoes start falling, it would be a huge mistake if you didn't bail them out. And you will be forced to do it.

The only way to prevent a bailout is to plan ahead of time for institutions which can be resolved and closed down. Derivatives present a very significant danger for that problem. We know that there was a run on the bank of Bear Stearns—

Mr. HIMES. Dr. Parsons, can I just ask you a question? I am running out of time here. The bailout that was done in 2009 was done pursuant to clear legal authority on the part of the Federal Reserve, was it not?

Mr. PARSONS. The problem was the—

Mr. HIMES. And—

Mr. PARSONS. The Federal Reserve has no ability to resolve those banks. It didn't have the legal tools in its hands to close them down.

Mr. HIMES. No, I understand that, but there was—

Mr. PARSONS. And the derivative portfolio—

Mr. HIMES. There was clear legal authority, and that subsequently has been altered, of course. If I understand your argument, you are making the argument that we would be required to violate the law if we were again faced with the need to or the proposition of buttressing too-big-to-fail institutions.

Mr. PARSONS. If we can avoid having too-big-to-fail institutions, then there won't be a problem with the law and necessity conflicting. Derivatives present a very major problem in the event of a crisis. We had a run on the bank of Bear Stearns, and part of that run was a run on the derivatives portfolio of the bank. We had a run on Lehman, and part of the run was a run on the derivatives portfolio of Lehman.

The Financial Crisis Inquiry Commission documented both of those and identified that portfolio as a major source of the run problem for both of those banks.

Mr. HIMES. If the chairman will indulge me for just one second, under H.R. 992, of course, all structured asset-backed swaps are, in fact, pushed out, so would you fear that the interest rate, currency, commodity swaps that would be permitted in federally-backed institutions, would you fear that there is a significant risk that those swaps would, in fact, create a system danger within those institutions?

Mr. PARSONS. Yes, I think it is important when we try to prevent a repeat of 2008 that we not try to prevent just the very, very, very same things from happening, but that we learn a lesson and say, oh, wait a second. Letting that kind of thing go on without our paying attention is a problem. All derivatives pose a risk. All derivatives have the danger of a bank run. It is not just structured derivatives.

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

Mr. BENTSEN. Mr. Chairman, could I just—if I might, to Mr. Himes, I think his points were well made. Two points: One, Section 716 wouldn't apply to Bear Stearns, and it wouldn't apply to Lehman, because neither of them were commercial banks. They were just broker-dealers. Neither of them were bank holding companies or financial services holding companies.

Two, Dodd-Frank does provide—not for the Federal Reserve, but for the Federal Deposit Insurance Corporation—the ability to step in and take over and resolve a failing institution. So that is in statute. I know it is of much debate, but that is in statute today because of Dodd-Frank.

And the last thing I would say is, there is risk in the financial system, be it a derivative, be it to a consumer loan. That is the nature of finance and credit intermediation.

Chairman GARRETT. I thank you all for those answers and for that discussion and also for the gentleman from Connecticut's candid observation on the journalistic integrity of the Huffington Post and Mother Jones, as well.

[laughter].

So, thank you.

Mrs. Wagner is recognized.

Mrs. WAGNER. Thank you, Mr. Chairman. I am pleased today that we are able to address a lot of these issues relating to Title VII of Dodd-Frank in a bipartisan way, and I know when individuals or families around the country hear us talk about derivatives or swaps, it is easy to lose sight about who exactly is impacted by misguided regulations. So I do want to note a survey of Main Street businesses that was released yesterday by the Center for Capital Markets Competitiveness, a U.S. Chamber-sponsored entity. It says, of all businesses which responded to that survey, one-half stated that they are "very closely involved" with the use of derivatives. Many of them use these instruments to manage risk and keep costs low for their customers, so we have to keep in mind that it is manufacturers, technology companies, their customers, and others that are impacted when regulation in this area misses the mark.

The survey also showed that for an overwhelming number of these businesses, it is important that the financial institution they use "has a wide spectrum of services to meet their needs." In other words, if regulation leads to fewer choices and less competition in the market, there is a real price to be paid.

With that said, I do want to focus my questions on Chairman Garrett's bill, because I believe robust economic analysis is a critical factor that, frankly, I think has been missing recently.

Congressman Bentsen, thank you for being here. Thank you all for being here. But the SEC was given an enormous amount of new authority as a result of Dodd-Frank and was tasked with writing around 100 different rules. Are you concerned that a proper cost-benefit analysis has been a missing factor in some or all of these rules?

Mr. BENTSEN. I think that the SEC, obviously, saw in the case of the proxy access case that a cost-benefit analysis was a necessary legal principle. And I think Congress has recognized and the Administration has recognized, certainly in Executive Branch departments, that there is a need for cost-benefit analysis, that regulation isn't free. There is a need for regulation, but you should weigh various factors in crafting that regulation.

And so, we think it is appropriate to follow up on what the Obama Administration and the Clinton Administration proposed by Executive Order. And again, to be fair, I think we are seeing the SEC now beginning to build a cost-benefit analysis structure, but we think this is an appropriate approach to take.

Mrs. WAGNER. And you do agree that this needs more attention, especially in the wake of Dodd-Frank?

Mr. BENTSEN. Absolutely.

Mrs. WAGNER. In your opinion, what has the SEC's track record—you talked a little bit about their movement forward in this—been in considering the cumulative costs of regulation and determining whether a regulation is inconsistent or duplicative of other regulations?

Mr. BENTSEN. Congresswoman, I almost think that is a broader question that—I don't think anyone has looked at the cumulative cost associated with all of the Dodd-Frank reforms. It doesn't mean not necessarily to do them, but I do think it is important to understand what the cost is in terms of capital allocation and capital formation and making—and then the other point you make is consistency, that you can't do these in a silo and just say, oh, we are just going to look at Title VII, we are going to ignore what is in Title I or Title II or the other costs attendant to that, but they all come together.

Mrs. WAGNER. Could you explain why it is, in fact, sound policy to exempt enforcement actions and emergency orders from the economic analyses?

Mr. BENTSEN. I think that would be appropriate in the sense that it reflects the enforcement and investor protection component of the Commission that you want to make sure that they have the ability to move swiftly in enforcing the law.

Mrs. WAGNER. I think the President actually put forward some very good principles for regulators in his Executive Order 2 years ago, and considering that the SEC has been one of the more active regulators recently, wouldn't you agree that it makes a lot of sense to codify those principles for the SEC, as well?

Mr. BENTSEN. For the SEC and the CFTC, I think that the President can only do so much by way of Executive Order, but I think it sets the pathway that this is as appropriate for independent agencies as it is for Executive Branch agencies.

Mrs. WAGNER. Thank you. I appreciate that, Congressman Bentsen.

And I yield my time back, Mr. Chairman. Thank you.

Chairman GARRETT. The gentlelady yields back.

Mr. Foster is now recognized.

Mr. FOSTER. One of my questions is, I guess, kind of a detail. In regards to the H.R. 677, the inter-affiliate bill, one of the—there are a couple of changes made with respect to last year's bill, and one of them is the change that would not include the affiliates of bank swap dealers and the affiliate exemption. And I was wondering, does this change allow in principle to have back-to-back swaps with a U.S. affiliate as a mechanism where you could potentially re-import overseas swap exposures with the—you have an overseas affiliate and you have a swap, and then it comes back to the United States, so that you effectively have a loophole? Do you understand what I am worried about here?

Mr. BENTSEN. I think we would be concerned that we think from a technical matter that the provision maybe should be looked at, because we think that the bank—that bank inter-affiliate swaps should be included in the exemption.

In terms of back-to-back swaps, cross-border back-to-back swaps, I think that—in something we have talked with the CFTC about and the SEC about is, the reason for inter-affiliate swaps is a risk

management tool within institutions, and where you have global institutions, they are having to manage risk globally.

So they are subject to tremendous oversight and regulation even within inter-affiliate exemption, so we don't think you should necessarily bifurcate and not allow that treatment cross-border.

Mr. FOSTER. Okay. And it is my understanding that the affiliates don't have to be wholly owned or anything like that, so that there can be misalignment of interests, where you have a partially owned affiliate? Or something like that? So this is not like you are just netting out to zero the risk from 2 affiliates that have 100 percent common ownership, so that they are actually—in principle, the situation could arise where you have a misalignment, where a part of the risk is transferred out of the organization, because of partial ownership and one of the affiliates involved in inter-affiliate swap.

Mr. BENTSEN. You are talking about either—within a financial institution or within a corporate entity?

Mr. FOSTER. Yes. Yes. One or both.

Mr. BENTSEN. I don't know if Mr. Deas wants to—

Mr. FOSTER. Is that a legitimate worry? Actually, if I could just go to a more general question, in this job, you get a massive respect for the ability of Senate not to do stuff, and so if we do not pass H.R. 677 and we are left only with the CFTC rulemaking, what are the major gaps that you see in the response of this? What is left undone by the CFTC rulemaking that would not be covered?

Mr. DEAS. Congressman, one of the things that we are concerned about is that the central Treasury units that serve the risk-mitigating function of taking these exposures from majority-owned subsidiaries and netting them out and then doing one smaller trade with a bank, for instance, could themselves be designated as financial entities and, if so, even though they are wholly owned subsidiaries of a U.S. manufacturing company like my own, they would be as financial entities ineligible for exemption from margining central clearing, all the end-user exemptions.

And so, that is one of the important aspects of H.R. 677, that it would make them eligible for the end-user exemptions.

Mr. FOSTER. Okay, but that is also something that in principle could be handled by a rulemaking—further rulemaking by the CFTC, correct?

Mr. DEAS. Well, sir, it hasn't been, and so that is why—and here we are, you know, 2½ years on, and so these ambiguities would require huge increases in information systems, if they are not resolved, so that we could do real-time reporting. It would cause us to make an investment in technology almost replicating a bank's trading room, in order to—

Mr. FOSTER. Sure. I understand the downside.

Mr. DEAS. Yes, sir.

Mr. FOSTER. Yes, very well. And just a quick question on the cost-benefit, this presumably will require significantly more resources for economic analysis before the rulemaking. I would normally have thought this would be accompanied by an increase in the budget of the regulator. And I was wondering if you had any comment on whether the extent to which this will simply just create a further delay in rulemaking, dilution of the SEC's ability to undergo enforcement, the fact that there is not—this is not accom-

panied by an increase in the budget to cover this additional workload? Any comments on that?

Mr. DEAS. Sir, I know there are various rules in this body on things that have to be offset, and I wouldn't be prepared to—I wouldn't pretend to understand that.

I can tell you that the economic analysis I cited to you of the $269 million that we would have to set aside to margin derivatives was one that end-users funded—we funded ourselves. We got together and that is really the only economic analysis that I have seen on that issue.

I would just think, with all the resources of the Federal Government, somewhere that work ought to be done. And I wouldn't presume to say how that should be funded.

