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REFORM OF THE OVER-THE-COUNTER DERIVATIVE MARKET: LIMITING RISK AND ENSURING FAIRNESS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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CONTENTS

	Page
Hearing held on:	
October 7, 2009	1
Appendix:	
October 7, 2009	77

WITNESSES

WEDNESDAY, OCTOBER 7, 2009

Ferreri, Christopher, Managing Director, ICAP, on behalf of the Wholesale Markets Brokers Association	55
Gensler, Hon. Gary, Chairman, Commodity Futures Trading Commission	8
Hall, David, Chief Operating Officer, Chatham Financial Corp.	48
Hill, James J., Managing Director, Morgan Stanley, on behalf of the Securities Industry and Financial Markets Association (SIFMA)	50
Hixson, Jon, Director, Federal Government Relations, Cargill, Inc.	43
Holmes, Steven A., Director of Treasury Operations, Deere & Company	54
Hu, Henry, Director, Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission	10
Johnson, Rob, Director of Economic Policy for the Roosevelt Institute in New York, on behalf of Americans for Financial Reform	57
Kaswell, Stuart J., Executive Vice President & Managing Director, General Counsel, Managed Funds Association (MFA)	52
Sleyster, Scott, CFA, Chief Investment Officer, Domestic, Prudential Financial, on behalf of the American Council of Life Insurers (ACLI)	47
Stulz, Rene M., Everett D. Reese Chair of Banking and Monetary Economics, Fisher College of Business, The Ohio State University	45

APPENDIX

Prepared statements:	
Garrett, Hon. Scott	78
Ferreri, Christopher	79
Gensler, Hon. Gary	106
Hall, David	120
Hill, James J.	124
Hixson, Jon	135
Holmes, Steven A.	140
Hu, Henry	147
Kaswell, Stuart J.	157
Sleyster, Scott	168
Stulz, Rene M.	175

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Himes, Hon. Jim:	
Written statement of Larry E. Thompson, General Counsel, The Depository Trust & Clearing Corporation	193
Manzullo, Hon. Donald:	
Written statement of John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard	203
Written statement of the International Swaps and Derivatives Association	208
Moore, Hon. Dennis:	
Written statement of the electric power and natural gas industries	210

Page

Watt, Hon. Melvin:
Written statement of Shawn A. Dorsch, Founder, Blackbird Holdings, Inc. 213

REFORM OF THE OVER-THE-COUNTER DERIVATIVE MARKET: LIMITING RISK AND ENSURING FAIRNESS

Wednesday, October 7, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

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

Members present: Representatives Frank, Kanjorski, Waters, Watt, Sherman, Meeks, Moore of Kansas, Clay, McCarthy, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Ellison, Klein, Perlmutter, Donnelly, Foster, Carson, Minnick, Adler, Himes, Maffei; Bachus, Castle, Royce, Lucas, Manzullo, Biggert, Capito, Hensarling, Garrett, Price, Campbell, Putnam, Marchant, Jenkins, Lee, Paulsen, and Lance.

Also present: Representatives Murphy and McMahon.

The CHAIRMAN. The hearing will come to order.

The subject today is derivatives. I want to talk a little bit about the process and then about the substance.

We are dealing with a set of issues that first came to light when Secretary Paulson set forward an agenda for regulation in April of 2008. Our attention was diverted for a while by an economic crisis. It was early this year when we felt that things had stabilized enough in the general economy in the credit area for us to take this up, and we have been working on it. It is very much a work in progress.

Some people have said that we are rushing it. First, we have been studying this, many of us, since April of 2008. It has been on everybody's radar screen. Second—I am sorry, but my clock hasn't started. I apologize, but I meant it in a way that it should come out of my time, so I will cut myself off 30 seconds early.

Yes, these things need to be studied. It is also the case though that some issues are not going to be joined until there are pieces of paper out there and people react to them. We have before us a discussion draft, which will and I believe should undergo significant change, but you have to start somewhere.

This bill will not, on the best timetable, be signed by the President until December. I hope we can. We certainly will meet a timetable of getting legislation to the Floor in November. And it is a process, as I said, in which we will be putting things forward. It is a process in which a large number of Members participate.

On the specific bill today, I agree with some of the criticisms that have been made. And again, I want to make it clear this was a discussion draft. Here is the goal, and we welcome participation in reaching it. It does seem to many of us that there is a distinction between derivatives as ends and derivatives as means.

When we first began to talk about this, I expressed some views, for example, about prohibiting naked credit default swaps. I did not expect people in the business of selling these, people in the financial industry, to be happy with that. They weren't. As I said, we didn't expect them to be. We didn't care whether they were or weren't.

What we began to hear were objections to some of this from those people for whom derivatives are not an end for making money as they are for the financial institutions, but a means so that they can go about their business of producing goods and services with some stability, with some reasonable expectation about cost. Derivatives are a very legitimate way for producers of end products, goods or services, to reduce volatility, which is very important for them to be able to make the calculations they make.

Our job is to find a way to preserve that legitimate function while diminishing the excessive volatility that comes from people who are doing it to speculate, from diminishing the risk that comes when people get overextended in doing it. And it has been a process that is still in place.

I notice, for instance, that Mr. Hu said that the discussion draft could unintentionally preserve existing regulatory gaps. He is quite right that it is unintentional. We will look for this expertise to deal with it.

Chairman Gensler told me yesterday that he thought that in the bill, it created a presumption against having things go essentially cleared, and that is exactly the opposite of our intention.

I want to say at this point that the staff of the Financial Services Committee has, in my judgment, given America this year the best value for its money that it has ever gotten. These are very intelligent dedicated people who work very hard, who put up with a lot from a lot of people, me sometimes included, and all of whom could be making a lot more money doing similar work under less stressful conditions elsewhere.

I have been urging them to get these drafts out so they can be discussed. If I thought we were going to get it right the first time, every time, then I guess we wouldn't need hearings, and we wouldn't need markups; we would just take them all up on the Floor.

And I acknowledge, and let me just say to my friends in the regulatory area, yes, I acknowledge there are some areas here where there are gaps that shouldn't have been there. There is this, and there may be a distinction here—I do believe that there is a need to distinguish between legitimate end-users and people who are there because this is a profit incentive for them.

Now, having said that, it is clear we can't expect financial institutions to be available to help the end-users as a charity. They need to make a profit or they will not be available to provide that liquidity, which is important. But that is the line we want to draw.

I have read this over, and I think we have in the first cut—well, this is the second cut because we put something out. I backed off some of the things, listening to the end-users. I think there is some room now to tighten up some of what we are doing. It is our intention to have a push in favor of clearing but a recognition that it won't always be possible. We picked up some things, like to the extent that this collateralization will not have to be cash.

The last point I would make is this: If we were starting from scratch, we would only have one person here. There would be an SEC/FTC; there wouldn't be an SEC and a CFTC. But we are not starting from scratch. Trying to merge these two would divert attention. What is important is that we work together, both legislatively and going forward, to harmonize their work, and that is going to be our goal.

And next, I recognize the gentleman from Alabama for 4 minutes.

Mr. BACHUS. I thank the chairman.

And we do have two gentlemen here with us, so I am not seeing double. I thank the chairman for convening the hearing.

And as the chairman said, derivatives are an essential tool used by countless American companies to help them manage risk associated with doing business both at home and abroad. Derivatives allow companies to hedge against risk, deploy capital effectively, lower costs, and offer protection against fluctuating prices.

There is nothing inherently wrong with derivatives. It is when they are abused. Congress must take steps to ensure increased transparency and enhance oversight of the derivatives market.

However, any new regulation should not hamper the ability of businesses to control costs, manage risk, compete in the global marketplace, and create jobs.

Last Friday, the chairman released draft derivatives legislation which represents a significant improvement over the proposal that the Obama Administration submitted to Congress in August. I commend him for that.

The chairman's draft wisely omits provisions from the Administration's proposal which would have severely restricted access to the derivatives marketplace and had the effect of magnifying rather than mitigating systemic risk.

However, while the chairman should be commented for addressing several of the serious flaws in the Administration's approach, there are a number of issues, I think, that still require careful attention.

For example, the chairman's draft would still require that some over-the-counter products be shifted onto venues like clearinghouses and exchanges. I think he has acknowledged today that may not always be possible.

The bill also calls on the regulators to classify some actors in the derivatives marketplace as major swap participants. This vague classification could force thousands of companies to divert millions of dollars of capital away from business investment for use as cash collateral. It seems counterintuitive during a recession, with unemployment approaching 10 percent, to leave companies exposed to greater risk, raise their cost to capital, and make economic recovery more difficult to achieve.

Another potentially troublesome provision of the discussion draft, and the chairman discussed this, was prohibiting certain swap transactions. Restriction on credit default swap contracts limits the ability of investors to appropriately calculate risk as it has become apparent that CDS spreads are often a more accurate reflection of credit risk than credit ratings. There is nothing inherently wrong with credit default swaps. And even in the last year I think that has been confirmed. It is when they are abused, as in the case of subprime mortgage securities, which were improperly rated and underwritten, that problems arise. It was the subprime loans that made up the securitizations, not the credit default swaps themselves, that caused the problem.

Mr. Chairman, as we move forward with regulatory reform, we should make every effort to strike the right balance between maintaining market stability and preserving useful innovations in the U.S. financial services industry. While the government certainly has a role in policing the derivative marketplace, it must be noted that there are private sector initiatives already under way to clear standardized derivative contracts and establish trade repositories that will furnish the information regulators and investors need to make informed judgments about potential systemic risk and counterparty exposures. Legislation in this area should seek to facilitate and, where appropriate, codify these market-based solutions while not subjecting U.S. companies that operate far from Wall Street to damaging new regulatory burden.

I thank the chairman, and I welcome our two witnesses.

The CHAIRMAN. The gentleman from North Carolina for 2 minutes.

Mr. WATT. Thank you, Mr. Chairman.

And let me try to do two things in the 2 minutes I have. Number one is to applaud the Chair for this whole process that he is going through, because as he indicated, you can go down a road, and then you have to reevaluate, which is what the hearings do, and then you have to redraft. So I just think the process that we have been following is an entirely appropriate and thoughtful and meaningful process to get to the right balance.

Number two, it is probably appropriate that I come after the ranking member here because I actually have some strong feelings on an issue that probably counter the ranking member's position, and I think that the most recent draft may have tilted us in a direction that is more contrary to what we are trying to achieve. And I specifically refer to the language on pages 27 and 28 of the chairman's most recent draft, discussion draft, where I think we have perhaps created a loophole that is way, way, way too big for major swap dealers and people who are engaged in major swap participants.

So I think we need to look carefully at that language in particular, and I will be, as I go through this bill, am trying to do that in a responsible way, but remembering that our objective here was to create real transparency in this market, and we need to stay focused on doing that.

The CHAIRMAN. The gentleman from Oklahoma. I am going to go to the gentleman from Oklahoma and the gentlewoman from Illinois, so we have equal amounts of time.

The gentleman from Oklahoma for 1½ minutes.

Mr. LUCAS. Thank you, Mr. Chairman.

Thank you for holding this hearing. I think the discussion draft the committee has before it today is an interesting next step in our review of the overall counterderivatives market. Since the Administration's proposal on this issue was published on August 11th, the end-user community has been constantly knocking on my door. As ranking member of the House Agriculture Committee, I listened to the testimony of the end-user community, the exchanges and the traders, when they appeared in front of that committee on September 17th. The common theme to the testimony was that the Administration's proposal overreached and would treat many bona fide hedgers as systematically risky financial institutions.