Mr. BENTSEN. I would just add, again, to give credit, the SEC has built out their RiskFin group, which started under then-Chairman Schapiro, and so they—I can't speak to the budget. That is your business, not mine. But they have started down that process in establishing—not just for cost-benefit, also look at, take an asymmetric look at markets, but in addition to build out a cost-benefit apparatus.

Mr. FOSTER. Okay, thank you. I yield back.

Mr. HURT [presiding]. Thank you. The gentleman yields back. The Chair now recognizes Mr. Hultgren for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman. And thank you all for being here.

First of all, I just want to agree with, and second, my good friend and colleague, Congressman Himes, on many of his statements. I do have a couple of questions or clarifications that I wanted to ask.

Mr. Bentsen, you issued a statement in support of H.R. 992 when it was introduced and highlighted the strong reservations from multiple Federal prudential regulators expressed regarding Section 716. I wonder if you could expound briefly on those concerns. And why are regulators nervous about sending certain swap trades to less-regulated entities?

Mr. BENTSEN. I think that they are concerned for two reasons. I think one concern is the creation of additional affiliates or subsidiaries, which creates a separate entity that has to be regulated, and the other concern is it takes capital from the parent or the holding company and puts it in another affiliate, so I don't think they like that. I think they like to have the supervision that they have over the direct entity, and this goes back to when Dodd-Frank was being adopted, but I think that concern still exists today, because Dodd-Frank in statute gives the prudential regulators even greater, more explicit regulatory oversight of both the holding company and the various entities.

So I think that they feel it is better to keep it close in and to keep the capital close in.

Mr. HULTGREN. Mr. Deas, from your perspective—really, from the perspective of end-users—many of whom use depository institutions as counterparties for their swap trades—could you talk just a bit about how they might be affected by pushing out certain swap trades, and whether if commodities, equities, and credit derivatives are spun off to affiliated entities, would you expect prices to go up for end-users?

Mr. DEAS. Yes, sir. We believe that—one of the themes of my comments here today has been that capital—excessive capital that is required to be placed against a derivative transaction has a cost that ultimately end-users and their customers have to bear. And so if these are pushed out into separately capitalized subsidiaries, the banks which have done that will need to get a return on that capital, and that will, we have estimated for—I think in my testimony I mentioned, for a 7-year interest rate swap, it could increase the credit spread by a factor of three.

And for a less creditworthy entity than my corporation, which has an $8 billion equity market cap, the formula works in a way to increase that credit spread almost exponentially. So those costs ultimately would float through the economy and we fear would result in the loss of jobs.

Mr. HULTGREN. Mr. Bentsen, back to you quickly, if I may. Am I correct that other jurisdictions have not passed similar prohibitions as those contained in Section 716, foreign jurisdictions?

Mr. BENTSEN. Not to my knowledge, no, sir.

Mr. HULTGREN. I wonder also, am I correct that all swap activities that remain within banks would be subject to a finalized Volcker Rule?

Mr. BENTSEN. That is correct.

Mr. HULTGREN. So these trades, if a bank is involved, would still generally be client-facing, is that right?

Mr. BENTSEN. We don't know where the Volcker Rule is going to come out, and to be fair, an affiliate or subsidiary of a bank would be subject to Volcker, as well. But you are right. Volcker would apply.

Mr. HULTGREN. Okay. All of these swap trades are still subject to the new regime outlined under Title VII, including, but not limited to, the reporting requirements, entity registration, exchanging clearing requirements. Is that right?

Mr. BENTSEN. That is correct.

Mr. HULTGREN. One last question. And just, again, Mr. Bentsen or others—I just have a minute left—but does the CFTC's expansive international reach and its lack of coordination with foreign regulators have the potential to impose additional costs on end-users? And I wonder again, if time allows, what effects might this have on the ability of end-users to hedge their risks?

Mr. BENTSEN. I don't know if you want to comment—

Mr. HULTGREN. Maybe it is best going to you.

Mr. DEAS. Sir, we fear that there could be a foreign regulatory arbitrage that would disadvantage U.S. users of derivatives vis-a-vis our foreign competition, that our costs would go up while their regulators would not have imposed those requirements. And so, ultimately, that is where the cost would be.

Mr. HULTGREN. I see we are winding down. I only have 20 seconds left. I yield back the balance of my time, so that others may be able to follow up further on this, if they are—

Mr. HURT. Thank you. The gentleman yields back.

The Chair now recognizes Mr. Carney for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman.

I want to thank the panelists for coming today and for your testimony. And I want to thank and compliment the members on both

sides of the aisle who have worked on these pieces of legislation, most of which—I think all but one of the bills is a repeat from last time, with some minor changes, and so we are going about it again. And most of those bills passed last time, as I recall, some here in committee by a voice vote, and all of them on the Floor with votes of over 300 Members.

And I say that at the outset, because I like to associate myself with some of the frustration that Congressman Himes articulated in terms of some of the public debate that has been in the press and in other places about this legislation, that somehow these pieces of legislation are trying to roll back all of Dodd-Frank.

Dr. Parsons, I read your testimony and listened to your comments today, and you used some pretty strong language to criticize the bills that are before us. And in your testimony, on page two, you say, "The subcommittee should not advance legislation that weakens the security of U.S. taxpayers by inviting continued risky behavior by the largest U.S. banks and by return to the deregulation of derivative markets."

Congressman Himes talked about all the regulations contained in Dodd-Frank and, frankly, significant changes to this situation prior to 2008. Could you be specific about the things in these bills that trouble you the most that would undermine, as you say, the security of the U.S. taxpayer?

Mr. PARSONS. To speak about the swaps pushout, I think I replied to Mr. Himes very directly about—

Mr. CARNEY. Right, and he said that it would basically require us to—or the Treasury to violate the law, which—I have heard that not just with respect to this piece of legislation, but with Dodd-Frank itself, in terms of resolution authority, that somehow we would do something different than what the law says that we are required to do or that the Administration would, I guess.

Mr. PARSONS. I understand that people may disagree. I am just answering your question. That is my reason on this particular issue, the pushout bill—

Mr. CARNEY. Okay.

Mr. PARSONS. —that because I think we have—in the larger picture of things, we have not yet finished taking care of too-big-to-fail, more steps—it would be—it is important to finish that job. I think when we invoke names like Bernanke and Bair and Frank, and say that they are in favor of it, it is a little bit out of context, because it would—there are different ways of solving the too-big-to-fail problem.

Mr. CARNEY. Okay, let's put too-big-to-fail aside for a second. Congressman Frank, by the way, supported most of these bills the last time around, with the exception of one, which has changed dramatically from the last time. So pushout gives you heartburn because of the too-big-to-fail problem. What else among the bills, in your view, undermines the taxpayer security?

Mr. PARSONS. That is the one for the taxpayer security. The other ones are because of not having the cop on the beat, so to speak, returning to a less regulated derivatives market.

Mr. CARNEY. So by exempting some of the end-user venues and that type of thing—the purpose in doing all that is to not—first of

all, are there—in your view, are there systemic issues that are implicated in those end-user legislative changes?

Mr. PARSONS. Yes, absolutely. I think—first of all, end-users are already exempt in the legislation. What we are concerned about is banking supervisors, prudential supervisors who are worried about the credit risk on the balance sheets of their various financial institutions, imposing prudential standards for how those banks manage margin, manage credit risk embedded in derivatives.

And I am worried that we seem to think that instead of a race to the top of having financial markets with good standards, where we lead the global community to an efficient market that is sound and everything, we are desperately saying, "Oh, my God, the other jurisdiction isn't doing something, we are losing competitiveness."

If you just look around you, we have a futures market in oil that has no exemption from clearing mandates, lots of margin is put up. It is the best-run commodity market in the world, and traders from all over the world come to the United States to this market, which mandates clearing, has no exemptions whatsoever, and trade there, because good markets win business. Sound, well-regulated businesses win business.

Exempted markets, loopholes, loopholes, loopholes for this constituency and that constituency, do not promote a successful marketplace. No other country has been able to compete with our oil derivatives market, except by creating unsupervised markets.

Mr. CARNEY. I see my time has expired. I wish I had more time, but I guess—

Mr. HURT. I thank the gentleman. The gentleman's time has expired.

The Chair recognizes Ms. Sewell for 5 minutes.

Ms. SEWELL. Thank you, Mr. Chairman.

I want to thank our panel participants today. This hearing gives us yet another opportunity to hear from witnesses and discuss Dodd-Frank's derivative reform and some of the challenges facing the U.S. and international markets.

We must, I think, remain vigilant in making sure that we address any unintended consequences of this new regulation, and that is why I support the bipartisan and common-sense technical corrections and clarifications, such as H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013, which helps to ensure that regulators continue to have the transparency in the derivatives markets needed, but at the same time helps to mitigate the risk in our domestic and our international markets.

I really do want to applaud both the CFTC and the SEC in drafting and implementing the crucial new regulations, many aspects of which were fine, but I think that in helping us clarify it, we only make this legislation better.

So I actually have two questions. One is to Mr. Childs. Can you please provide your perspective on how your trade repository has responded and cooperated with the regulators in the crisis and how the indemnification provisions would help or hurt those effects in the future?

Mr. CHILDS. Yes, thank you for that question. There is very rarely a day that goes by that we are not actually talking to the CFTC

about how we as a swap data repository can help increase the transparency in the derivatives markets, and how we can provide them the data that they need to fulfill their function, how we can improve upon that data. So there is a very good collaborative effort at the operational level with the regulators on the provision of data.

Specifically to the indemnification side of the language, obviously, as we talked about earlier, it is really important in global markets that the data is provided to those in regulatory roles that need that data. And the indemnification language, as it stands at the moment, just makes that sharing of data that much more difficult.

Ms. SEWELL. Thank you.

Mr. Bentsen, on cross-border issues, what are your concerns related to the proposed CFTC cross-border guidance?

Mr. BENTSEN. I would say we have three concerns. Number one, in terms of what the U.S. person definition is, the initial proposal was a departure from established law and regulation with respect to who is deemed a U.S. person or not, that had a potential discriminatory effect at worse or at least a redundant effect.

The second is the substituted compliance regime, which went across, I think, 16 different transactional or entity-level activities on almost a country-by-country basis and company-by-company basis that we think really sort of goes against the international comity and the sort of traditional mutual recognition approach.

And then the third would be a matter of process, both in terms of coming out too quickly and then having to backfill, as I mentioned earlier, with various exemptive relief and no action relief, which we have been to three stages of now and we will have more, but the other in doing it—in terms of guidance as opposed to an actual rule proposal, which we think is appropriate.

And, lastly, we think, given that cross-border application really tees off of definitions, and Congress wisely said that definitions had to be proposed jointly by the SEC and the CFTC, that would have been appropriate here.