Are there problems in the derivatives markets? Yes. What we cannot do is overreach or overregulate. If we do, the impact will be felt far beyond Wall Street and reach Main Street. It will cost jobs, economic development, and ultimately increase the prices consumers pay for energy, food, and manufactured goods.

I am anxious to hear from our second panel today if this draft allows effective legitimate domestic risk management better than the Administration's proposal. And I am equally anxious to hear if our regulators still want to regulate everybody to avoid regulatory arbitrage or if they recognize the concerns that we shared when they appeared in front of the House Agriculture Committee that their approach will make risk management too expensive and increase prices and volatility.

Mr. Chairman, we need to improve the safety and soundness of our financial regulation, but we cannot do it at the expense of economic development, increased prices, and job losses.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Illinois for 1½ minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman.

I think that the new draft has some troubling things in it. In its current form, I am afraid there is still a one-size-fits-all approach to regulating derivatives and a "Big Brother" regulatory model that may stifle innovation, unnecessarily tie up capital, and see owners standards on businesses, exchanges, and clearinghouses.

The bill doesn't seem like the right answer to reforming the OTC marketplace at a time when our feeble economy is trying to regain steam and at a time when we need businesses to use capital to invest in their businesses to grow and create jobs for Americans.

We all know that there were abuses in the OTC markets. They must be addressed. But to my knowledge, when the entire financial system was on the verge of collapse last fall, the futures markets pulled through. This bill doesn't seem to, in a targeted approach, address those abuses, but rather considers all parties, anti-users as well as end-users as well as exchanges risky and treat them as such. Non-risky market participants may now unnecessarily have increased capital requirements, mandatory central clearing margin requirements, and product approval by bureaucrats in Washington.

This doesn't seem like the right answer to managing risk and addressing abuses in the marketplace. We need robust competition, restored investor confidence, and healthier markets.

I yield back.

The CHAIRMAN. The gentleman from New York, Mr. McMahon.

I would ask unanimous consent that Mr. McMahon be allowed to ask questions out of our 10 minutes.

Is there any objection? I hear none. I thank the Minority for accommodating Mr. McMahon. Let me just say, while he is not a member of this committee because by the time he came to Congress, there was no room, and I must say, not to take away from anybody's time, I am glad that the Speaker finally recognized that there is some limit to the size of this committee. I think that she thought that we were infinite.

So I regret Mr. McMahon not being able to join us, but I had to accept the principle.

But Mr. McMahon is someone whose district is heavily involved in this, has some expertise, and that is why I asked that he be able to ask some questions.

And I thank our colleagues on all sides for allowing it.

The gentleman is recognized for 3 minutes.

Mr. MCMAHON. Thank you, Chairman Frank, and Ranking Member Bachus, and all the members of the committee for allowing me to join you today at this very important hearing.

I would also like to especially thank Chairman Frank and his dedicated staff for putting together this balanced discussion draft as an excellent starting point for our deliberations in working with my legislative director Jeff Siegel, who has done an outstanding job as well.

I know I can speak for many of my colleagues and the new Democrats when I say that we look forward to working with you constructively to improve this draft in the days ahead.

Although the regulation of derivatives is complex, this issue is extremely important to the proper functioning of our capital markets and to almost every business in America, and we need to get this right. We all know the effect of derivatives and what role they played in particular with the credit default swaps in the collapse of AIG and the broader credit crisis. Derivatives amplified the effects of the subprime mortgage crisis and the overleveraging of our economy.

There is no doubt that we need much greater transparency and regulation of our derivative markets to be sure that we do not have to face another AIG-type collapse or spend billions of dollars bailing out companies for taking imprudent risks. But we must be sure that any new regulation is smart and rational regulation. We need to target any new rules to directly address the potential for systemic risk without needless imposing of regulations that could have unintended effects.

Because derivatives are financial instruments that help all of us, they help keep our energy costs low and stable. They help insurance companies keep premiums low. They help companies complete construction projects on time and under budget. And despite the negative press and lack of understanding of the derivatives market, for the most part, the derivatives market works. We cannot throw the baby out with the bath water.

We must work to protect the end-users, good American businesses that are just trying to manage their cash flows and hedge against uncertain risks beyond their control in a cost-effective man-

ner. We should work to require standardized trades between entities that pose systemic risk, swap dealers, and major swap participants to clear their trades. For products that are more unique, those should continue to be traded in the OTC markets but with higher margin and capital requirements for the big players.

At the same time, we must increase transparency and disclosure requirements and grant regulators the authority to monitor these important markets for any sign of stress or overexposure. Our derivative markets need more regulation, but we also must be sure not to needlessly tie up capital or increase the cost of credit in ways that stifle economic growth or risk sending our financial services industry overseas, particularly important to the 80,000 people from my district in Staten Island and Brooklyn, New York, who work every day in the financial services industry.

In this age of instant global capital flows, if the regulations are not carefully written, any poorly conceived rule here in Washington could have a dramatic impact on our economy.

Mr. Chairman, I yield back the remainder of my time, and I again thank you for the honor of being here today.

The CHAIRMAN. I thank the gentleman.

He yielded minus 4 seconds.

The gentleman from Texas is recognized for 1½ minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

As I look at all the root causes of our economic turmoil, I haven't quite convinced myself that the derivatives market is among them.

We all certainly know what happened to AIG's Financial Products Unit with the credit default swaps. I am sure not sure that wasn't a symptom as opposed to a cause.

Now, clearly, their behavior in retrospect was reckless, and I for one do not agree that the taxpayer should have been asked to pick up the tab.

Be that as it may, it is important to know as we go forward what the history is, and the history is that the relevant regulator did not lack regulatory authority. They may have lacked regulatory expertise, but they did not lack regulatory authority.

Now, as we look at the new draft of the derivatives bill, I would like to commend the chairman for significantly improving the Administration's bill. It is only 10:20 in the morning, and I find myself in the unusual position of having agreed with my chairman 3 times now, and the day is early. It probably won't happen again any time soon.

But, nonetheless, I think that it is important that all of us realize that ultimately derivatives have a very important function in our market. Many of us have received correspondence from the Coalition for Derivatives End-Users. I would like to quote from that letter, which includes 170 of the largest job creators in America, "Business end-users rely on OTC derivatives to manage risk, including currency exchange, interest rates and commodity prices by insulating companies from risk; customize OTC derivatives; provide businesses with access to lower capital, enabling them to grow, make new investments and retain and create new jobs." We should be very, very loathe to ruin that.

Thank you. I yield back.

The CHAIRMAN. The gentleman's time has expired.

And indeed, I would recommend that the gentleman take the rest of the day off.

The gentleman from New Jersey is recognized for 1½ minutes.

Mr. GARRETT. I thank the Chair.

When viewed in the context of the proposal that the Administration previously put forward, the chairman's discussion draft is basically an improvement in many respects.

But when we review it in the broader context of exactly what problems we are trying to solve with several new layers of cumbersome bureaucracy over a huge part of the economy that has nothing to do with our financial troubles, the bill really does look less attractive.

The bill sets up a dual regulatory regime with the CFTC and the SEC, two agencies that, quite frankly, have a poor record of working together. Not only that, we are essentially setting that up to be prudential regulators, something that they are not equipped to do and which the SEC has already failed at, over non-financial companies that really don't need this prudential regulation.

So, to me, that is a fundamental flaw with a basic structure of the bill. Rather than certainty, there is a clumsy sort of multi-regulator approach to the derivative market that will breed widespread uncertainty, uncertainty that will reduce credit availability, hamper risk management, and cost jobs in the broader economy.

And while end-users may think that the direction that the bill has headed from is better, this legislation will still set up a regime with the authority to propose mandatory requirements and capital that could have negative consequences on them in the end. There is also a mandatory clearing component that I fear could rush cooperative buy-side and sell-side and regulatory effects to responsibly address the central clearing issue and could increase rather than decrease the potential for systemic risk in the process.

I have other concerns as well, and I hope that this committee and the second panel as well can explore it further.

Thank you. I yield back.

The CHAIRMAN. We will now begin with our witnesses.

We have the Chair of the Commodities Futures Trading Commission. And let me acknowledge, particularly in the presence of the ranking member of that committee, that the primary jurisdiction over this agency is in the Agriculture Committee.

And I want to say I am very pleased because I think jurisdictional disputes are Congress at its worst. Egos and pettiness come out. We have worked very closely with the Agriculture Committee, that was in complete agreement, and I thank the gentleman for acknowledging that. We even had an unusual joint hearing on the subject. And we will continue to work with the Agriculture Committee because cooperation between our two committees, as between these two agencies, is essential if we are going to get this job done.

Chairman Gensler.

STATEMENT OF THE HONORABLE GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee.

I am pleased to testify today regarding OTC derivatives reform and the discussion draft. I also want to commend your staff, Mr. Chairman—David, Peter, Jeanne, Lawranne and others who have worked tirelessly on this, and I agree with that.

AIG demonstrates the need for comprehensive regulatory reform. Every single taxpayer in this room, every member of this committee put money into that failed institution. Nearly $414 million per each of your congressional districts went into AIG.

Now, I would like to address much-needed regulatory reform in the context of two principle goals: lowering risk for the American public; and promoting transparency of the markets.

At the conclusion of last month's G–20 summit, President Obama and other heads of state made these two goals, lowering risk and promoting transparency, key. And I am just going to quote from that statement: "All standardized OTC derivatives—this is President Obama and 20 heads of state—all standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms where appropriate and cleared through central counterparties by end 2012 at the latest."

It is I think our challenge now, our challenge as an Administration and regulators and hopefully working with Congress, to achieve this goal. We need to lower risk in the system for the American public. That is going to require capital standards explicitly set for the large financial institutions. They already have capital, but we should be explicit about it: margins, so that we lower the risk with the counterparties; business conduct standards to make sure that boring stuff in the back office works; and, yes, importantly, centralized clearing on those products that can be cleared, still accommodating customized products, but central clearing is key.

Transparency is the second key principle. And as we discuss proposals of OTC derivatives, I believe it is inherent that we get this right. But, first, strict recordkeeping and reporting requirements should be established and vigorously enforced. Second, that all non-cleared transactions should be reported to a trade repository. Third, that the data on transaction should be available and aggregated for the public so the public can address an information deficit they have on these markets. But fourth, very critically, that standardized part of the market, those products that can be brought to an exchange or trading venue be moved onto these facilities so we have the same benefit that we have in the securities and futures markets of transparency. Every economist that looks at transparency, it benefits markets.

I will just now briefly turn to six quick issues raised by the discussion draft. First, the discussion draft shifts the Administration's proposals presumption that all standardized derivatives be cleared to one where product will be cleared only if required by a market regulator and then puts the burden on the regulators to possibly do this contract-by-contract.

Second, end-users' transactions should be brought to the central clearinghouse to lower risk. End-users should be allowed to enter into individualized credit arrangements with their financial institutions, but the Administration's proposal would still get the benefit of central clearing, again, only on the part of the transactions that

can be cleared, not the customized transactions. We think if there is an end-user exception that Congress believes they need to endorse that it be very narrowly defined, as the chairman said, to address non-financial entities that use swaps to hedge actual commercial risk as contrasted to financial entities.