Ms. SEWELL. Very good. Are there any examples of any adverse impact on market participants? Can you give us—

Mr. BENTSEN. We have seen—we have had members report to us that certainly around October 12th, which was sort of the kickoff date of swap dealer registration in the United States, that confusion over who would be deemed a swap dealer or not, a major swap participant, resulted in certain foreign counterparties moving away with swap entities that were required to register as a swap dealer in the United States. And so, that continues to be a concern if there is confusion in the marketplace around the globe.

Ms. SEWELL. Thank you. I yield back the rest of my time.

Mr. HURT. The gentlelady yields back.

Before we adjourn, are there any Members who wish to be recognized? No? With that, I would like to thank each of the witnesses for appearing today for this important testimony.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these wit-

nesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, this hearing is now adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

A P P E N D I X

April 11, 2013

Opening Statement
Of
Gwen Moore
Subcommittee on Capital Markets and GSEs
Legislative Proposals Regarding Derivatives and SEC Economic Analysis
Words: 854

April 11, 2013

I appreciate the opportunity to continue the dialog on derivatives reform.

I know it is time consuming for our witnesses to be here, so I very much appreciate you sharing your expertise with this committee.

My remarks will touch broadly on the subject of derivatives, talk more specifically about H.R. 742 and H.R. 677, and then discuss why I cannot support H.R. 1062, the "cost-benefit" bill.

Derivatives remain a divisive subject, given the staggering monetary value they represent, their abuse by some, and the role they played in the financial crisis.

However, it logically follows that there was, and continues to be, large positions in derivatives because they fulfill important roles for businesses and in markets. I want them to continue to fulfill those roles in a way that is consistent with the long-help principles of accountability and transparency.

It does not make sense to ignore real problems in the global marketplace simply because they relate back to the class of securities called derivatives.

H.R. 742 repeals a provision that requires foreign, and even some domestic regulators, to "indemnify" U.S. domiciled SDRs and regulators as a condition to access swap trade data.

Bottom line is that no regulator, including U.S. regulators, will indemnify any other SDR or regulator. The ultimate result of not passing this legislation will be no aggregated *global* trade information will exist.

We have MOUs in place that were the result of global coorperation to deal with the information sharing.

The indemnification requirement only serves to undermine the vital Dodd-Frank objective of mitigating systemic risk by improving global trade transparency.

H.R. 742 is a simple and clear-cut fix that is supported by Congress, the SEC, and 3 of the 5 CFTC commissioners.

Moving onto the issue of inter-affiliate swaps.

The question is not *if* inter-affiliate swaps should be treated the same as couter-party swaps. We know that inter-affiliate swaps are different and should therefore be treated different for regulatory purposes.

Clearing is intended to mitiage credit risk, which does not apply in these cases. Furthermore, regulatory reporting does not yield additional regulatory advantages, nor do the trades offer no additional price discovery.

The question is why given the CFTC rules on inter-affiliate swaps is this bill necessary.

As a philosophical starting point, why wouldn't Congress want a statutory fix for this issue? I appreciate the great work the CFTC has done to ameriliorate this oversight in Dodd-Frank, but it is less that ideal to have regulators use their exemptive authority.

Furthermore, the bill contains important provisions that the CFTC rules do not, including issues related to corporate treasury centers.

I get the sensitivity that many have regarding changes to Title VII, but the inter-affiliate bill passed in the 112th Congress with overwhelming support, including that of Rep. Frank.

It is important to keep our heads and understand that we are not talking about a "loophole" or any wholesale change to new regulatory regime for derivatives.

Finally, I feel obligated to express my opposition to to H.R. 1062.

The circumstances of the financial crisis uttlerly sapped the argument of those people that reflexively decry any regulation and that pretend that consumer protection does not serve an important market function, which is why I am so dismayed and confused by the introduction of H.R. 1062.

The bill is a stalking horse to permit industry to wipe away any reasonable regulations and to turn U.S. markets into a *caveat emptor* "Wild West" regime. It is a model that experience demonstrates not only does not work, but also causes a lot of economic calamity and pain.

The SEC's primary mission is to "*protect investors.* H.R. 1062 is not reasonable calculated to enhance that mission; rather, it bootstraps on the terrible and widely criticized *Business Roundtable* decision to permit industry to sue the government in order to overturn regulation.

Of course, consumers and regulators are prohibited from demonstrating the costs and externalizations of deregulation. A consumer or consumer group would have no standing in a court, giving industry a huge advantage over the public.

In other words, a government for business over the people.

I would also point out the SEC now does cost-benefit analysis in rulemakings.

Finally, it is the job of Congress to consider and balance the costs and benefits of regulatory approaches. I understand that there are costs to industry associated with regulations that I support, but I understand the benefits of the regulations to both industry and to consumers.

It is my job as a representative of the people. It is not the job of the courts.

Permitting industry to set public policy through the courts is an abdication of our responsibility as legislators.

I will vigorously oppose attempts, like H.R. 1062, to weaken U.S. markets and to leave consumers at the mercy of the worst impulses of the most unscrupulous parties.

I can't even imagine why Wall Street thinks this bill is in their interest, as their ability to raise capital is largely predicated on the public having faith in them and regulators. A bill like this would further erode trust in U.S. market participants and ultimately hurt U.S. capital formation.

Statement for the Record

by

The Honorable Kenneth E. Bentsen, Jr.

on behalf of the Securities Industry and Financial Markets Association

before the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises

United States House of Representatives

Re: Legislative Proposals Regarding Derivatives and SEC Economic Analysis

Thursday, April 11, 2013

Subcommittee Chairman Garrett and Ranking Member Maloney. My name is Ken Bentsen and I am Acting President and CEO of the Securities Industry and Financial Markets Association (SIFMA).[1] SIFMA appreciates the opportunity to testify on several important legislative improvements to Title VII of the Dodd-Frank Act being considered by Congress.

As you know, the Dodd-Frank Act created a new regulatory regime for derivative products commonly referred to as swaps. Dodd-Frank seeks to reduce systemic risk by mandating central clearing for standardized swaps through clearinghouses, capital requirements, and the collection of margin for uncleared swaps; to protect customers through business conduct requirements; and to promote transparency through reporting requirements and required trading of swaps on exchanges or swap execution facilities. To date, there have been significant reforms put in place that market participants have implemented. Late last year, firms engaged in significant swap dealing activities were required to register with the CFTC as swap dealers and became subject to reporting, recordkeeping and other requirements, many more of which will be phased in over time. Recently, the first swap transactions were required to be cleared at central clearinghouses to decrease systemic risk in the swap markets.

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

However, as with all regulation, if Title VII is implemented incorrectly it may cause more harm than good. SIFMA supports the goals of Dodd-Frank with respect to much, but not all, of Title VII. However we remain concerned about how regulators are interpreting and proposing to implement many of these provisions and in some cases believe Congress should clarify or make changes to the Act. Further, we believe some provisions of the Act are unnecessary and, in fact, counterproductive. Incorrect implementation of Title VII has the potential to detrimentally limit the availability and increase the cost of derivatives, which are a valuable risk management tool for American businesses, including manufacturers and the agricultural industry.

We recognize the tremendous undertaking required by regulators in their efforts to implement derivatives reform. Throughout this process, SIFMA has frequently sought to constructively engage with regulators in a constructive way.

As an overarching matter, I want to emphasize our belief that appropriate sequencing of Title VII rules and coordination between the various regulators responsible for them is critical to the successful implementation of the Dodd-Frank Act. In order to adapt to the new swap regulatory regime, our member firms are making dramatic changes to their business, operational, legal, and compliance systems. We continue to work closely with the relevant regulators on developing an appropriate implementation timeline to avoid a rushed process that would raise unnecessary complications and risk. The implementation of these new rules is not as simple as flipping a switch. They require a significant systems build, testing, training, and new documentation involving both dealers and customers. In addition, we encourage the regulators to harmonize their rules so that similar products will be subject to similar rules.[2] Conflicting or redundant rules, at best, add unnecessary cost and, at worst, increase risk.

In the remainder of my testimony, I would like to focus on a few specific issues that are the topic of legislation currently pending before this Committee, which could have a profound impact on the success of Title VII and its impact on the marketplace.

The Swap Push-Out Rule:

The first important initiative I would like to highlight is legislation to amend Section 716 of the Dodd-Frank Act, often referred to as the "Swap Push-Out Rule." The Swap Push-Out Rule was added to the Dodd-Frank Act at a late stage in the Senate and was not debated or considered in the House of Representatives. It would force banks to "push out" certain swap

[2] SIFMA/ISDA Comments to CFTC on Proposed Schedule for Title VII Rulemaking (June 29, 2012), http://www.sifma.org/issues/item.aspx?id=8589939400; SIFMA Comments to SEC on the Sequencing of Compliance Dates for Security-Based Swap Final Rules (Aug. 13, 2012), http://www.sifma.org/issues/item.aspx?id=8589939893.

activities into separately capitalized affiliates or subsidiaries by providing that a bank that engages in such swap activity would forfeit its right to the Federal Reserve discount window or FDIC insurance.

The Swap Push-Out Rule has been opposed by senior prudential regulators from the time it was first considered. Ben Bernanke, Chairman of the Federal Reserve, stated in a letter to Congress that "forcing these activities out of insured depository institutions would weaken both financial stability and strong prudential regulation of derivative activities."[3] Sheila Bair, former FDIC Chairwoman, said that "by concentrating the activity in an affiliate of the insured bank, we could end up with less and lower quality capital, less information and oversight for the FDIC, and potentially less support for the insured bank in a time of crisis" further adding that "one unintended outcome of this provision would be weakened, not strengthened, protection of the insured bank and the Deposit Insurance Fund."[4]

In addition to the increase in risk that would be caused by the Swaps Push-Out Rule, the limitations will significantly increase the cost to banks of providing customers with swap products as a result of the need to fragment related activities across different legal entities. As a result, U.S. corporate end users and farmers will face higher prices for the instruments they need to hedge the risks of the items they produce. Mark Zandi, Chief Economist at Moody's Analytics, stated in a letter to Congressman Garrett that "Section 716 would create significant complications and counter the efforts to resolve [large financial] firms in an orderly manner."[5]

Last Congress, Congresswoman Nan Hayworth introduced H.R. 1838, legislation that would strike Section 716 from the Dodd Frank Act. The House Financial Services Committee considered and made significant changes to this bill. The first change was to modify this bill so that additional types of products could remain within the bank. This bill also included an important provision for foreign institutions. SIFMA supported both of these changes and submitted a letter of support for this bill.[6]

Last month, Congressmen Hultgren and Himes introduced bipartisan legislation (H.R. 992) that would, in his words, "modify the 'push-out' provision in the Dodd-Frank Act to ensure that federally insured financial institutions can continue to conduct risk-mitigation efforts for clients like farmers and manufacturers that use swaps to insure against price

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[3] Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), *available at* http://blogs.wsj.com/economics/2010/05/13/bernanke-letter-to-lawmakers-on-swaps-spin-off/.