Third, the discussion draft widens an exception for major swap participants. It was the goal of the Administration bill to cover major swap participants. We are concerned that it may be an unintended consequence that swaps entered into for risk management purposes would not be covered and as thus the major swap participant category would be so narrowed inadvertently.

Fourth, the discussion draft makes trading on regulated exchanges or regulated trading platforms available but not required. And as I said, I think that transparency is critical to the markets and for all of the end-users that have concerns elsewhere in the bill, this actually benefits end-users to have the transparency in pricing. I don't know why we would accommodate it, and it is natural that Wall Street might have a different view of this, but we are trying to recommend things that benefit Main Street and end-users who use these products.

Fifth, U.S. regulators must work with international regulators to protect the American public. We just look forward to working with the committee to make sure that any efforts to accommodate foreign regulatory standards do not inadvertently permit market participants to shop for lax foreign regulators.

And then, lastly, the discussion draft could inadvertently enable standardized agricultural swaps to be traded bilaterally off exchange. It does not impose the protections that we believe are necessary for the market.

In addition to these points, we look forward to working with you in the next several days on other technical thoughts. We look forward to working with the SEC as well. Next week, we are going to be reporting on the request the President made that we look to harmonize our rules, and we look forward to making that available to this committee and Congress to help in these efforts.

Thank you.

[The prepared statement of Chairman Gensler can be found on page 106 of the appendix.]

The CHAIRMAN. Thank you.

Mr. Hu is the Director of the SEC's new Division of Risk, Strategy, and Financial Innovation.

Mr. Hu?

STATEMENT OF HENRY HU, DIRECTOR, DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. HU. Thank you, Mr. Chairman.

Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to testify on behalf of the Securities and Exchange Commission concerning the Over-the-Counter Derivatives Markets Act of 2009 proposed in August by the Treasury Department, and the discussion draft recently circulated by the chairman.

I am especially pleased to appear with CFTC Chairman Gary Gensler, with whom the SEC has worked closely over the last several months on a variety of issues. Both of our Commissions are eager to address these issues and ensure that remaining differences are justified by meaningful distinctions between markets and products.

As you know, the recent financial crisis revealed serious weaknesses in the U.S. financial regulation, including gaps in the regulatory structure. Both the SEC and the CFTC are fully committed to filling gaps and shoring-up the regulatory system.

One significant gap is the lack of regulation of OTC derivatives, which were largely excluded from the regulatory framework in 2000 by the Commodity Futures Modernization Act.

OTC derivatives present a number of risks. They can facilitate significant leverage, enable concentrations of risk, and behave unexpectedly in times of crisis. And while some derivatives can reduce certain risks, they can also cause others.

Importantly, these risks are heightened by the lack of regulatory oversight of dealers and other market participants—a combination that can lead to insufficient capital, inadequate risk management standards, and associated failures cascading through the global financial system.

Lastly, the largely unregulated derivatives market can also undermine the regulated securities and futures markets by luring participants to a less-regulated alternative.

The discussion draft is an important step forward in improving transparency and establishing the necessary regulatory framework. While it would go a long way towards improving the regulation of OTC derivatives, I believe it should be strengthened in several ways.

First, to minimize regulation arbitrage, swaps should be regulated like their underlying references. Market participants often view derivatives and the underlying assets they reference as substitutes. Whether the participation is direct or indirect, the same or similar economic effects can often be achieved.

As a result, even subtle differences in the regulation of economic substitutes can lead to gaming advantages for any one participant. But that participant's regulatory arbitrage activity, and a general migration to the less-regulated derivatives markets, can undermine the interest of other participants, as well as everyone's interest in minimizing fraud and systemic risk. The easiest way to achieve this goal is to move over the existing securities regime to securities-related swaps. If Congress decides to retain the bill's existing rulemaking framework, it should include these swaps within the definition of securities within the Federal securities laws. This will ensure that existing protections and authority can automatically flow through to these products. Exemptions could be provided where needed. I believe it is better to start from an existing framework for substantially similar products than to start from scratch not knowing what might be missed in some cross reference, not knowing what future financial innovation may bring.

Second, it is essential that the legislation address anti-fraud authority matters and provide the tools needed to appropriately enforce anti-fraud authority. The discussion draft seeks to retain cer-

tain existing anti-fraud authority over, for instance, certain broad-based swaps, but may have inadvertently weakened that authority over certain other related swaps.

The SEC should also have the tools needed to effectively exercise the anti-fraud authority. The discussion draft recognizes the importance of inspections and examinations of swap dealers and major participants to the SEC. We recommend that this authority be extended to central counterparties and swap repositories, so that regulators can have quick access to comprehensive data.

Third, the discussion draft should clarify that the definition of "securities-based swap" includes not only single and narrow-based credit default swaps but broad-based credit default swaps where payment is triggered by a single security or small group of securities.

Fourth, the legislation should narrow the "risk management" exclusion for major swap participants. Regulation of major swap participants and dealers is a vital part of the OTC regulatory regime. We do understand that there may be entities that use swaps that should not fall into this new framework. The discussion draft, however, effectively provides an exclusion for major participants who hold positions, "for risk management purposes." The term "risk management" is ambiguous and could cause a large number of important entities to fall outside this new regime.

Finally, the legislation should direct regulators to adopt stronger business conduct rules to protect less sophisticated investors and end-users.

In closing, this proposal makes significant strides towards addressing current problems in the OTC derivatives marketplace. I look forward to continuing to work with this committee, the Congress, the Treasury, and the CFTC to enact strong legislation in this area.

Thank you for the opportunity to testify here today. I look forward to answering your questions.

[The prepared statement of Mr. Hu can be found on page 147 of the appendix.]

The CHAIRMAN. Thank you.

As I said, I think we appreciate and we are in agreement with much of what you say. There will be some disagreements. Let me start off with two points, though.

Some of the points you make, Mr. Gensler and also Mr. Hu, you have to take them to the Agriculture Committee. For example, your proposal—your objection to the swaps between agriculture entities, it would be an intrusion on the jurisdiction of the Agriculture Committee, and we will be working on this together. We will be submitting our bill, and they will be offering some amendments. Where you were talking about a swap between agriculture entities, you have to take it to them.

I have said that I think there is a presumption that we have jurisdiction over things that aren't edible, but they are certainly clearly in charge of the edible, not just that, but I guess tangible is a better way of putting it.

So, secondly, Mr. Hu, I will say that some of your points similarly are jurisdictional issues between yourself and the CFTC. And that means between us and the Agriculture Committee. There are

some substantive issues where I very much agree and a couple where I don't agree, but I do want to say, as I go through your points, some of them will have to go to the Agriculture Committee.

For example, Mr. Gensler, your fourth point where you say the discussion draft makes trading on regulated exchanges or regulated trading available to swap dealers but not required. And then, again, that is covered in your sixth point, agriculture swaps. Let me put it this way, for agriculture swaps, you need to deal with the Agriculture Committee.

On your fourth point, to the extent that we are dealing with swaps that are not agriculture, we would be inclined to agree with you. So points four and six, you will have to split those.

Let me just go through a couple of the other points you make. On the question of clearing, no, we did not mean to have a presumption against clearing. I do think it is appropriate to have the presumption in favor of clearing, understanding when it doesn't happen, so we will work with you on that. And you should, I believe, have the authority to deal with a broad class of swaps, even under that presumption. And again, the two of you together. I assume this is one.

Mr. HU. We are good friends.

The CHAIRMAN. That one point appears in both of your statements, so on that one, we are there.

On the clearing requirements for end-users, you say you recommend that they all go to a clearinghouse. I don't think you are going to see that happen because of the response that many will have to the end-users. But at the bottom of the page, you say, "To the extent that Congress decides not to follow this approach, any clearing exceptions for end-users should be very narrowly defined to only include non-financial entities that use swaps incidental to their business to hedge actual commercial risk." That is the essence of what we are trying to do. We will work with you to do this.

But I do have one question. Obviously, when you mention insurance, people think of AIG, which was a major problem here. But is it possible to make a distinction between insurance qua insurance, and insurance companies that make so much money they won't get themselves in trouble? That is, we generally agree with this financial non-financial. But there is a definitional question about insurance. People who are in the business of selling insurance to policyholders, how would you classify them in this? Obviously, if an insurance company is engaging in non-insurance-related transactions like AIG, they should not be exempted. But what about an insurance company that is selling life insurance or automobile insurance?

Mr. GENSLER. We would believe that insurance companies should be under, just like other financial firms and bring their standard product, not the customized product, but to the benefit of the clearinghouse.

The CHAIRMAN. We will be working on that one, because there is I think some question that was there. And then both of you, I guess, had this issue. You worry that our exemption for risk management, that could be a huge loophole. I agree that it could be a loophole, and people want to make it one. I would hope you would work with us so that we could define risk management better, both

substantively and procedurally. That is, we would define risk management, and you would be the primary deciders of that. And the fact that someone was doing something that met GAAP, we wouldn't be interfering with GAAP, but that would not be dispositive of the issue. They couldn't say, well, this is risk management according to GAAP, therefore, you guys mind your own business. Work with us on that, because, again, there is more common agreement here on the goal, and we would be able to deal with this.

Finally, let me say, Mr. Gensler, you say market participants should only be exempt from American regulation where there has been a determination by U.S. regulators that the foreign regulatory scheme is comprehensible and comparable. Agreed, we will do that. So, as I said, I think we will probably still do more for end-users in terms of exemptions than you would like. But in almost every other case, we are in agreement, saving those where you are going to have to take it to the Agriculture people.

Mr. GENSLER. I thank the chairman for that quick review. If I could just comment on two of the points.

On exchange trading, I take it that maybe we are closer together that we should mandate the benefits of either exchange or these execution facilities. Accommodating some transactions that are illiquid and too large can come to a mandate.

The CHAIRMAN. Mandate is too strong a word. You talked about a presumption. There would be a presumption that they would be there, and you would have the ability to decide that. I don't know how you mandate them all, and then you say you can't mandate everything except for a few.

Mr. GENSLER. But to require those products that are able to be cleared—

The CHAIRMAN. Yes, so burden of proof should be on those to show you that they can't be.

Mr. GENSLER. That those would not only have the benefit of clearing but also exchange trading or trading venues.

The CHAIRMAN. Right.

Mr. Hu?

Mr. HU. Chairman Frank, I truly welcome your remarks about the risk management exclusion.

The CHAIRMAN. It is always nice to feel welcome, Mr. Hu.

Mr. HU. A Texas-size welcome. I really welcome it because—

The CHAIRMAN. Okay. Since you agree, I can't take time to do that. Do you have any—

Mr. HU. Yes. In terms of the exclusion, we are calling for objective, narrow, and verifiable notions of "risk management."

The CHAIRMAN. All right. We will deal with that. I am taking other people's time, and I can't do that. We have a conceptual agreement. We will work with you.

The gentleman from New Jersey.

Mr. GARRETT. I thank the chairman.

And I thank the members of the panel. The first question, I guess, is for both of you. On page 165 of the draft, it states that margin requirements for swaps set by the SEC and the CFTC for end-users shall provide for non-cash collateral, non-cash assets as collateral. The way I read this is it doesn't mean that they always have to do so, but they have some flexibility in there. Is that the

way you read it? And if so, then how will you actually implement the use of those assets? And if not, do you have broader authority than that under this direct proposal?

Mr. GENSLER. We believe that in working with the committee, we can get this right, but that end-users should be able to enter into individual credit arrangements with the swap houses and the financial entities, and that would be allowed non-cash collateral in that regard. But that which could be cleared could still be brought to the clearinghouse and benefit from that lower risk.

Mr. HU. In terms of how we interpret this provision, as we understand it, this provision applies to dealers accepting non-cash collateral. And in terms of non-cash collateral, it could be things like Treasury bills. Highly liquid matters could fall under that rubric. The provision does not, we understand, apply to clearinghouses. In terms of clearinghouses, we are hoping that, in fact, the requirement in terms of collateral would be involving a tighter rein by regulators.

Mr. GARRETT. Through the clearinghouse, then, what is the tighter range—what would potentially the clearinghouses be required to provide if not those assets? Would they require cash assets, cash?

Mr. HU. Well, we allow things like—

Mr. GARRETT. But could they—under the authority, could the circumstances be that it is not going to be non-cash assets, but they could actually have to require cash?

Mr. HU. In terms of our existing clearinghouses that the SEC regulates, we do allow things like money market funds and other kinds of liquid, high-quality assets.

Mr. GARRETT. And if those are required, could that not cause a deleterious effect upon the end-users at the end of the day? I know the end-users at this point feel, hey, we have been sort of carved out, and we are happy about this, but if the clearinghouse arrangement is not done in that particular manner, the authority is broad enough to actually require, that they may not be as scot-free in this as they think they may be?

Mr. HU. There are two possible ways in which those concerns are alleviated. First, the SEC historically has viewed clearinghouses as public utilities subject to heavy regulation to make sure that there is open access—and that the fees are reasonable and the other requirements are reasonable.

The second way is that we really want to do everything we can to ensure the safety and soundness of clearinghouses, a central element to minimizing the AIG interconnectedness problem.

Mr. GARRETT. So it might take away from this, is that is going to be a paramount requirement and concern of you is the systemic risk aspect of the clearinghouses and their soundness of that, and so that will be—that would trump necessarily, under certain circumstances, potentially over the end-users situation.

I only have a little bit of time. You also, Mr. Hu, spoke to the issue of trading swaps—I will use layman's terms—trading swaps, basically, and implementation of the rules with the same manner and such as derivatives, right, in your opening statement.

Mr. HU. To have securities-related swaps being treated like securities would help simplify matters.

Mr. GARRETT. Does it simplify matters? In actuality, how does that actually play out in real life? Because under the rules that you would have to apply to them, can they basically implement them and carry them out in the same timely manner that you would necessarily do it with the swaps?

Mr. HU. Well, in terms of that issue, right now there is a distinction, for instance, between broad-based security-based swaps and narrowly-based security swaps. Broad-based security swaps basically fall under the jurisdiction of the CFTC, while security-based swaps and narrow-based security swaps fall under the jurisdiction of the SEC.

We feel that because of the arbitrage possibilities from using two broad-based security-based swaps to get targeted exposure to a single company or a narrow group of companies, that it allows for easy gaming. By simplifying things to treat, for instance, all security-based swaps as securities and falling within the parameters of the Federal securities laws simplifies matters, reduces the possibility of gaming of gaps, and facilities more efficient responses.

Mr. GENSLER. We think that the Administration proposal and the discussion draft got this right, and it kept in line the 27-year arrangement where broad-based indices and futures and derivatives on them are regulated by one. And the market regulator and the narrow-based are by the SEC. Of course, the chairman noted, we are two agencies, so there are boundaries.

Mr. HU. May I quickly respond to that?

The CHAIRMAN. No. There is an interagency here. We will have to move on. I will have to tell the SEC, you are up against a pretty high hill if you have the Administration and the Agriculture Committee on one side.

Mr. GARRETT. And that is the uncertainty that I guess we are questioning.

The CHAIRMAN. But it is certainly our responsibility to resolve it. The gentleman brought up an important issue.

The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

First of all, allow me to congratulate Mr. Gensler and the SEC. You are certainly a lot closer than you were 2 months ago when we had our opening discussions as to what to do. I do have a question, and I guess the last question by Mr. Garrett really triggers it. What unresolved problems in the jurisdiction between the two agencies have not yet been resolved, and when will it be resolved?

Mr. GENSLER. We intend next week to report to the President and the Congress on a report of the gaps in our oversight. And in that, we will be having a series of recommendations, some related to enforcement matters, some related to product review, cross margining. It looks across the whole gamut of issues between our two regulatory approaches and makes recommendations, where appropriate, to Congress; some recommendations for ourselves in rule writing.

Mr. HU. On September 2nd and 3rd, the SEC and the CFTC held historic joint meetings to seek input from the public on the harmonization of regulation and futures. It was very successful, and there have been ongoing discussions on a wide range of matters, and the talks have been going very well.

Mr. KANJORSKI. Very good. All in all, looking at the discussion draft do you see anything so fundamentally offensive that you would not be supportive of its enactment into law?

Mr. GENSLER. Congressman Kanjorski, we look forward to working with this committee and Congress to enhance this important step. But as I highlighted, we do believe that the American public needs to benefit from the full transparency that comes from getting the standard part of this market onto trading platforms and exchanges. We do want to narrow this exception for major swap participants and in the presumptions that we talked about in the other areas in the testimony. We think those are important so that we cover this entire marketplace.

Mr. HU. We do think it is important in terms of the securities framework that it basically apply to substitutes, to economic substitutes. Otherwise the dangers of arbitrage and gaps occurring are too serious.

Mr. KANJORSKI. Very good.

Mr. Chairman, I have had an opportunity to ask a lot of questions in the past. Let me yield back to the Chair so other members may have an opportunity.

The CHAIRMAN. I thank the gentleman.

And I apologize, I should have gone directly—I wasn't looking at my list—to the gentleman from Oklahoma who serves on this committee and is also the ranking member of the Agriculture Committee, and so he has been an important part of our trying with the gentleman from Georgia, Mr. Scott, and some others, Mr. Minnick, to try to make sure that our two committees are at least abreast of what each are doing.

The gentleman from Oklahoma.

Mr. LUCAS. Thank you, Mr. Chairman, and I appreciate your observations, and I think we have very good working relationship, the House Agriculture Committee having passed an earlier attempt at this reform concept this year, and now Chairman Peterson indicates that we may well be addressing another series of hearings and potentially markups to have a companion bill.

So, let me direct my first question to the Securities and Exchange Commission. SEC has had anti-fraud and anti-manipulation jurisdiction over credit derivative markets since 2000. Could you list for us, please, how many cases the SEC has brought and in what years those cases were initiated?

Mr. HU. There is one very important case going on right now that involves using credit derivatives for insider trading purposes—involving people who learned about certain restructuring events at a company and whom the SEC believes used credit default swaps as a way of betting on that particular transaction.

One of the great things about this bill, relating to your question, is in terms of being able to bring more cases by being able to look more carefully at the transactions going on. There is a drastic increase in transparency flowing from the clearinghouses and the swap repositories. With this greater transparency, it would help us ensure a greater ability to detect market manipulation.

Mr. LUCAS. So, in the last 8 years, we have had how many cases brought?

Mr. HU. Congressman, I am afraid—

Mr. LUCAS. That you are aware of.

Mr. HU. Congressman, I am afraid I have been at the SEC all of 4 weeks, and I will have to get back to you and find out about the other cases.

Mr. LUCAS. Since we are talking about, in many cases, some substantial increase in enforcement authority, I think it would be fascinating to know how many have been brought under existing rules in a very complicated time, so I look forward to that, very much, to that response.

Now, I address this to both of you. Looking at the way this draft proposal is crafted, tell me what kind of resource increases, both personnel and dollars, would you expect from an administrative perspective you will have to have to implement the language, assuming we ultimately come up with a bill very similar to this draft.

Mr. GENSLER. Congressman, it is good to see you in both committees. We will look forward to working with Congress, the appropriators on additional resources as I believe we will need that. We have not scaled it yet, but it is clear to us that we will need additional resources. And all I can commit to you is to work with this committee and the appropriators and the Agriculture Committee as the scope of this comes together over the next month or 6 weeks.

Mr. HU. There will be a material increase in resources that will be needed. Indeed, we at the SEC realize the need for expertise—real-world Wall Street expertise in terms of areas like credit derivatives and the like. And I personally have been involved in terms of recruitment efforts in that respect. And so with a wider jurisdiction over this previously unregulated market, there will be a corresponding increase in resources needed.

Mr. LUCAS. Just as the CFTC's primary focus are these issues all the time, I appreciate that greatly. I also realize that the Securities and Exchange Commission has a wide variety of responsibilities. Over the course of the last so many years, how many people have been committed at the SEC to doing this kind of work already within existing jurisdictions?

Mr. HU. In terms of specific numbers of people, I am afraid I will have to get back to you. I could tell you that in terms of these derivatives-related activities, they cut across Divisions. For instance, the Division of Trading and Markets has been very concerned in terms of certain derivatives issues and the Division of Enforcement in terms of insider trading. The Division of Investment Management has been concerned with mutual funds investing in derivatives and the like—we are seriously concerned about that issue and have asked an ABA subcommittee to look at those kinds of issues.

The creation of this new Division is in part a reflection of the need to adopt a more integrated approach to thinking about the benefits and the costs associated with the derivatives revolution.

Mr. LUCAS. The reason I ask those questions, of course, is it appears that we will have another opportunity to visit about this in the Agriculture Committee in a few days, perhaps a few weeks. So preparing information in regards to both, I look forward—because after all, we are not just talking about expanding authority for both agencies and compelling you to work together; we are also reviewing how efficiently you have used the resources and the responsibil-

ities you have already had. That is a key, I think, measure that needs to be taken.

With that, thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman.

Mr. Hu, I want you to help me understand something about credit default swaps. From everything that I have learned, I came to the conclusion that they should be banned. So I am very pleased that the chairman has included language which would allow the CFTC and the SEC to ban abusive swaps, including credit default swaps. However, I am concerned with the problem of what I have come to know and I understand of empty creditors. And let me read an article to you that was recently in Financial Times. There have been a lot of articles on this.

"The relationship between Goldman Sachs and ailing commercial lender CIT provides further evidence of the dangers of the credit default swap market. Credit default swaps have become an increasingly contentious issue in debt restructuring, such as one that CIT is now trying to complete. Many creditors who hold such insurance make more if a company files for Chapter 11 bankruptcy protection than they make on their debt if the company succeeds in restructuring its debt outside of bankruptcy. In the case of CIT, the market has bought more insurance than the company's $30 billion in debt. These holders include Goldman Sachs, which purchased such a credit protection to hedge against a June 2008 rescue financing of up to $3 billion to CIT, Goldman said. Goldman also held other CIT debt, although the company declined to comment on these other exposures."

Now, we bailed out Goldman, and we bailed out AIG. We bailed out AIG to the tune of $100 billion, I believe. We—and it appears that they ended up paying Goldman about—I think about $13 billion. Now we see the CIT situation. How will the Commission be able to use this new authority to prevent empty creditors or lenders who are net short their own clients? Would the Commission need any additional statutory authority to address this problem, or does this bill provide you with enough tools to prevent empty creditors from triggering defaults and bankruptcies?