[4] Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2010-05-04/pdf/CREC-2010-05-04-pt1-PgS3065-2.pdf#page=5.

[5] Letter from Mark Zandi, Chief Economist, Moody's Corporation, to Congressman Scott Garrett (Nov. 14, 2011).

[6] http://www.sifma.org/workarea/downloadasset.aspx?id=8589937400

fluctuations."[7] SIFMA applauds Congressman Hultgren for this critical legislation and urges the Committee to favorably report this bill.

Cross-Border Impact of Dodd-Frank:

Though Title VII was signed into law two-and-a-half years ago, we still do not know which swaps activities will be subject to U.S. regulation and which will be subject to foreign regulation. Section 722 of the Dodd-Frank Act limits the CFTC's jurisdiction over swap transactions outside of the United States to those that "have a direct and significant connection with activities in, or effect on, commerce of the U.S." or are meant to evade Dodd-Frank. Section 772 limits the SEC's jurisdiction over security-based swap transactions outside of the U.S. to those meant to evade Dodd-Frank. However, the CFTC and SEC have not yet finalized (and, in the SEC's case, proposed) rules clarifying their interpretation of these statutory provisions. The result has been significant uncertainty in the international marketplace and, due to the aggressive position being taken by the CFTC as described below, a reluctance of foreign market participants to trade with U.S. financial institutions until that uncertainty is resolved.

While the CFTC has proposed guidance on the cross-border impact of their swaps rules, that guidance inappropriately recasts the restriction that Congress placed on CFTC jurisdiction over swap transactions outside the United States into a grant of authority to regulate cross-border trades. The CFTC primarily does so with a very broad definition of "U.S. Person," which it applies to persons with even a minimal jurisdictional nexus to the United States. In addition, the CFTC has released several differing interim and proposed definitions of "U.S. Person" for varying purposes, resulting in a great deal of ambiguity and confusion for market participants. SIFMA supports a final definition of U.S. Person that focuses on real, rather than nominal, connections to the United States and that is simple and objective so a person can determine its status and the status of its counterparties.[8] Further, the CFTC proposed guidance has resulted in significant protests from foreign regulators as it appears to contradict the historical comity and mutual recognition by seeking to impose a new form of substituted compliance on both a transactional and entity basis, jurisdiction by jurisdiction in a manner that could result in redundant application of rules at the expense of US registered swap dealers. Equally significant, the CFTC has issued its proposed cross-border release as "guidance" rather

[7] In addition, the bill would fix a drafting error acknowledged by the Swap Push-Out Rule's authors, under which the limited exceptions to the rule that apply to insured depositing institutions appear not to include U.S. uninsured branches or agencies of foreign banks.

[8] SIFMA Comments to CFTC Proposed Interpretive Guidance (August 27, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589940053; SIFMA/TCH/FSR Comments to CFTC on Further Proposed Guidance (Feb. 6. 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589941955.

than as formal rulemaking process subject to the Administrative Procedure Act. By doing so, the CFTC avoids the need to conduct a cost-benefit analysis, which is critical for ensuring that the CFTC appropriately weighs any costs imposed on market participants as a result of implementing an overly broad and complex U.S. person definition against perceived benefits.

The SEC has not yet proposed cross-border rules. The Commission and its staff have publicly suggested, however, that they will consider a holistic cross-border rule proposal later this year. It is rumored that this document will be nearly 1,000 pages long and will include many questions for public comment.

Last Congress, Congressmen Himes and Garrett introduced bipartisan legislation (H.R. 3283) that would provide clarity on this issue. The Himes-Garrett bill would permit non-U.S. swap dealers to comply with capital rules in their home jurisdiction that are comparable to U.S. capital rules and adhere to Basel standards. The legislation also prevents the requirement that registered swap dealers post separate margins for each jurisdiction under which they are regulated. During the 112th Congress, the House Financial Services Committee acted to support this legislation by a vote of 41 to 18. SIFMA strongly supports this effort to clarify the jurisdiction of U.S. regulators and urges the House Financial Services Committee to vote for this critical legislation.

Congressmen Garrett, Carney, and Scott have introduced bipartisan legislation, the Swaps Jurisdiction Certainty Act (H.R. 1256), that would harmonize the cross-border approaches by requiring the CFTC and SEC to jointly issue a rule related to the cross-border application of the Dodd Frank Act within 180 days. This joint rule would have to be in accordance with the Administrative Procedures Act. Second, this measure ensures that foreign countries with broadly equivalent regimes for swaps will not be subject to U.S. rules. Finally, this legislation requires that the Commissions jointly provide a report to Congress if they determine that a foreign regulatory regime is not broadly equivalent to United States swap requirements. On March 20, 2013, H.R. 1256 was approved by voice vote by the House Agriculture Committee to be recommended favorably to the House. SIFMA urges the Committee to support H.R. 1256.

Swap Execution Facilities:

As I noted above, the Dodd-Frank Act requires a subset of the most standardized swaps to be traded on an exchange or a new platform known as a "swap execution facility," commonly called a "SEF." Congress generally defined what constitutes a SEF but left further definition to the CFTC and SEC. To date, both the CFTC and SEC have proposed differing SEF definitions for the products under their respective jurisdiction, but neither Commission has adopted a final definition.

An appropriately flexible definition of "SEF" is critical for ensuring that SEF trading requirement does not negatively impact liquidity in the swap markets. In truth, it remains unclear what will happen to liquidity of instruments that have been traditionally transacted bilaterally when they are subjected to a SEF environment. Understanding this reality, the SEC has proposed a rule that would permit SEFs to naturally evolve their execution mechanisms for those swaps that are widely traded. These SEFs could be structured in many different ways, similar to how electronic trading platforms have evolved in the securities markets.

The CFTC has proposed a different rule that would require customers to either trade swaps on SEFs as if they were traded on exchanges or to solicit prices by issuing requests for quotes, generally known as "RFQs," from a minimum of five market participants for each swap subject to the SEF trading requirement. This differs from current market practice and could have significant impact on the liquidity in the swap market. By signaling to the market the desire to purchase a swap, customers may be telegraphing important information that may impede best execution of their orders. While we appreciate the CFTC's goals of encouraging competition among dealers to decrease the price of swaps, the reality is that this practice will do just the opposite and drive up the cost of transactions, ultimately harming the corporations and other swaps users this rule aims to protect.

Last Congress, the House Financial Services Committee supported, by voice vote, legislation that would require CFTC and the SEC to adopt SEF rules that allow the swaps markets to naturally evolve to the best form of execution (H.R. 2586). H.R. 2586 would explicitly not require a minimum number of participants to receive or respond to quote requests and would prevent regulators from requiring SEFs to display quotes for any period of time. Finally, this bill would prevent regulators from limiting the means by which these contracts should be executed and ensuring that the final regulation does not require trading systems to interact with each other. SIFMA urges Congress to support similar legislation in this Congress.

Inter-Affiliate Swaps:

The Dodd-Frank Act is effectively silent on the application of swap rules to swaps entered into between affiliates. Such inter-affiliate swaps provide important benefits to corporate groups by enabling centralized management of market, liquidity, capital and other risks inherent in their businesses and allowing these groups to realize hedging efficiencies. Since the swaps are between affiliates, rather than with external counterparties, they pose no systemic risk and therefore there are no significant gains to be achieved by requiring them to be cleared or subjecting them to margin posting requirements. In addition, these swaps are not market transactions and, as a result, requiring market participants to report them or trade them

on an exchange or swap execution facility provides no transparency benefits to the market—if anything, it would introduce useless noise that would make Dodd-Frank's transparency rules less helpful.

During the 112th Congress, the House of Representatives voted 357 to 36 in support of legislation (H.R. 2779) that would exempt inter-affiliate trades from certain Title VII requirements due to the important role the transactions play in firms' risk management procedures and the negative impact the full scope of Title VII regulation would have if applied to them. In this Congress, Congressmen Stivers and Moore introduced H.R. 677, the Inter-Affiliate Swap Clarification Act, which would exempt certain inter-affiliate transactions from the margin, clearing, and reporting requirements under Title VII. On March 20, 2013, H.R. 677 was approved by voice vote by the House Agriculture Committee to be recommended favorably to the House. SIFMA supports this initiative and urges the Committee to vote in support of this important bill.

Cost-Benefit Analysis:

As noted above, it is critical that regulators carefully balance the benefits of swap-related regulation with the potential decreases in liquidity and increased costs to customers wishing to hedge their activities. As a result, throughout the Title VII rulemaking process, SIFMA has encouraged regulators to conduct comprehensive cost-benefit analysis for all Dodd-Frank rules.

This is consistent with the Obama Administration's efforts to promote better cost-benefit analysis for federal agencies through Executive Order 13563,[9] which requires all agencies proposing or adopting regulations to include cost-benefit analyses in an attempt to minimize burdens, maximize net benefits and specify performance objectives. The President also stated that regulations should be subject to meaningful public comment, be harmonized across agencies, ensure objectivity and be subject to periodic review. In 2012, in testimony before the House Committee on Government Reform, the SEC Chairman Schapiro stated "I continue to be committed to ensuring that the Commission engages in sound, robust economic analysis in its rulemaking, in furtherance of the Commission's statutory mission, and will continue to work to enhance both the process and substance of that analysis."[10]

Congressmen Garrett has introduced legislation (H.R. 1062) that would improve the consideration by the SEC of the costs and benefits of its regulations and orders by requiring the

[9] http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order

[10] http://www.sec.gov/news/testimony/2012/ts041712mls.htm

Commission to "assess the costs and benefits of available regulatory alternatives, including the alternative of not regulating, and choose the approach that maximizes net benefits" and "take into consideration the impact of the regulation on: investor choice; market liquidity in the securities markets; and small businesses." SIFMA strongly supports H.R. 1062 and urges the Committee to support this vital initiative that would enhance cost-benefit analysis done by the SEC.

Basel III:

Implementation of the Basel III capital standards accord is an area of great interest and concern for our members and the financial services industry as a whole. The industry is in strong support of efforts to promote consistent international standards that provide a level playing field, while avoiding competitiveness issues and market distortions that impact the real economy.

The European Union is currently finalizing its implementation of Basel III, known as Capital Requirements Directive IV (CRD IV). As drafted, CRD IV would exempt EU supervised swap dealers from certain Basel III capital mandates, specifically the credit valuation adjustment (CVA), when doing business with non-financial end-users, pension funds and sovereign entities. While market participants globally have raised legitimate concerns about the CVA calibration, and we believe the Basel Committee should revise the calibration, the EU CRD IV exemption is troubling in that it is a diversion from a uniform application of capital standards incongruous with the G-20 principle and further will result in an un-level playing field for non-EU dealers. Such a diversion could result in other jurisdictions exemptions for similar transactions, further undermining the G-20 principles. Recently, Canada announced a delay of the CVA (despite finalizing the rest of Basel III) given uncertainty around the provision's global implementation and effects on nonfinancial entities.