Mr. HU. In the interest of full disclosure, I am afraid I am the one who came up with the term "empty creditors." In particular, the Goldman situation—CIT situation you referred to might be of the "empty creditor with a negative economic interest" variety. This variety poses particularly difficult issues relating directly to your broader question in terms of this anti-abuse provision.

This anti-abuse provision appears for the first time in this bill in this discussion draft. The SEC is right now just starting to analyze this particular provision. And your particular example of the Goldman Sachs/CIT situation illustrates some of the questions we are thinking about and we are working our way through.

For instance, this anti-abuse provision talks about watching out for products that destabilize the system or an individual market participant and possibly banning them. What if it turns out that something—a particular kind of swap—is beneficial to the system in the sense of allowing banks, for instance, to hedge against risks or financial institutions to make loans and so forth, and yet per-

haps be harmful to a particular market participant? The bill's provision doesn't answer that. It also raises issues—difficult issues that we are starting to analyze—as to what extent should some of the benefits flowing from a particular product be balanced against the potentially destabilizing effects of the products?

Naturally, these issues raise profound questions that we are starting to look at, and we will be engaging in many consultations with other concerned regulatory agencies. But you raise a very, very good issue, Congresswoman Waters.

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

Mr. WATT. [presiding] The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

I have no doubt that our derivatives market can be improved, made more competitive, made more transparent. But I usually ask myself a threshold question when proposals are put on the table, and that is, is the cure worse than the illness?

I don't think we would be here today but for AIG. Again, I haven't convinced myself they weren't a symptom as opposed to a cause. But if you believe they are a cause, just to ensure what we are trying to protect against, are you gentlemen aware, were there other abuses in the derivatives market or other major economic players besides AIG that bring us here today?

Mr. GENSLER. Absolutely, Congressman. Derivatives are an unregulated marketplace, and we believe that the dealers, whether it was the affiliates of Lehman Brothers, the affiliates of Bear Stearns, or even the affiliates of the institutions that made it through last year with the support of the government—taxpayers supported a lot of institutions last year—many institutions used derivatives, significantly leveraged up their exposures to risk, and it did it in a nontransparent way. So what we are here about discussing is how do we lower risk to the American public, not just in AIG's case, but lower risk to the American public and also address information deficits? The public knows—

Mr. HENSARLING. I am sorry. Specifically, which companies do you view as abusing derivatives; and it was a derivative, or was it a problem with the underlying asset being residential real estate?

Mr. GENSLER. Derivatives allow for risks to be managed, managed well. But also in the aggregate, particularly in the books of many financial institutions, it also allows risks to be accumulated and large leveraged to—

Mr. HENSARLING. I understand that, but can you name specific companies?

Mr. GENSLER. I believe that in—many financial institutions have used derivatives to take on significantly extra risk, and so we are saying we need to bring this into the capital regime as a cushion, whether it is any of the remaining 15 large—

Mr. HENSARLING. Let me try asking a slightly different variation of the question. Are you aware, then, of any other major economic institution in the economy besides AIG that wrote credit default swaps without posting collateral to their counterparties?

Mr. GENSLER. Yes.

Mr. HENSARLING. Who?

Mr. GENSLER. We could go straight down the list of the large financial institutions, many of them that still exist today, and recall that of the first $90 billion that went into AIG, $60 billion went overseas to overseas institutions. It gives you a sense of how interconnected we are. The other $30 billion went to many of the other financial—

Mr. HENSARLING. I understand that. That is the reason why many of us opposed that in the first place.

We have had the head of OTS previously testify before this committee, that is the prudential regulator. They had the authority to rein in AIG's Financial Products Division with their credit default swaps. They simply missed it. They didn't lack the regulatory authority. Do either of you disagree with that testimony, which, by the way, was under oath?

Mr. HU. Congressman, to this question you just asked as well as the previous question, one of the key aspects of AIG, and, in a sense, of the involvement of other financial institutions and credit default swaps, is the whole issue of interconnectedness. When markets panic, they sometimes can freeze up. And part of what caused the financial problem and caused the intervention with respect to AIG subsequent to Lehman was the notion that this interconnectedness was spreading, that people were suddenly refusing to deal with each other and so forth. By having these clearinghouse arrangements so that in effect people don't really have to depend on—

Mr. HENSARLING. Forgive me for interrupting. I see my time is about to run out. With respect to interconnectedness, is it not possible that some type of mandatory clearing, is that not making us more interconnected? Is that not somehow centralizing the risk in one particular location? And if interconnectedness is a critical component of systemic risk, why aren't we arguing—

Mr. GENSLER. It actually lowers risk, because right now the large swap dealers, there are about 15, maybe generously 20, around the globe are also in the banking business, they are in the securities business, they are in the insurance business, and the leasing business and proprietary trading business, and they are central counterparties. AIG was a central counterparty, not a regulated clearinghouse.

What we are trying to do is we are trying to separate out of the large financial houses this counterparty function regulated. I would daresay if this committee—if somebody came here and said, could the large central counterparties today that are regulated go into the leasing business, go into the banking business, go into the insurance business, you would say, no, no, no, we want to keep that separate and make sure that function is regulated and has the discipline of a daily marking to market, a daily accounting, a daily settling up. It is a harsh discipline in a sense, but it works in the futures industry, the largest clearinghouse there. It works well. It works in the options on securities, which is called the Options Clearing Corporation. It works very well, and it is separated out from banking securities and so forth, obviously, with great benefit.

Mr. WATT. The gentleman's time has expired. And I recognize myself for 5 minutes.

Mr. Gensler, I am going to zero in on the part of your testimony on page 10 that deals with exchange trading. And I know that you and the Chair have had an exchange about this earlier, but I want to be clear on where this is likely to lead. It seems to me that the Administration's draft dealt with this, and the discussion draft that has been circulated by the chairman now muddies the water. Is that your assessment? That seems to be what you are saying on page 10.

Mr. GENSLER. The Administration bill, which I fully support, requires that those products that can be cleared also have the benefit of either trading platforms, execution facilities or exchanges, and that benefits all these end-users that we have been talking about earlier on the clearing issue.

Mr. WATT. And that would be—under the Administration's bill, swap dealers and major swap participants would be required to do a certain set of things, and then everybody else would not be, or would everybody be required to—

Mr. GENSLER. It requires all of the transactions that can be cleared and listed to be listed on these facilities. Now, some have raised the issue of what if there is not enough liquidity and so forth. And what we have recommended here in this testimony and look to work with this committee on is that through rulemaking the SEC and the CFTC, just as we do in futures and securities, would allow for certain block trading and certain transactions to happen, but still be less—

Mr. WATT. But legislation won't accommodate the rulemaking. You can't make a rule that is inconsistent with the legislation.

Mr. GENSLER. That is right. The discussion draft does not allow for this. The discussion draft goes from requiring exchange transparency to just making it optional.

Mr. WATT. Now, the thing that I wasn't clear on when I read this was whether this—this appeared to me to be as potentially a drafting error as opposed to a conscious decision. I don't want to put you in the position of deciding whether that—is this something that can be fairly easily corrected?

Mr. GENSLER. Absolutely. My compliments to the dedicated staff of this committee. This could very well just be an unintended consequence. But we think that, aligned with what President Obama and the heads of state laid out, that we should move towards the exchange and exchange venue transparency, get the benefits of the self-regulatory function, the trade affirmation function and all that goes on on these exchange and trading venues.

Mr. WATT. So just changing it back to making it, at least for major swap dealers and major swap participants, mandatory, is there another category outside swap dealers and major swap participants for which it may be—there may be a different standard?

Mr. GENSLER. There is a benefit to end-users. If I can tease out—the end-user issue on clearing, which is a very real issue and we are all grappling together on that about posting margin and capital and so forth, is different than on the exchange side. It is all about transparency. This truly does benefit every small utility company, every small user of derivatives to have greater transparency. The only party that would naturally be opposed is Wall Street because

they right now have the information advantage, and that is natural.

Mr. WATT. Talk to us about some of the advantages of greater transparency outside Wall Street. I understand that some people on Wall Street would like to have that kind of advantage, but what are some of the advantages to greater transparency outside?

Mr. GENSLER. The advantages that economists for decades have noticed is that end-users then get the benefit of seeing that price discovery function. If you are a small hospital in any State, and you are thinking about hedging an interest rate risk, you can see what happened even a half an hour earlier on a standard interest rate hedging transaction.

Mr. WATT. How does that compare, for example, with the kind of transparency that is currently available on a regular exchange?

Mr. GENSLER. Well, it would be very close to the transparency that you would see on the regulated securities, exchanges and regulated trading venues. There is also these alternative trading venues in the securities and in the futures world.

Mr. WATT. Thank you.

My time has expired, and the gentleman Mr.—let me see who is next—Mr. Castle, I think, is next.

Mr. CASTLE. Thank you, Mr. Chairman.

I am impressed by the testimony of both of you and the work you have done on this, including this committee and the Agriculture Committee, which has been referenced. And I just want to get confirmation from you. I assume that you are—this is a positive question, not a negative question. You are working together with respect to the various recommendations which you are working on. I don't see a lot of space between you, and I would assume that is the case, and you are working jointly with this committee and the Agriculture Committee; you are not setting one off against the other is my assumption, based on what I am hearing.

Mr. GENSLER. I thank you for that, Representative Castle, and I believe that would be the case at the staff and Commission and Chair levels.

Mr. CASTLE. Let me ask you this, Mr. Gensler. You mentioned earlier in your testimony the need for explicit capital standards. And I am not enough of an expert to perhaps even ask the right question, but I am worried about the liquidity in all of this. Capital is one thing, but sometimes there is capital without liquidity. Is that a factor that is taken into consideration, or am I not understanding it correctly in terms of the capital versus liquidity needs and trading circumstances?

Mr. GENSLER. Liquidity is fundamental to markets and fundamental to all the users of these products. Capital is that the financial institutions that hold themselves out to the public as dealers have sufficient shock absorbers, so to speak, in their business.

One of the key assumptions to regulation is that we were regulating the large financial institutions, and I truly believe the financial regulatory system failed the American public. So that is why we are recommending that it has to be more explicit in writing rules about the capital. These large financial institutions already were supposed to have capital for their derivatives business; not AIG, but the others, so to speak. We think that is just more trans-

parent, go through the usual Administrative Procedures Act and have real explicit rules on the capital on these products.

Mr. CASTLE. Thank you.

Like everybody here, and I think you are addressing these issues, I obviously believe we need greater transparency and accountability of OTC derivatives, but there are—and we all know this—users out there who are concerned that implementing these reforms will limit the use of derivatives as a way to manage risk because margin capital requirements to participate in these deals may be too costly. And I think I am referring mostly to entities that use the trade and these various derivatives for business, or whatever it may be. So there is some legitimate concern about that. Have you addressed—have we addressed this in the legislation, and are you taking this into consideration as you comment on this?

Mr. GENSLER. We are concerned that we get this right, the balance is right, and what we suggested is that the end-users be allowed to enter into their own individual credit arrangements with the financial institutions so that the financial institutions still bring the transactions to central clearing. However, if Congress doesn't accept that approach, we think that we would want to work with this committee and Congress just to make sure it is a very narrow exception for end-users that are non-financial institutions that are using swaps not—they are incidental to the business, and it is to hedge particular commercial risk.