Accordingly, Congressman Fincher recently introduced the Financial Competitive Act, (H.R. 1341), that would direct the Financial Stability Oversight Council (FSOC) to examine differences in the implementation of derivatives capital requirements and the CVA. Further, the bill would require FSOC to assess the effects on the US financial system and to make recommendation to minimize any negative impact on US financial firms and end-users.

For the above reasons, SIFMA strongly supports this thoughtful legislation and urges the Committee to pass this bill.

Thank you for giving me this opportunity to explain our views related to several important measures to be considered by the Committee.

Testimony of

Christopher Childs
Managing Director and Chief Executive Officer

DTCC Data Repository (U.S.)

Legislative Proposals Regarding Derivatives and SEC Economic Analysis

House Financial Services Committee
Capital Markets and Government Sponsored Enterprises Subcommittee

April 11, 2013

Thank you for holding today's hearing to discuss legislative proposals to amend or repeal provisions in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The Depository Trust & Clearing Corporation (DTCC) and its subsidiary, DTCC Data Repository (U.S.) support efforts to improve the effectiveness of this landmark legislation, particularly in areas related to regulators' ability to access and utilize a global data set for systemic risk oversight and mitigation purposes.

DTCC strongly supports the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013 (H.R. 742), a bipartisan proposal co-sponsored by Congressman Bill Huizenga (R-MI), Congresswoman Gwen Moore (D-WI), Congressman Rick Crawford (R-AR), and Congressman Sean Patrick Maloney (D-NY). The legislation was reported out of the House Agriculture Committee on March 20, 2013 with bipartisan support. H.R. 742 will resolve issues surrounding Dodd-Frank's indemnification provisions and confidentiality requirements.

My testimony today explains the Dodd-Frank indemnification provision, how it will fragment swap data, and how fragmentation will hinder regulators' efforts to oversee a global market. I also provide information on how indemnification risks negating the existing global data sharing framework. Finally, I will address the Commodity Futures Trading Commission's (CFTC) Interpretative Statement, what it may mean for U.S. regulators, and explain why legislation is needed in this instance.

I appreciate the opportunity to bring greater attention to the unintended consequences of these provisions and the need for a legislative solution. These concerns have been echoed by regulatory officials and policymakers globally, including by representatives of the European Parliament, European Commission and Council, by Asian governments and by both Republican and Democratic Members of the U.S. Congress.

The Dodd-Frank Confidentiality and Indemnification Provisions

Sections 728 and 763 of Dodd-Frank apply to swap data repositories (SDRs) registered with the CFTC and the Securities and Exchange Commission (SEC), respectively. Prior to sharing information with U.S. prudential regulators, the Financial Stability Oversight Council, the

Department of Justice, foreign financial supervisors (including foreign futures authorities), foreign central banks, or foreign ministries, Dodd-Frank requires (i) registered SDRs to receive a written agreement from each entity stating that the entity shall abide by certain confidentiality requirements relating to the information on swap transactions that is provided and (ii) each entity must agree to indemnify the SDR and the CFTC or the SEC (as applicable) for any expenses arising from litigation relating to the information provided.

In practice, these provisions have proven to be unworkable.

As an initial matter, indemnification is a common law concept with its origin in tort law. Many countries and their legal systems do not recognize indemnification, and further, many foreign governments cannot or will not agree to indemnify foreign, private third parties (U.S. registered SDRs). Further, regulators have noted that they are already following policies and procedures to safeguard and share data based on both the OTC Derivatives Regulators' Forum (ODRF) and the International Organization of Securities Commissions' (IOSCO) Multi-Lateral Memorandum of Understanding.

Indemnification Requirement Will Fragment the Global Data Set and Impede Regulatory Oversight

The continued presence of the indemnification requirement is a significant barrier to the ability of regulators globally to effectively utilize the transparency offered by a trade repository registered in the U.S. Without a Dodd-Frank compliant indemnity agreement, U.S.-registered SDRs may be legally precluded from providing regulators market data on transactions that are subject to their jurisdiction. In order to access the swap transaction information necessary to regulate market participants in their jurisdiction, global supervisors will be forced to establish local repositories to avoid indemnification.

Foreign regulators have noted concerns with a scenario in which a foreign regulator has an interest in certain data in a U.S. SDR resulting from a jurisdictional nexus with respect to the currency or underlying reference entity, where neither party to the transaction falls under the foreign regulator's oversight authority. For example, a U.S. and a London-based bank may trade on an equity swap involving a Japanese underlying entity, and the trade is reported to a U.S. SDR. If the Japan Financial Services Agency has an interest in accessing such data, it does not appear to be able to do so absent a confidentiality and indemnity agreement.

The creation of multiple SDRs will, by definition, fragment the current consolidated information by geographic boundaries. While each jurisdiction would have an SDR for its local information, it would be far less efficient, more expensive, and prone to error when compared with the current global information sharing arrangement in place today.

Further, a proliferation of local trade repositories would undermine the ability of regulators to obtain a timely, consolidated, and accurate view of the global marketplace. If a regulator can only "see" data from the SDR in its jurisdiction, then that regulator cannot get a fully aggregated and netted position of the entire market as a whole. And if a regulator cannot see the whole market, then the regulator cannot see risk building up in the system or provide adequate market

surveillance and oversight. In short, regulators will be blind to market conditions as a direct result of the indemnification provision. In the name of transparency, this provision creates opacity.

This could have a profound impact for U.S. regulators if other jurisdictions adopt a provision like Dodd-Frank's confidentiality and indemnification requirement. The imposition of the indemnification requirement on foreign governments increases the potential that foreign regimes will adopt reciprocal provisions. The CFTC, SEC, and others may find themselves precluded from accessing non-U.S. SDR data unless they agree to indemnify the non-U.S. private third party trade repository.

Last year, before this Subcommittee, the SEC testified that the agency "would be legally unable to meet any such indemnification requirement and has argued vigorously against similar requirements in other contexts."[1] The CFTC would likely face a similar challenge.

Indemnification Requirement Threatens Existing Global Data Sharing Framework

The indemnification provision threatens to undo the existing data sharing system that was developed through the cooperative efforts of more than 50 regulators worldwide under the auspices of the ODRF and the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS-IOSCO).

For nearly three years, regulators globally have followed the ODRF guidelines to access the information they need for systemic risk oversight. It is the standard that DTCC uses to provide regulators around the world with access to global credit default swap (CDS) and interest rates data stored in its trade repositories. For example, under ODRF guidelines, regulators must maintain the confidentiality of information they obtain from DTCC's trade repositories and must affirm that information obtained is of material interest to their oversight.

The Dodd-Frank indemnification requirement has not been copied by Asian and European regulators. In fact, the European Market Infrastructure Regulation (EMIR) considered and rejected an indemnification requirement. Congress should enact H.R. 742 quickly to bring American law in line with the rest of the world.

Limitations of the Commodity Futures Trading Commission Interpretative Statement

In May 2012, the CFTC issued an *Interpretative Statement Regarding the Confidentiality and Indemnification Provisions of the Commodity Exchange Act* (Interpretative Statement).

DTCC appreciates the Commission's serious effort to address these problems in the context of its rulemaking authority. However, due to the limitations inherent in a regulatory modification to a statutory problem, and in light of discussions with regulators globally, the language of the statute

[1] *H.R. __, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2012: Hearing Before the Subcomm. on Capital Mkts. and Gov't. Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. (2012) (statement by Ethiopis Tafara, Director, Office of International Affairs, SEC), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-112-ba-wstate-etafara-20120321.pdf.

ultimately requires a "legislative fix" to clarify the scope and applicability of Dodd-Frank's confidentiality and indemnification provisions. Many regulators globally have expressed to DTCC the belief that a legislative resolution is needed to address the issues presented by this provision. Congress should act to bring certainty and clarity to global swaps markets.

While the Interpretative Statement provides clarification with respect to how the Commission proposes to construe the application of Dodd-Frank, it does not provide complete resolution to the concerns expressed by foreign regulatory authorities relating to regulator access. Even with adoption of the Interpretative Statement, which DTCC supports as a necessary first step, the indemnification provisions may still cause limited data sharing across jurisdictions.

The Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013

The *Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013* would make U.S. law consistent with existing international standards by removing the indemnification provisions from sections 728 and 763 of Dodd-Frank. DTCC strongly supports this legislation, which we believe represents the only viable solution to the unintended consequences of indemnification.

H.R. 742 is necessary because the statutory language in Dodd-Frank leaves little room for regulators to act without U.S. Congressional intervention. This point was reinforced in the CFTC/SEC January 2012 *Joint Report on International Swap Regulation*, which noted that the Commissions "are working to develop solutions that provide access to foreign regulators in a manner consistent with the DFA and to ensure access to foreign-based information."[2] It indicates legislation is needed, saying that "Congress may determine that a legislative amendment to the indemnification provision is appropriate."[3]

H.R. 742 would send a clear message to the international community that the United States is strongly committed to global data sharing and determined to avoid fragmenting the current global data set for over-the-counter (OTC) derivatives. By amending and passing this legislation to ensure that technical corrections to indemnification are addressed, Congress will help create the proper environment for the development of a global trade repository system to support systemic risk management and oversight.

Bipartisan and Regulatory Support for the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013

The SEC supports removing the indemnification provision from the DFA. Just this past week, SEC Chairman Elisse Walter reiterated the SEC's public support for a legislative fix, citing limitations of the indemnification requirements.[4] Last year, during a hearing before this

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[2] CFTC and SEC, *Joint Report on International Swap Regulation* (Jan. 31, 2012), at 103, *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf.

[3] *Id.*

[4] Chairman Elisse Walter, Secs. and Exch. Comm'n, Remarks at the American Bar Association Spring Meeting, Regulation of Cross-Border OTC Derivatives Activities: Finding the Middle Ground (Apr. 6, 2013).

Subcommittee, the Commission testified that the "indemnification requirement interferes with access to essential information, including information about the cross-border OTC derivatives markets. In removing the indemnification requirement, Congress would assist the SEC, as well as other U.S. regulators, in securing the access it needs to data held in global trade repositories. Removing the indemnification requirement would address a significant issue of contention with our foreign counterparts, while leaving intact confidentiality protections for the information provided."[5]

CFTC Commissioners Scott O'Malia, Bart Chilton, and Jill Sommers have publically stated their support for a legislative solution to address the unintended consequences of the provision.[6] Recently, during a Senate Committee on Agriculture, Nutrition & Forestry hearing, CFTC Chairman Gary Gensler identified the indemnification issue as one that Congress may address.[7]

There is bicameral, bipartisan support to resolve the consequences of indemnification. In the last Congress, H.R. 4235 secured 41 co-sponsors and was one of the few DFA corrections bills to garner bipartisan, bicameral support. While the legislation passed the House Financial Services Committee, it was ultimately taken off the House Agriculture Committee hearing calendar.