I should note this is only really a debate about the standard or clearable contracts, because all the end-users, appropriately the Administration, the CFTC support, should be able to enter into tailored or customized products for their particular risks.

Mr. HU. I should emphasize that one of the key ways we want to protect end-users is to make sure that the clearinghouses don't overcharge. So what we have done historically in terms of ensuring that is to, in fact, refuse to tie a particular exchange to a particular clearing service. So the result is that we have a single stock or a similar product trading across multiple exchanges cleared through one entity, and that has really redounded to the benefit of the investors. So this public utility model of clearinghouses, we think, is very important.

A second aspect in terms of protecting end-users, I think, is that while central clearing and exchange trading are both worthy goals, worthy to think about in terms of improving transparency and the like, but in terms of making exchange trading mandatory, historically in terms of the securities laws, we don't require mandatory exchange trading. We have alternative trading systems to stock exchanges and the like, and study after study have shown they have made things more efficient for the investors.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

We have had quite a number of regulators sit where you gentleman are. Now, every time I hear from regulators, they always want to regulate. They never want to abolish the actual activity that would eliminate the need for regulation. We have a $592 trillion over-the-counter derivatives industry. This makes all of Las Vegas seem like a single grain of sand. For the most part, as far as I can tell, most of these derivatives are just gambling contracts.

There is no airline hedging against increases in fuel costs. There is just somebody who thinks they can make money that day by betting on airline fuel.

The question—one of the reasons this casino grew so large is that those who are betting believed that if the individual casino got in trouble, the Federal Government would be there to bail them out with regard—there is substantial possibility of that. Those who bet at the Lehman Brothers casino were wrong; those who bet at the much larger AIG casino turned out to be right and haven't lost a penny.

The question is can the over-the-counter derivatives industry work without an implicit possible—because we saw sometimes it is there, sometimes it is not—Federal guarantee? If, for example, Congress did not adopt section 1204 of the Treasury proposal and did not provide a mechanism by which the Federal Government could come in with hundreds of billions of dollars and bail out one of these casinos, what harm would there be to the economic institution and to over-the-counter derivatives industry?

Mr. GENSLER. Congressman, if I—I apologize. If you can remind me of section 1204?

Mr. SHERMAN. Section 1204 is the mechanism by which the Executive Branch can lend unlimited amounts of money or make unlimited investments in any systemically important—which really means top 20—financial institution.

Mr. GENSLER. I thank you.

We believe that it is really important to separate out this central counterparty function from these large financial institutions precisely for the reason that you just raised, that they are so large that there is this moral hazard issue of where is the government, what is the government's role in those institutions. So in separating them out, in central counterparties that are fully regulated and have to take an accounting on a daily basis, have to have collateral posted, and it is separated from a lending business, separated from an insurance or securities or proprietary trading business, we firmly believe that lowers—

Mr. SHERMAN. If we separate it out, do you have a system that will work without a section 1204, without an implicit Federal contingent guarantee?

Mr. GENSLER. I think separated out, the central counterparties should be rigorously regulated and have to have the posting of that daily collateral.

Mr. SHERMAN. Sir, I have a limited amount of time.

Mr. GENSLER. It might be better to avoid the moral hazard.

The CHAIRMAN. The chairman yields—it is the Member's time.

Mr. SHERMAN. Will your system work if Congress makes it clear that there is no implicit guarantee? Do you need that guarantee to make it work?

Mr. GENSLER. On the central counterparties, I don't think so, sir.

Mr. SHERMAN. So if we were to go with your system and prohibit or at least not provide for future Federal bailout, the system would still achieve its economic purpose?

Mr. GENSLER. I am referring to just solely the central counterparty clearinghouses.

Mr. SHERMAN. What about the rest of the over-the-counter derivatives industry? Mr. Hu?

Mr. HU. The chances of needing this kind of emergency backup are so reduced with just fishbowl or a series of fishbowls that we are creating, simple activities that we look at—

Mr. SHERMAN. Mr. Hu, will it work without a code section that provides for this admittedly rare Federal bailout possibility?

Mr. HU. That would call for analysis that we would have to do.

Mr. SHERMAN. I look forward to your analysis. Thank you.

The CHAIRMAN. The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman. First, I want to commend you, Mr. Chairman, for trying to bring far greater clarity to many of the definitions of parties, instruments, and practices.

I think the discussion draft brings back the focus to systemic risk, which I think is tremendously important. And, for example, I think the provision of a clear exemption from most of the new requirements for end-users and hedgers who use derivatives primarily for operational risk management. Though we need to be cautious about this, because we don't want to create all these loopholes, it is important, however, for us to be reasonable and responsible to require end-users who pose no systemic risk and who do the right thing by hedging business risks they don't control to be subject to the same capital or margin requirements as financial institutions and market makers who are, in fact, systemically significant institutions.

Secondly, I think it was also important that we bring the focus back on proper capitalization and margining of trades by major players and by putting the responsibility of evaluating the appropriate level of capital and margin to a given market participant's functional regulator. Again, this brings the focus back to systemic risk by addressing issues of leverage and safety and soundness.

And third, that other forms of collateral be held by independent third-party custodians, which is critical, I believe, in protecting the system from some critical abuses as identified in the past year.

And lastly, how we deal with—and I have been talking about this a lot—international transactions, how they will be dealt with, and the criteria which—and a process by which certain international players may be excluded if they pose a systemic risk.

However, there are still a few things that I think are out there that we need to—and I would like to get your opinions on this. I think we need more clarity. They include the degree of independence and competitiveness of clearinghouses which may be subject to natural monopolies, and which may have the power to skew the competitive playing field in their favor, particularly if they are predominantly owned by dealer banks.

The other area of concern I think that we need to keep a close eye on, and I would like to get your opinion on that, is how our new regulations encourage continued innovation and competition in this space. Specifically, with new powers given to many regulators, particularly the SEC and the CFTC, it would be critical, I think, to hold them to a higher standard of efficiency and responsiveness. I would like to get your opinion on that.

Mr. GENSLER. If I may, we agree with the goal of promoting competition on exchanges, on trading venues and on clearinghouses.

What we have proposed is: the clearinghouses be open and accept transactions from any of the exchange venues, and I believe that was included in the discussion draft that we have some technical things just to make it nondiscriminatory; second, that the clearinghouses be open in membership, that they allow some of the nonswap dealers in as long as they meet the membership requirements of these clearinghouses; and third, that the governance be opened, and that governance not just be controlled—as you suggest you would want to avoid as well—controlled by the dealer community, to help promote competition.

Working with this committee, we could also work on rules to make sure, as Mr. Hu said, that the clearinghouses couldn't just demand such charges for their central clearing because of the concerns you say they might naturally end up being single entities.

Mr. HU. Congressman, you raise excellent questions. The SEC has historically emphasized very much the public utility model as to clearinghouses so that we actually expect fair representation of people who use these clearinghouses so that there is active involvement in terms of making sure that the fees are not exorbitant, that they don't unfairly burden people. And we have set up this model to prevent exchanges from controlling clearinghouses. We believe that is an essential element as well.

In terms of innovation, competition, the discussion draft Treasury proposal recognized both the benefits of financial innovation and some of the costs. And in terms of this balance, these are issues that the CFTC and the SEC, together with this committee and other committees, will work closely on.

Mr. MEEKS. Thank you.

The CHAIRMAN. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

It appears that questions surrounding the idea of a central counterparty still remain, and one of those is the argument that some economists make, and it basically goes like this. They say by inserting this third party into the mix, you end up concentrating the credit risk, and, of course, you weaken the due diligence that would otherwise exist among the counterparties. The line of argument they make, and I would like to hear your response to this, is that while central counterparties do not have market risk, they do have the credit risk to their members. So it appears that the central counterparty idea presents a tradeoff between the benefits of economies of scale and the concentration of credit risk in the central counterparty.

So the way it is portrayed by economists is the central counterparty would become systemically significant and thereby will be perceived probably as being "too-big-to-fail." And if the central counterparties' capital and the additional capital it can raise by making capital calls on its members are insufficient to cover losses from defaulting members, then who will bail out the central counterparty? That becomes sort of the moral hazard problem that might result. Who is the lender of last resort, especially when you consider a multinational central counterparty?

Do you think there is justification in that concern? Does that erode market discipline and due diligence? Do you think there is an argument there?

Mr. GENSLER. Congressman, we currently have central counterparties that are called Wall Street financial institutions. Generally, there are about 15 around the globe. There are 5 major ones right now that are 80 to 90 percent of these markets. And they are not being regulated to lower risk as central counterparties, they are being regulated as banks and securities firms.

So we think we need to separate out that which we can, put it into central clearinghouses that are regulated, only the product that can be cleared, that has enough liquidity, and then you get the benefit of lowering risk, because there is a daily accounting, there is a daily settling up where collateral is posted, and we truly actually are addressing the same issue those economists you referred to are trying to address, but trying to lower risk, because right now we have a very highly concentrated financial industry, but we are not regulating this activity separately.

Mr. ROYCE. Yes, Mr. Hu?

Mr. HU. I agree with those. In addition, one of the central points I want to emphasize is that these big derivatives dealers are engaged in a tremendously wide-ranging set of activities, everything from merchant banking to insurance to all manner of activities, much of which may not be transparent. With clearinghouses, in addition to these really tight controls, daily controls, you have a tightly limited set of activities. So it becomes much easier to make sure that they have the right capital and so forth. It is a much simpler regulatory task.

Mr. ROYCE. Let me ask you the other half of that equation, because the other part of the concern with that is the weakening of due diligence among the members of a central counterparty. If by definition, the central counterparty then absorbs the counterparty risk of its members, will this structure encourage the outsourcing of due diligence by the members of the central counterparty? And I will give you an example.

We saw with the rating agencies the outsourcing of due diligence, right, and the outsourcing to institutions that were perceived to have superior knowledge. And we saw that was a mistake which could result in unintended consequences. Do you think that humans could make the same error here in judgment?

Mr. GENSLER. Humans definitely are prone to make similar errors, I concur with that. What this replaces it with is rather than another judgment on credit risk, it replaces it with the discipline of actually doing a daily accounting and a daily settling up with margin. So that is the replacement rather than just unsecured exposures.

Mr. HU. Two differences. One is that in contrast to merely doing due diligence in terms of other counterparties—that is, that one bank trying to figure out whether another bank is reliable, here we have government actually coming in and saying, you have to do "X," "Y," and "Z." So it goes beyond just the screening, informational element. Very important.

The second issue involves flipping it around. We are talking about reducing burdens to end-users and the like, those who use these products that are on clearinghouses. Flipping it around—if you have assurance that, in fact, the central clearinghouses worked, you don't need to spend money investigating.

The CHAIRMAN. Thank you.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Chairman Gensler, I know you are a proponent for mandatory exchange trading. There are benefits to exchange trading, but I have heard from some end-users, not Wall Street bankers, but a number of small businesses and even Kansas farmers who say custom derivatives provide a useful tool to hedge risks.

I am also concerned about mandatory exchange tradings, a blunt instrument, when strong incentives can drive derivative trading to clearinghouses and exchanges. So at a time when credit remains tight and business activities restrained, Chairman Gensler, do you have any concern that mandatory exchange trading could slow the economic recovery underway?