On March 14, 2013, the House Agriculture Committee held a hearing on various legislative proposals, including the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013. Americans for Financial Reform, which characterized this bill as a "non-substantive and necessary change[ ] to facilitate the achievement of the goals of the [Dodd-Frank Act]," testified that it does not oppose H.R. 742. On March 20, 2013, the Committee approved the bill with bipartisan support.

In addition, several other Members of Congress have publicly declared their support for a technical correction to the provision. Senate Agriculture Committee Chairwoman Debbie Stabenow (D-MI) and former Ranking Member Pat Roberts (R-KS), and former House Appropriations Agriculture Subcommittee Congressman Jack Kingston (R-GA) and Ranking Member Sam Farr (D-CA), authored separate letters to their counterparts in the European Parliament expressing interest in working together on a solution to this issue.[8]

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[5] H.R. __, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2012: Hearing Before the Subcomm. on Capital Mkts. and Gov't. Sponsored Enters. of the H. Comm. on Fin. Servs., 112th Cong. (2012), *supra* note 1.

[6] *See* Commissioner Jill Sommers and Commissioner Scott O'Malia, Dissenting Statement, Interpretative Statement Regarding the Confidentiality and Indemnification Provisions of Section 21(d) of the Commodity Exchange Act, *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/sommers_omailadissentstatement; *see also* Dodd-Frank Derivatives Reform: Challenges Facing U.S. and International Markets: Hearing Before the H. Comm. on Agric., 112th Cong. (2012) (Commissioner Bart Chilton expressing support for a legislative solution), transcript *available at* http://agriculture.house.gov/sites/republicans.agriculture.house.gov/files/transcripts/112/112-35New.pdf.

[7] *See* Oversight of the Commodity Futures Trading Commission: Hearing Before the S. Comm. on Agric., Nutrition, and Forestry, 113th Cong. (2011) (colloquy between Chairman Gensler and Senator Saxby Chambliss).

[8] *See* Letter from Representative Jack Kingston and Representative Sam Farr to Mr. Sharon Bowles, Mr. Jean-Paul Gauzes, Dr. Werner Langen, and Mr. Gabor Butor (May 18, 2011); *see also* Letter from Senator Debbie Stabenow and Senator Pat Roberts to Ms. Sharon Bowles and Dr. Werner Langen (June 2, 2011).

DTCC Has Experience Operating Global Trade Repositories

DTCC provides critical infrastructure to serve all participants in the financial industry, including investors, commercial end-users, broker-dealers, banks, insurance carriers, and mutual funds. We operate as a cooperative that is owned collectively by its users and governed by a diverse Board of Directors.

DTCC has extensive experience operating as a trade repository and meeting transparency needs. We provide trade repository services in the U.S., the U.K., Japan, Singapore and the Netherlands and have established a global trio of fully replicated GTR data centers. To support Dodd-Frank requirements, the DTCC Data Repository (DDR) applied for and received provisional registration from the CFTC to operate a multi-asset-class SDR for OTC credit, equity, interest rate, foreign exchange (FX) and commodity derivatives in the U.S. DDR began accepting trade data from its clients on October 12, 2012 – the first day that financial institutions began trade reporting under the DFA. Furthermore, on December 31, DDR was the first and only registered SDR to publish real-time price information. DTCC has been providing public aggregate information for the CDS market on a weekly basis, including both open positions and turnover data, since January 2009. This information is available, free of charge, on www.dtcc.com.

Last month, DTCC announced that registered swaps dealers are now submitting OTC derivatives trade information for all five major asset classes into the DDR. The DDR is the only repository to offer reporting across all asset classes, a major milestone in meeting regulatory calls for robust trade reporting and risk mitigation in the global OTC derivatives market. Currently, there are approximately three million new positions across asset classes for a total of nearly seven million positions registered in the DDR.

I am pleased to report that DTCC's application for registration to establish a Japanese OTC derivatives trade repository was recently approved by the Financial Services Agency of Japan (J-FSA). DTCC began operating this service ahead of the J-FSA's mandated April 1 deadline for market participants in Japan to begin reporting their OTC derivatives transactions. DTCC Data Repository (Japan) KK (DDRJ) is the first trade repository to be approved and established for the Japanese market. DDRJ will support trade reporting across four major OTC derivatives asset classes including credit, equities, interest rates, and FX.

In 2012, DTCC expanded the Global Trade Repository (GTR) in order to support mandatory regulatory reporting requirements for OTC derivatives. The GTR, which holds detailed data on OTC derivatives transactions globally, gives market participants and regulators an unprecedented degree of transparency into this $650 trillion market – an essential tool for managing systemic risk.

The GTR is now established as the industry's preferred provider for global OTC derivatives reporting. It holds data on more than 98% of credit default swaps, 70% of interest rate derivatives and 60% of equities derivatives traded globally – and it is expanding to include foreign exchange and commodities derivatives.

Thanks in large part to the financial industry's voluntary effort to report data to the GTR, the CDS market is the most transparent in the world as far as regulatory understanding of counterparty exposures. In fact, we believe the CDS market is even more transparent than the equity and bond markets.

The GTR's Regulators Portal, which provides detailed information on counterparty positions as well as notional and transaction-level data, is leveraged on a regular basis by more than 40 supervisors globally to help manage sovereign debt crises, corporate failures, credit downgrades and significant losses by financial institutions. The portal is the first global service of its kind in the financial marketplace to provide regulators with granular data on transactions that occur within their jurisdictions.

Although DTCC and the industry continue to work closely to meet regulatory reporting requirements, the obstacles presented by the DFA indemnification provisions and confidentiality requirements aren't going away. Ultimately, Congress must act to avoid further unintended consequences and to ensure market transparency and risk mitigation of global financial markets. I urge Congress to pass H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013.

Thank you for your time and attention this morning. I am happy to answer any questions that you may have.

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Hearing before the Subcommittee on Capital Markets and Government Sponsored Enterprises – Committee on Financial Services

U.S. House of Representatives
Room 2129 Rayburn House Office Building
Washington, DC 20515

"Legislative Proposals Regarding Derivatives and SEC Economic Analysis"

Testimony of Thomas C. Deas, Jr. – Vice President & Treasurer,
FMC Corporation

April 11, 2013

Good morning Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I am Thomas C. Deas, Jr., Vice President and Treasurer of FMC Corporation and Chairman of the National Association of Corporate Treasurers, an organization of treasury professionals from several hundred of the largest public and private companies in the country. FMC and NACT are part of the Coalition for Derivatives End-Users (the "Coalition"). Our Coalition represents thousands of companies across the United States that employ derivatives to manage business risks they face every day. Thank you very much for giving me the opportunity to speak with you today about derivatives regulation.

End-Users' Concerns with Derivatives Regulation

The Coalition supports your efforts to oversee the implementation of the Dodd-Frank Act. We very much appreciate the strong bipartisan efforts by the Members of the Committee on Financial Services on behalf American companies who use derivatives to manage many of the risks they face in running their businesses every day. We recognize the need to redress problems with derivatives experienced during the financial crisis in 2008. I want to assure you that FMC and other end-users were not and are not engaging in risky speculative derivatives transactions out of which some of that turmoil arose. End-users comprise less than 10 percent of the total over-the-counter ("OTC") derivatives market and do not significantly contribute to systemic risk. We believe there is broad agreement with the concept that end-users should not be subject to regulations designed to reduce the risk of swap dealers and others who maintain open or systemically significant derivatives positions and engage in market-making activities. At the time of passage of the Dodd-Frank Act, we understood from a plain reading of the legislative language as well as from letters and colloquies by the principal drafters, that end-users would be exempted from certain provisions intended to reduce the inherent riskiness of swap dealers' activities. In addition, recognizing the potential adverse consequences on the competitiveness of American business and ultimately on

jobs here at home, regulators vowed to keep their actions in sync with those of our international trading partners and not impose any undue regulatory burdens on U.S. end-users.

However, at this point over two-and-a-half years after passage of the Dodd-Frank Act, there are several areas where continuing regulatory uncertainty compels end-users to appeal for legislative relief from actions we believe will raise costs unnecessarily and hamper our ability to manage business risks with properly structured OTC derivatives. Among several areas of concern, I would like to invite your attention to three in particular:

- Margining of derivatives,
- Inter-affiliate derivatives transactions, and
- Capital requirements for derivatives transactions.

Margining of Derivatives

Please allow me to illustrate end-users' use of derivatives with a specific example from my company. FMC is the world's largest producer of natural soda ash, the principal input in glass manufacturing, and is one of the largest employers in the state of Wyoming. We are also developing innovative new chemically related applications that scrub sulfur compounds from flue gases of factories and power plants. We can mine and refine soda ash products in southwestern Wyoming, ship them to South Asia, and deliver them at a lower cost and with higher quality than competing Chinese producers. Energy is a significant cost element in producing soda ash and FMC protects against unpredictable fluctuations in future energy costs with OTC derivatives to hedge natural gas prices. These derivatives are executed with several banks, all of which are also supporting FMC through their provision of $1.5 billion of credit. Our banks do not require FMC to post cash margin to secure mark-to-market fluctuations in the value of derivatives, but instead price the overall transaction to take this risk into account. This structure gives us certainty so that we never have to post cash margin while the derivative is outstanding. However, if we are required by the regulators to post margin, we will have to hold aside cash and readily available credit to meet those margin calls. Depending on the extent of price movements, margin might have to be posted within the trading day as well as at the close of trading. Because failure to meet a margin call would be like bouncing a check, and would constitute a default, our corporate treasury would act very conservatively in holding cash or immediately available funds under our bank lines of credit to assure we could meet any future margin call in a timely fashion and with a comfortable cushion.

Adopting more conservative cash management practices might sound like an appropriate response in the wake of the financial crisis. However, end-users did not cause the financial crisis. End-users do not contribute to systemic risk because their use of derivatives constitutes prudent, risk mitigating hedging of their underlying business. Forcing end-users to put up cash for fluctuating derivatives valuations means less funding available to grow their businesses and expand employment. The reality treasurers face is that the money to

margin derivatives has to come from somewhere and inevitably less funding will be available to operate their businesses.

FMC and other members of the Business Roundtable estimated that BRT non-financial member companies would have to hold aside on average $269 million of cash or immediately available bank credit to meet margin calls, assuming a 3 percent initial margin and no variation margin. In our world of finite limits and financial constraints, this is a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. In fact, the study extrapolated the effects across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs. The effect on the many thousands of end-users beyond the S&P 500 would be proportionately greater. We would also have to make a considerable investment in information systems that would replicate much of the technology in a bank's trading room for marking to market and settling derivatives transactions.

Let me give you a direct example of why our banks have agreed that cash margin is not necessary for FMC's derivatives trades. Because we are always hedging an underlying business risk, if a current valuation of a derivative is underwater, then the risk we are hedging must be in the money, resulting in a net neutral position. To continue with our natural gas hedging example, as the price of gas fluctuates, the valuation of the derivative changes by an equal and opposite amount in relation to our natural gas purchases. If the price of gas falls by 10 percent, then the value of the derivative is out of the money by the same amount. This results in no net gain or loss when the derivative and the underlying exposure are valued together at any point in time. Although we have to pay the bank an amount equal to the 10 percent fall in gas prices for the agreed volume hedged, we owe that much less for the gas we are buying. FMC benefits from not having unpredictable demands on liquidity. For this balanced structure, we agree to a small markup payable at maturity of the derivative transaction I've just described. This is far cheaper in both financial and administrative cost than if we had to keep idle cash or immediately available credit to meet cash margin postings and undertake significant information systems investments. Customized OTC derivatives allow us to operate with predictable energy costs, reducing our business risk.

By forcing end-users to post cash margin, the regulators will take the balanced structure I've just described and impose a new risk. Treasurers will have new and unpredictable demands on their liquidity. Swap dealers are market makers who take open positions with derivatives and we agree central clearing and margining is appropriate for them. However, since end-users are balanced, with derivatives exactly offsetting underlying business risks, forcing them into the swap dealers' margin rules adds the considerable risk for end-users of having to fund frequent cash margin payments. This will introduce an imbalance and new risks onto transactions that are matched and will settle with offsetting cash payments at maturity.

As the Members of this subcommittee well know, the Prudential Banking Regulators; consisting of the Treasury, the Federal Reserve, FDIC, FCA, and FHFA; have proposed rules that would subject end-users to uncertain future margining requirements. This puts these regulators out of step not only with proposed margin rules from the Commodity Futures Trading Commission ("CFTC"), but also with proposed rules from the European Union's G-20 Working Group on Margining Requirements. This complements other actions by the European Union to provide a very clear exemption from margining for its end-users. The Coalition commends the bipartisan efforts of Members of this Committee to redress the problem for American industry through support for such bills as H.R. 634, the *"Business Risk Mitigation and Price Stabilization Act of 2013"*.

Inter-affiliate Derivatives Transactions

Throughout the legislative and rule-making processes surrounding the Dodd-Frank Act, the Coalition has advocated for strong regulatory standards that enhance financial stability while avoiding needless costs. New regulations are scheduled to become effective within months that could impose on many end-user companies additional costs and regulatory burdens in connection with long-standing, widely used procedures they employ to net exposures within their corporate groups. The Commodity Futures Trading Commission has recently announced important relief in the form of a final rule and "no-action" recommendation from two of the CFTC's divisions. Assuming several conditions are met, the final rule and the no-action relief would exempt many inter-affiliate swaps from mandatory central clearing and some reporting requirements. However, there are several areas where sought-after relief was not provided. The Coalition strongly supports H.R. 677, the *"Inter-Affiliate Swap Clarification Act"*, which would address the remaining uncertainty and impermanence of the CFTC's regulations. Among the areas that still need legislative action are:

- Financial entity designation – Many central treasury or hedging units, even those part of a corporate group headed by a parent company that is clearly a non-financial entity, run the risk of themselves being categorized as financial entities subject to mandatory central clearing and margining requirements beginning on June 10, 2013.
- Internal swaps with majority-owned affiliates in the European Union, Japan, or Singapore would still be subject to mandatory clearing unless certain external clearing or margining conditions are met.
- Internal swaps with majority-owned affiliates located in jurisdictions outside the U.S., European Union, Japan, or Singapore are required to clear their market-facing swaps as a condition of electing the inter-affiliate clearing exemption (subject to certain temporary conditions), even if the foreign jurisdiction does not require such swaps to be cleared or even have clearing available for the particular type of swap.

Treasurers of non-financial end-users who operate centralized treasury units that serve the risk-mitigating function of aggregating exposures on the books of a special-purpose subsidiary within their corporate group, netting the inter-affiliate exposures, and then entering into smaller derivatives with a bank or other swap dealer for the net amounts, could have to wind down those efficient units or meet burdensome new regulatory requirements that will be hard to justify. The remaining alternative would be to retain more risk because hedging would no longer be cost effective. As pointed out above, these treasury centers are subject to designation as financial entities, in which case they would be denied the end-user clearing exemption despite the fact that they are executing trades for non-financial end-user affiliates.

Capital Requirements for Derivatives Transactions

With your help, end-users could successfully navigate the regulatory issues I've described, obtaining necessary relief from the most burdensome rules on margining, mandatory clearing, real-time reporting on both third-party and inter-affiliate derivatives transactions, only to find that the uncleared OTC derivatives they seek to continue using have become too costly because of much higher capital requirements. The Prudential Banking Regulators have proposed rules entitled "Advanced Approaches; Risk-Based Capital Rule; Market Risk Capital Rule" (the "Capital Proposal"). The Capital Proposal implements a new Credit Valuation Adjustment ("CVA") that would increase the current capital bank counterparties would have to hold against derivatives in anticipation of a possible future deterioration in the financial markets such as that experienced in 2008. Our analysis shows the cost for my company to enter into a 7-year cross-currency swap could increase by a factor of three compared to current rules. Less financially strong companies will see significantly larger increases.

European policy makers seem to be enacting capital charges on derivatives positions significantly more favorable to end-users than the Capital Proposal of the U.S. Prudential Banking Regulators. Their approach is to recognize that end-users' hedging activities are in fact reducing risks; and so, should attract less capital than activities of financial entities keeping open positions or making markets in derivatives. They propose to exempt non-financial end-users from the additional capital requirements for CVA risk. The absence of a U.S. exemption will put American companies at a meaningful competitive disadvantage compared to our European competitors.

In summary, we believe the legislative intent of the Dodd-Frank Act was to exempt end-users from having to use their own capital for mandatory margining of derivatives transactions, diverting these funds from investment in business expansion and ultimately creating jobs. The current Capital Proposal would undermine this intent by forcing end-users' bank counterparties to hold much more of their own capital in reserve against end-users' derivatives positions, passing on the increased costs to these end-users.

Summary

Let me take a moment to summarize our principal concerns with the application of derivatives regulation to end-users:

- First, we are concerned that the regulations have imposed an uncertain framework requiring several types of end-user derivatives to be centrally cleared with mandatory posting of daily cash margin, potentially diverting billions of dollars from productive investment and employment into a new regulatory levy.
- Second, even if the final regulations clearly exempt end-users from margining requirements, we still have the risk that the banking regulators will require excessive capital be held in reserve against uncleared over-the-counter derivatives – with the cost passed on to end-users as they attempt to manage their business risks. The unintended consequence of punitive capital requirements could be for some end-users to cease hedging risks or to pay hedging costs that put them at a disadvantage against foreign competition operating where end-user exemptions have been made more effective.

Conclusion

Thank you again for the opportunity to testify today on these important issues.

We are very concerned that an impending regulatory burden on end-users of derivatives will result in higher costs to Main Street companies that will limit their growth, harm their international competitiveness, and ultimately hamper their ability to sustain and, we hope, grow jobs.

The consequences of getting derivatives regulation wrong will be borne by American business and ultimately our fellow citizens.

I will do my best to respond to any questions you may have.

Forwards, not Backwards, with Derivative Market Reform

Dr. John E. Parsons
Massachusetts Institute of Technology

Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises,
Committee on Financial Services,
United States House of Representatives,
in a Hearing on "Legislative Proposals Regarding Derivatives and SEC Economic Analysis"

April 11, 2013

My name is John E. Parsons. I am a Senior Lecturer in the Finance Group at the MIT Sloan School of Management and the Head of the MBA Finance Track. I am also the Executive Director of the MIT Center for Energy and Environmental Policy Research. I have a Ph.D. in Economics from Northwestern University. At MIT I teach a course on risk management for non-financial companies, the so-called end-users or commercial hedgers, and I co-author a blog on the subject, bettingthebusiness.com. I have published research on theoretical and applied problems in hedging and risk management, and I have been a consultant to many non-financial companies on hedging problems of various kinds, as well as on other financial issues.

Introduction

Title VII of the Dodd-Frank Act mandates important changes in U.S. derivative markets. Nearly three years since the passage of the Act, many of these changes are not yet fully implemented. Americans remain threatened by the same dangers that exploded on the country in 2008. Congress should consider ways to encourage and enable the full implementation of the Dodd-Frank derivative reforms.

Instead, five of the seven legislative proposals being considered by this Subcommittee and which are the focus of today's hearing take us in the opposite direction.[1] They reverse key elements of the reform. They resurrect the old system in which major segments of the derivatives markets are off-limits to the cop on the beat. They reinstate the old system in which the cop's discretion and authority is severely limited, while at the same time, financial players are given greater license and more loopholes.

It is nearly five years since U.S. taxpayers found themselves trapped and extorted for bailout money by the collapsing dominoes of the financial system. Since then, millions of Americans have been further punished by the enormous damage that the financial crisis wreaked on the job market and business prospects. Few people are confident that the country is completely secure against a new slew of failures that would leave U.S. taxpayers trapped once again. This Subcommittee should not advance legislation that weakens the security of U.S. taxpayers by inviting continued risky behavior by the largest U.S. banks and by a return to the deregulation of derivative markets.

Americans need better. Instead of searching out opportunities to reverse key elements of the financial reform, Congress should first finish the job of making U.S. taxpayers safe and secure. Congress should see the reform through to completion. Derivative regulators need to be resourced to fully implement the Dodd-Frank derivative reform, and encouraged to finish the task. This would assure American citizens that U.S. derivative markets are once again a source of stability and productivity to American and international industry and commerce

Which Business Model for OTC Swaps?

A range of different derivative securities and market designs are needed to serve the range of different demands of American and international businesses. The OTC swaps marketplace is uniquely positioned to offer customized as well as less liquid derivatives, which complement the standardized derivatives offered for trade on futures exchanges. This was the business model when the OTC swaps market first arose at the end of the 1970s. Providing these complementary products is useful, and can be supported by a proper regulatory framework like Title VII of the Dodd-Frank Act. Congress is well

[1] The five which I characterize as a step backwards are: H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013, H.R. 677, the Inter-Affiliate Swap Clarification Act, H.R. 992, the Swaps Regulatory Improvement Act, H.R. 1062, the SEC Regulatory Accountability Act, and, H.R. 1256, the Swap Jurisdiction Certainty Act. The two, which I would not characterize as a step backwards, are H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013, and H.R. 1341, the Financial Competitive Act of 2013.

advised to examine and reexamine ways to support and encourage this type of derivative trade which provides a real service to the economy.