Let me ask one more thing, too. Might it have a negative impact on end-users that have used derivatives in a responsible way?

Mr. GENSLER. I think it is a positive for end-users and a positive for this recovering economy, because it brings transparency and still allows, exactly as you said, the customized product—we are not talking about the customized product, but that which is standard in these markets, which, depending upon estimates, is between 50 and 80 percent of the market, still leaving a very large part of customization. But that 50 to 80 percent would be either on exchanges or on trading venues—people have different words for that—but alternative trading platforms, and then it would be very positive for the end-users to get that transparency and benefit. Even if it is a few basis points, it is large for the economy and for the end-users.

Mr. MOORE OF KANSAS. Mr. Hu, what are your views on the potential effect of mandatory exchange trading, sir?

Mr. HU. We differ slightly from Chairman Gensler as to the mandatory exchange trading as distinguished from the clearinghouse arrangements. We believe that clearinghouse arrangements will get you a lot of the transparency and other benefits associated with the two.

And in terms of the burdens on end-users, we believe that the enhanced transparency and the standardization of a lot of these swaps that the end-users will be relying on may in some ways reduce costs, in some circumstances, for end-users.

Mr. MOORE OF KANSAS. Thank you.

And, Mr. Hu, something to remember as we consider derivatives regulation is that we are not legislating in a vacuum, and this is part of a broader regulatory reform package. I believe there are some items related to municipal swaps that should clearly remain under the jurisdiction of the SEC in order to be covered by the increased protections for many securities and advisors that are coming out of the SEC and other parts of regulatory reform. But what are your thoughts on the unique nature of municipal finance that often require their contracts to be more customized?

Mr. HU. In terms of how municipalities most directly relate to this bill and these customized products, I think it has been the area of business conduct. And so one of the areas that we think may be appropriate would be, in fact, enhancing the business conduct requirements with respect to less sophisticated participants,

some of whom may be municipalities. We have real concerns about that. We have seen issues involving municipalities and their derivatives activities that concern us.

Mr. MOORE OF KANSAS. Thank you, sir.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from California, Mr. Baca.

Mr. BACA. Thank you, Mr. Chairman.

Mr. Gensler, when you testified before this committee in July, I addressed my concerns about the initial transfer of the standardized derivatives into the clearinghouse. There was a proposal that initially a few clearinghouses will compete to carry these products. I was concerned, however, that this may create a conflict of interest similar to what we have experienced in the credit rating agencies. The discussion draft now calls for the Federal regulators to determine whether these derivative products are standardized enough to go into the clearing mechanism. In your mind, would this change eliminate any possibility of conflict to exist, or are more safeguards needed?

Mr. GENSLER. Congressman, I concur with you that we need to ensure that the clearinghouses, through that conflict, don't force things in that ought not be there, and there should be strong oversight of that process. Working with this committee, though, we look forward to making sure that the presumption still is if it can be cleared, it would be in the clearinghouse. But I think that we can get this right working with your staff.

Mr. BACA. So this would eliminate some of the conflict of interest or not?

Mr. GENSLER. I think that the regulator should have oversight with regard to it, but that on a first order, the clearinghouses should determine under their risk management guidelines which contracts are clearable. Also, we would not want the burden to go the other way, that we force something into a clearinghouse that they can't properly risk manage.

Mr. BACA. Mr. Hu?

Mr. HU. One thing we appreciate about this discussion draft is the ability for the regulators to help determine what should be cleared or not. This way, there is greater likelihood that, in fact, the particular clearinghouse meets the needs of the end-users and other participants. It is a more regulated process rather than the automatic—the much more presumptive approach of the Treasury bill.

Mr. BACA. Thank you.

In continuation, the discussion draft proposes a joint rulemaking between the CFTC and the SEC, and, Mr. Hu, in your testimony, you expressed concerns over his proposal. Instead of referring to Congress to include definitions in the legislation, if the SEC and the CFTC officials are supposed to be experts in these matters, in regulating the abuse, wouldn't it be best interest to agree on definitions rather than Congress so this way you don't wash your hands? And can you comment on why you think this legislation is a better or more effective approach?

Mr. HU. I think perhaps an illustration may be helpful in terms of answering this question.

Right now, in terms of the world of security-based swaps, those based on broad-based swaps basically fall within the Commodity Futures Trading Commission's jurisdiction. The narrow-based securities-based swaps fall within the SEC's jurisdiction.

In fact, in the real world, with clever hedge funds and others, you can use two different credit default swaps, or two different security-based swaps involving broad-based indices, to get very targeted exposure.

So you might have a system where, in effect, one falls within securities law and pure securities law considerations apply. The other may deal with exactly the same kind of concerns and yet be subject to a wider range of perspectives. So you may end up with gaps between the two approaches. And this is one of the reasons why we think that close economic substitutes ought to be treated the same.

Mr. BACA. Thank you. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. And welcome to the committee.

I first want to thank you, Chairman Frank, for listening to some of our concerns earlier on and responding in a very positive way with the new draft bill for the increased clearing flexibility for end-users and the situation regarding our foreign board of trade by linking them to U.S. contracts. I still remain somewhat concerned about not overregulating foreign boards of trade, and being wary that they could, and it might invite retaliation by foreign regulators. I think that is something we should keep our eye on. I certainly want to commend you for that and also for—I appreciate your concerns and your response by exempting end-users of derivatives from the clearing capital and margin requirements.

But my understanding is that the bill still mandates capital requirements for non-financial dealers, which could very well drive non-bank dealers out of the over-the-counter derivative market and end up concentrating a tremendous amount of power in the hands of the large banks. So, Mr. Gensler, could you comment on that? Are you somewhat concerned about the concentration of over-the-counter swap dealer markets, and do you believe that we ought to be concerned here in Congress that some of the proposals like capital requirements for non-financial dealers will give large banks, which already control 90 percent of this market, even more power? Is that a healthy thing?

Mr. GENSLER. I share the Congressman's view that there is a highly concentrated market here, and probably 5 or 10 years from now, it will be even more concentrated. This happens in the airline and other industries as well.

But I do think on the non-bank dealers, people holding themselves out in dealing in these, that there is an appropriateness to have capital; that we don't want to have something outside the system. These are generally in the commodity swaps area, the oil and natural gas and commodity areas, and many of them have capital. It is not to be additional capital, what they currently have, but just to make sure they have a minimum amount of capital if they are holding themselves out and making markets in these commodity swaps or other swaps as a non-bank dealer.

Mr. SCOTT. But are you worried that it may drive some of them out of the market, thereby lessening transparency?

Mr. GENSLER. Our concern is overall to lower risk in the system and enhance transparency, to promote the competition that you, too, as well want. But we want to ensure that there then wouldn't be some regulatory arbitrage that a non-bank could have zero capital and all the banks have to have capital. So we do think it is appropriate to have some minimum amount of capital if you are holding yourself out to the public as a dealer. This is the dealers themselves. And that is generally only in, as I said, the energy commodity swaps.

Mr. SCOTT. Yes, Mr. Hu?

Mr. HU. In terms of your specific point about perhaps driving business abroad, one of the things that helps is the extensive financial coordination going on right now: the OTC Derivatives Regulators Forum, IOSCO—indeed, Chairman Schapiro is at an IOSCO meeting in Switzerland today—the Over-the-Counter Derivative Supervisors Group. And among the reforms that have been discussed are things like standardized clearing, encouraging trading on exchanges, a lot of the same kinds of things that are going on here. So the international coordination should help a lot.

Mr. SCOTT. Going back to you for a minute, how would the CFTC plan to implement and structure capital requirements for non-financial dealers so that we do not create a bank-monopolized over-the-counter derivative market?

Mr. GENSLER. Similar in some regards to what we do overseeing futures commissions merchants, we work with other prudential regulators to look at their capital regimes. Where they are regulated by somebody else, we generally have lower regimes at the CFTC than the Federal Reserve or the SEC. I would envision it would be very similar to that, and we would allow the capital they have in their business—it could be in oil and gas reserves, it could be elsewhere—but just at the minimum. It doesn't have to be liquid capital.

Mr. SCOTT. I yield back. Thank you again, Mr. Chairman, for—

The CHAIRMAN. The gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. I will apologize in advance since I missed part of this hearing. If these questions have been asked, or some of this, I will apologize in advance.

But if we talk about the standardized clearing and so forth, and then the custom products, which is what I am hearing you call them, either in your opinion or under the discussion draft, other than transparency, would there be any limitations to the creation of and marketing of customized products, either ones that we currently see or ones that haven't yet been developed?

Mr. GENSLER. We believe that the legislation should cover all of the products, but allow for hedgers to hedge risk, and even if they are tailored in particular and customized, so that they would be able to innovate, and that is part of our important risk management in our economy.

Mr. CAMPBELL. Mr. Hu?

Mr. HU. The financial innovation process is critical not only for this country, but the financial services industry and the social wellbeing. This bill does not stop that; it controls it. It tries to con-

fine it so that the externalities of these kind of activities are severely limited.

Mr. CAMPBELL. Let us get to that, because homogenizing derivative products is not an easy thing. Obviously, everyone even in the bond market you haven't been able to homogenize and make an exchange trade and so forth. How much would fit in this standardized? How much homogenization is there going to be? And is there, then, incentive for me to create products that do not homogenize, because even though there is transparency, there can be more margins in something that is outside of this—well, not exchange, but outside of this clearing than would be inside the clearing?

Mr. GENSLER. Well, I was going to say it depends on the market today, but in the rates-based various estimates, close to 80 percent of the market is already standard in some regard. In the commodity and the credit default space, it is lower, but still probably 60 or 70 percent. These is anecdotal evidence of that. But we are not trying to homogenize the other 20 to 40 percent. There is no goal in the Administration proposal or in the discussion draft to do that.

Mr. HU. The standard process of modern financial innovation involves the OTC derivatives market as being the hothouse for financial innovation. The weird products basically appear there first, the newest products, and they migrate. They get standardized. So right now interest rate swaps are highly, highly commoditized. Back in the 1980's, hardly so. You sometimes still had to argue about documentation. There is a process.

Mr. CAMPBELL. Okay. So you are saying that 60 to 80 percent of the market today is naturally homogenized simply by the marketplace so that buyers and sellers, people on both sides of the hedge, understand what they are getting, they are used to it, etc., etc., and that they are naturally homogenized not by government action or whatever, and that there is no further homogenization—probably not a word—that either would need to be done or should be done by government or by you or by anybody?

Mr. GENSLER. Not on the economic terms. There is a desire to have rulewriting for these two agencies in terms of the processing, the netting and the documentation, what I will call the back office terms, but not on the economic terms.

Mr. HU. The existence of these designated products, designated for clearing on these clearinghouses under the draft bill, under the discussion draft, makes it very transparent what standardized products are out there, and that with this kind of transparency, various end-users and others can determine, well, gee, do I really need a customized product, or will that standardized product get me 99 percent of the way there? Should I pay that extra markup that you referred to, Congressman?

Mr. CAMPBELL. Right, right. But if I do want to have that customized product, I would be able to do that, and there would be some transparency to that, that doesn't currently exist, but I am not going to be limited.

Mr. GENSLER. That is correct. You would not be limited, and you would benefit by seeing where the standard product, the homogenized product, traded 10 or 20 minutes ago when you think about the particular risk you want to hedge.