Unfortunately, alongside this useful service arose another trade in derivatives fueled primarily by the lack of regulation of the OTC swaps market. This trade valued operating in dark markets and the ability to evade supervision. This trade warehoused growing volumes of credit risk on the balance sheets of derivative dealers. This trade does not complement the risk management services that can be offered on America's regulated futures markets. Growth in this trade during the late 1900s and early 2000s was a classic case of regulatory arbitrage. Unfortunately, over time this arbitrage trade came to dominate the OTC swaps industry and shifted the focus of its business model. This arbitrage trade did not have an interest in sound and stable markets because its very existence relied on a lack of regulation and oversight. This arbitrage trade did not advocate wise regulation: it fought hard for no regulation. This is best epitomized by the legislative fight over the now infamous Commodity Futures Modernization Act of 2000.

When the financial crisis exploded in 2008, it was the unregulated OTC swaps market that contributed to the crisis, not the regulated futures markets. Title VII of the Dodd-Frank Act put an end to the regulatory arbitrage by applying three principles already characteristic of the regulated futures markets:

- universal supervision – all swaps are now subject to supervision by the CFTC and the SEC;
- transparency, and,
- clearing of standardizable products.

If and when it is fully implemented, this reform puts an end to the regulatory arbitrage.[2]

Unfortunately a large portion of the OTC swaps industry remains wedded to the old business model of relying upon legislated loopholes and regulatory exemptions to preserve its share of the market. It constantly turns to Congress in a bid to repeat the success it had before the financial crisis blocking sound and universal standards for market conduct.

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[2] As some elements of the reform begin to take effect, we are seeing one consequence of the disappearance of this arbitrage: the futurization of swaps. This is happening through several different channels, which I have discussed in my blog at some length, but which are not central to today's discussion. For example:
http://bettingthebusiness.com/2012/08/01/otc-rip/
http://bettingthebusiness.com/2012/08/10/moodys-slips-on-ice/
http://bettingthebusiness.com/2012/11/13/futurization-2-why/
http://bettingthebusiness.com/2012/12/04/futurization-advances-in-interest-rate-products/

Just as an illustration, let's take the example of clearing. Futures markets in the U.S. have employed universal clearing since the early 20th century. Throughout the 20th century these markets were global leaders in serving the needs of diverse types of businesses in agriculture, metals, energy and all parts of the economy. Once implemented and operating, there was no complaint from business that clearing was an obstacle to these markets. On the contrary, every textbook or industry manual described clearing as an essential element of the success of these markets. But the arbitrage trade in the OTC swaps market evolved without the same rigorous standards for clearing. It benefited from and relied upon the regulatory arbitrage this enabled. Although the Dodd-Frank Act requires that clearing be extended to the OTC swaps marketplace, the arbitrage trade continues to see special exemptions and loopholes as the key to its success. Instead of providing a better derivative product or service, the arbitrage trade requires weakened market supervision and lowered standards in order to maintain its market share.

Much of the legislation at hand in today's hearing supports the bad business model of the OTC swaps industry's arbitrage trade. That model based on legislative favor and protection from supervision. The legislation is animated by the private benefits of loopholes for select constituencies, and overlooks the value of universal standard and sound financial markets that benefit the U.S. economy.

What the country needs is an OTC swaps industry focused on serving the real financial needs of American business. What the country needs is good regulation that supports sound and stable derivatives markets providing real services to America's businesses. What the country needs is to finish the implementation of the Dodd-Frank derivative markets reform. As of today, the job is not yet done, and that is where Congress should focus its attention.

Cost/Benefit Analysis

I'd like to conclude with some personal reflections specific to H.R. 1062, the Swaps Regulatory Accountability Act, which purports to improve the SEC's consideration of the costs and benefits of regulations.

I am an advocate of good cost/benefit analysis. It is a core element of my identity as a finance professional. I am affiliated with a university that has a reputation for quantification. I am the Executive Director of a research center with the mission to promote rigorous and objective empirical research to support decision-making by government and industry. I have played an active role in analyzing the costs

and benefits of the Dodd-Frank Act's derivative reform. Just recently, a study I did which addresses the cost of certain provisions of the Dodd-Frank Act's derivative reform was published in Morgan Stanley's *Journal of Applied Corporate Finance*.[3] I had presented earlier versions of the study to regulators and legislators. Some of my colleagues, working within the government, have been strong advocates for more widespread attention to rigorous cost/benefit analysis, and I support their efforts. So I am at one with the stated intention of this legislation.

However, I do not believe the legislation truly advances sound cost/benefit analysis. Instead, it undermines it. I have seen up close how seemingly well intentioned mandates such as this can actually undermine honest cost/benefit analysis and the democratic process. Many so-called 'studies' already get produced for the sole purpose of influencing the regulatory process. Already, existing legal mandates generate many studies custom tailored by well paid lobbyists to fit the terms of those mandates. These studies, animated as they are by private interests and strategic maneuvering, often miss the real points that ought to inform the public debate on costs and benefits. They always have a top line number prepared for headlines and legal briefs. But underneath the analysis is shoddy, at best, and literally non-existent in some cases. In other realms of finance where analogous mandates exist, the same distortion of the process occurs. Business people familiar with the poor quality of "fairness opinions" used in mergers and acquisitions will understand what I am talking about.

Sorting out the good analysis from the bad is a long and arduous process. The United States has a proud history of openness in rulemaking, complemented by vigorous public debate and an energetic press corps. Ultimately, it is the democratic process that assures that the good analysis wins out more often than not. That democratic process cannot be short cutted by mandates like the ones embodied in this legislation, but it can be damaged by them. I have personally witnessed strategy sessions in which players cynically worked to exploit existing cost/benefit mandates in order to frustrate the rulemaking process, and not to shed more light on the critical issues. That, too, is a part of the democratic process, for good or for ill. We should not be naïve as we attempt to improve the quality of information in the regulatory process.

As a professional deeply involved in advocating higher quality cost/benefit analysis in public policy formation, I am afraid that I see H.R. 1062 as a step backwards.

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[3] Mello, Antonio S., and John E. Parsons, 2013, Margins, Liquidity and the Cost of Hedging, Journal of Applied Corporate Finance 25(1). http://onlinelibrary.wiley.com/doi/10.1111/jacf.2013.25.issue-1/issuetoc

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April 9, 2013

The Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC

Re: Support for H.R. 1341

Dear Committee Members:

The Financial Services Roundtable urges that the Committee support and approve H.R. 1341, the "Financial Competitive Act of 2013," sponsored by Rep. Stephen Fincher. The bill would require the Financial Stability Oversight Council ("FSOC") to conduct a study on how variations in the regulatory capital charges applied to derivatives will affect the health of the U.S. financial system. Furthermore, the study would also include recommendations on how U.S. regulators can develop greater uniformity in the standards applied to globally active banks and how Congress and regulators can respond to the existence of inconsistent capital standards for derivatives exposures.

H.R. 1341 will specifically direct the FSOC to examine differences that may exist between the United States and other jurisdictions with regards to the credit value adjustment ("CVA") capital requirements contained within the Basel III global agreement on bank capital standards. The Basel III CVA standards require that banks conduct a thorough examination of their derivatives exposures to ensure that they are protected against possible counterparty default. When applied, the CVA standards strengthen the stability of the market by ensuring that banks measure and prepare against the risk posed by their derivatives exposures. The CVA requirements also encourage central clearing by exempting derivatives from CVA risk-weighting if they are transferred through clearinghouses that meet strict regulatory guidelines.

In its comment letter to the Federal Reserve Board, FDIC, and OCC regarding the proposed regulations to implement the Basel III standards in the United States, the Roundtable supported the general application of the CVA requirement with very limited exemptions.[1] Unfortunately, the recent proposal to implement Basel III requirements in the Europe, known as the Capital Requirements Directive or "CRD VI", would exempt a wide variety of derivatives exposures held by European banks from having to follow CVA capital requirements. These entities include pension funds and all commercial counterparties that are exempt from clearing requirements.

[1] These exemptions included transactions with Central Banks such as the Federal Reserve, and development banks such as the International Monetary Fund.

The Roundtable believes that a potential deviation between the United States and other jurisdictions with regards to CVA implementation could lead to price imbalances that will put U.S.-based institutions at a significant competitive disadvantage. Impacted entities include not only banks that could lose business to banks based overseas, but also mainline commercial businesses that would be forced to pay higher prices for hedging their risk than their international competitors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act established the FSOC to study emerging risks to the global financial system and the effects of such risks on U.S. institutions. As such, we believe that Congressional action to direct the FSOC to carefully study the CVA issue is warranted. We again urge the Committee to move expeditiously to approve H.R. 1341.

Sincerely,

Scott Talbott
Senior Vice President for Public Policy
The Financial Services Roundtable

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

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April 11, 2013

The Honorable Stephen Lee Fincher
U.S. House of Representatives
Washington, DC 20515

Dear Representative Fincher:

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector, and region, and dedicated to promoting, protecting, and defending America's free enterprise system, supports H.R. 1341, the "Financial Competitive Act of 2013," which would help ensure that "end-users"—main street businesses that use derivatives to hedge their day-to-day business risk—continue to have efficient affordable options in the market for risk mitigation.

End-users have argued for years that new regulations requiring swaps to be cleared, margined, and reported in real time—while important for many segments of the market—should not apply to their transactions, which are risk reducing rather than risk taking, and because end-user transactions represent a small fraction of the overall market. Congress has consistently recognized the importance of protecting end-users and included a critical exemption from clearing requirements in Dodd-Frank.

An exemption from margin requirements, however, has been elusive despite the clear intent of Congress during the Dodd-Frank debate. The Chamber has strongly supported legislation—H.R. 634—to create this exemption to prevent end-users from having to post substantial new cash collateral with their swaps. These cash calls would drain liquidity from our main street businesses, hampering job creation and economic growth.

Even if end-users are ultimately exempted from regulatory margin requirements, capital rules proposed by banking regulators would undermine the value of the exemption. These rules would require end-users' counterparties to hold extra capital against end-user hedging transactions, which will increase the cost of hedging substantially. The Europeans have created an end-user exception from this aspect of their capital rules. While this exception would promote prudent risk management in Europe by lowering end-user hedging costs, it creates inconsistent transatlantic standards that could disadvantage U.S. end-users by driving up the cost of hedging with their U.S. counterparties. A consistent standard is needed to ensure end-users' ability to hedge is not needlessly impacted and to put American businesses on a level-playing field with European competitors, therefore, the Chamber strongly supports a parallel exemption for end-users here in the United States.

H.R. 1341 would require the Financial Stability Oversight Council (FSOC) to study the inconsistent application of the Basel III Credit Valuation Adjustment (CVA) capital charge and its effects on end-users, swaps dealers, and the international derivatives market. FSOC would issue its report to Congress in 90 days. The Chamber has consistently supported efforts both to protect end-users, and to ensure that policymakers conduct serious economic analysis as part of their work. H.R. 1341 serves both goals.

The Chamber supports the "Financial Competitive Act of 2013" and looks forward to working with the Congress to ensure the U.S. maintains its position as the world leader in fair, efficient, and innovative capital markets.

Sincerely,

R. Bruce Josten

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