Mr. CAMPBELL. And the clearinghouses themselves would be through how, through what—who operates clearinghouses?

Mr. GENSLER. The clearinghouses would be private entities, but regulated by our two agencies and overseen for risk management.

Mr. CAMPBELL. How many of those do we think there would be?

Mr. GENSLER. It is hard to determine. Right now, there are five or six that are trying to compete in this space, and whether that narrows down to be one here in the North American and one in Europe, by product or otherwise. We think it is important, though, that we get full access. If it ends up in Europe, that is all right, but do we get full access as we would think foreign regulators should have full access if it ends up in the United States.

Mr. HU. Right now, in terms of clearinghouses for credit default swaps, there have been three or four or five that exist, two or three of which are active.

Mr. CAMPBELL. Okay. My time has expired. Thank you, Mr. Chairman.

Thank you both.

The CHAIRMAN. By the way, that is a recess, not a vote, So we hope to be able to finish soon.

The gentleman from Texas, Mr. Green. And then we will go to—I cannot accommodate non-members, I apologize. But this committee is too big, and we can't do it.

Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

I thank the witnesses for appearing. I thank the Administration for its guidance and leadership. And I would like to repeat some things that have been said, but probably say them slightly different.

It seems to me that what we have is this: We have a stock market that is mostly regulated, I think you will agree. We have a swap market that is mostly unregulated, and they are at the end zones. And then in the middle, we have this twilight zone of "swap stop" or "stop swap" market that is somewhat regulated and somewhat unregulated, which is where AIG was in this sort of twilight zone of swap market and stock market. Is that a fair statement, Mr. Gensler?

Mr. GENSLER. I don't wish to disagree with you, but I think—

Mr. GREEN. Please do.

Mr. GENSLER. AIG was largely in the ineffectively regulated, and the products that they were trading in, the products were not regulated at all.

Mr. GREEN. So they had more of a swap market unregulated than they did the stock market that was regulated?

Mr. GENSLER. That is correct.

Mr. GREEN. Mr. Hu?

Mr. HU. It is a huge gap that this discussion draft helps address. How we get there is a matter that we are all going to work together on.

Mr. GREEN. Exactly. And what this proposal seeks to do is deal with that unregulated swap market to a great extent. And in so doing, you have promulgated some rules that we have not had heretofore. One would be a proposal to deal with abusive and—products that would pose a threat, a systemic threat. And in so

doing, you can go so far as to declare some products as unworthy of being products in the regulated market. Are all of these fair statements?

Mr. HU. The anti-abuse provision that you refer to is something that we are just starting to analyze, but among the issues is this.

Mr. GREEN. Exactly.

Now, let me say this: One of the reasons why—there may be a multiplicity, but one of the reasons we are so concerned about this is because of the systemic risk that developed with AIG, and other companies as well, and it is really the systemic risk that we are trying to deal with. We, generally speaking, wouldn't be in this position, wouldn't be here today, if we had not had some systemic risk problems we had to deal with, and taxpayer dollars ultimately had to help us maintain the financial system. So this is why we are here.

Now, with reference to products that create a risk that can be deemed systemic by virtue of being pervasive and by virtue of being so risky that they just don't fit well in a regulated market, are there any products at all that you can think of that would be so abusive or so systemically risky that you would not have them in this market?

Mr. HU. In terms of that issue, we have not tried to look for particular products that—

Mr. GREEN. I understand.

Let me share this with you: We talked with Chairman Bernanke recently and this question was posed to him, and I think his response was that he thought that no-doc loans just didn't have a place that was one that could be placed in a market, but no-doc loans were just not good.

I am asking you because, if there are no products, no products that are so abusive and so systemically risky that we would want to—I don't want to say "outlaw," but say that this is something we really shouldn't have, is this provision going to be effective?

Mr. HU. Congresswoman Waters, earlier on, referred to the Goldman Sachs "empty creditor with a negative economic interest" situation.

Mr. GREEN. Exactly.

Mr. HU. So that—and similarly in terms of Goldman Sachs—was perhaps an empty creditor as to AIG. So in terms of the Goldman Sachs situation Congresswoman Waters was referring to, incentives may sometimes be created for creditors not to care about what happens to their borrowers.

Mr. GREEN. Because my time is going to expire, let me go quickly to this.

A part of the problem also was that many of these counterparties outsourcing their risk management to the rating agencies, because if it was a triple-A rating, which is what AIG had, they relied on that, rather than having their own internal risk management.

Will this deal with that kind of circumstance wherein you can outsource your risk management to the rating agency?

Mr. GENSLER. I think it will largely regulate the credit default swap area, which is at the heart of what you just said, because that outsourcing of ratings was also relying on these credit default swaps. So I do believe that the Administration proposal and the

discussion draft brings that into regulation, and this last provision that you talked about would add to it.

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

Mr. MOORE OF KANSAS. [presiding] The Chair next recognizes the gentleman from California, Mr. Perlmutter.

Mr. PERLMUTTER. Just a comment, and then I want to yield to Mr. Murphy from New York.

The terminology, the nomenclature, how we describe these things, changes all the time from swaps to straddles to just different things. It is just different methods of calling how you hedge, how you risk, how you speculate, how you gamble.

My goal here, in all of this, is that there not be a risk to the system; that you two have enough resources within your agencies to make sure that whoever is doing this trading has the capital if their bets go south. And really that is all I want to know, because I don't want—I am okay with people trading and trying to manage their risks and doing whatever, so long as it is over here in the corner and can't pull the whole system down; that there is clearing on a daily basis or there is posting on a daily basis, or so that you know what kind of leverage really exists in the market.

So at any time, if you don't think you have the resources to manage this stuff, I would like you to just come to this committee ASAP. Otherwise, we are going to spend another $700 billion like we did last fall, and we can't have that. Just a statement.

Now I want to yield to Mr. Murphy, who does understand all of the ins and outs. I am looking at the bigger picture. Now I am going to turn it over to him.

I yield to Mr. Murphy from New York.

Mr. MURPHY. Thank you, Congressman.

A question to you, Mr. Gensler, trying to understand the idea of requiring everything to be exchange traded or through a trade execution vehicle. I am not sure I can get my hands around this.

So in the standard market that we are familiar with for fixed floating swaps, some company is going to borrow $10 million and they want to change it from fixed to floating, or vice versa, and they do that transaction with a swap dealer. They want it to start the day their loan is going to close, so it happens to be November 25th, and it is going to last for 10 years or 10 years and 3 months, so there is still some nuance to that.

What does it mean to put that on an exchange? I am not sure I really understand, because there is not going to be a big market of 8 other guys who want a 10-year, $10 million fixed floating swap on November 28th.

So what does that mean?

Mr. GENSLER. Right. First, I want to say, Congressman, in view of the time, we are here today saying we don't have the authority and the resources we need—for the record, to make it clear.

In terms of bringing it on into this central, transparent trading platform, we have some examples now. They are called exempt commercial markets. An organization called ICE does this in the energy space. And many—over 700 contracts are listed in oil and natural gas contracts. They are swaps. So it would mean they would be listed.

In your example, a 10-year interest rate swap would be listed, and it would be quoted, and there would be some bids in office on a regular basis. We would write rules so that if the transaction that you just referred to was so illiquid or specific that, just like block trading today in the futures world and the securities world can be done off-exchange, but you would still get the benefit that you see some listed market on the standard product, the trade is affirmed through the trading platform and then reported. Just as in the futures world, it is within 5 minutes when it is an off-exchange or block trade. It is a little different over here.

So we get the benefit of multiplicity and competition of trading venues. It is not all on a fully-regulated exchange. We get the benefit of some self-regulatory function even on the trading venues, trade affirmation, trade reporting; and, where possible, you also get some bids and offers on the standard product that you can see a picture of the marketplace.

Mr. MURPHY. So you would be reporting the trade even if you are not hitting the exact standard. What is the nuance if it is a 10-year trade versus a 10-year-and-2-month? Does that put it in the customized world, or does that still go through the kind of standard? Because everything else is standard and clearable, but yet it is not maybe going to hit something that is listed.

I guess my sense is that is going to be most of the transactions, so I am trying to understand that.

Mr. GENSLER. No, actually most of the transactions in the interest rate product area are clearable.

Mr. MURPHY. Absolutely. But I think almost none of them would be exchange tradable in terms of volume or specificity based on what I have always seen in business when we put these trades on.

Mr. GENSLER. And I think we are suggesting a change of a model, that Wall Street dominates this and keeps it close hold, and that small companies or small municipalities can't see a picture of that marketplace.

We say that we allow for that. We allow the current inter-dealer brokers, who would register as swap execution facilities. Others that don't even exist today would compete in this area, similar to my example of ICE Atlanta that has over 700 contracts in the energy market, and we would see real competition in this world and transparency for these individual products.

But, again, I think it would be appropriate to write into statute that we can write rules for what I would call voice-brokered transactions off exchange. They still then would be brought and affirmed on the platform, reported on the platform. There would be some self-regulatory function of those platforms, as we have in our two regulatory regimes.

Mr. MOORE OF KANSAS. The gentleman's time has expired.

The Chair would next recognize the gentleman from Minnesota, Mr. Ellison.

Mr. ELLISON. Well, I am glad we have Congressman Murphy here asking you guys, talking mano-a-mano, sort of.

Let me ask this question. The new draft legislation requires dealers to report prices at 5:00 for derivatives not traded on an exchange or electronic platform. Do you think this requirement goes

far enough in terms of promoting price transparency in the derivatives market?

Mr. GENSLER. We think that it may be an unintended consequence, but there are some exceptions in foreign trading, and it leaves it as an optional. But we think we should bring some real-time reporting, hopefully maybe not end of day, but during the day as well.

But we think it is the right goal, and we will work with committee staff on this.

Mr. ELLISON. Mr. Hu?

Mr. HU. Indeed, one of the areas we are looking at is regulators getting real-time information so that we can catch things very quickly.

Mr. ELLISON. Thank you. How does this approach differ from the Administration's bill, which would require all standardized derivatives to trade on an exchange or alternative swap execution platform?

Mr. GENSLER. In one case, it is required. We are suggesting it be required and allow for some rule-writing for this voice-brokered or upstairs market. And in the discussion draft, it is optional. We would like to work with the committee to close those differences.

Mr. ELLISON. Do you prefer or have any thoughts on which would be better for the public?

Mr. GENSLER. I think it is better for the public to have the additional protections of the markets, including the trading venues, that it is not always a fully regulated exchange. But I believe the Administration proposal brings greater transparency and protections to the public.

Mr. ELLISON. Mr. Hu?

Mr. HU. We think that clearinghouses could get you many, many of the benefits of exchange trading, so our views don't quite match up with the CFTC's.

Mr. ELLISON. Thank you.

The draft bill provides an exemption for entities primarily using derivatives for hedging and risk-management purposes. However, as you know, Fannie Mae and Freddie Mac are also major end-users of derivatives which they use to hedge interest rates and other risks.

Would the draft language potentially exempt Fannie and Freddie and their counterparts from submitting standardized contracts to central clearing?

Mr. GENSLER. I believe that the discussion draft would exempt the Government-Sponsored Enterprises. I think this is probably an unintended consequence of the drafting around what are called major swap participants.

Mr. ELLISON. Do you think that is something that should be addressed?

Mr. GENSLER. We believe it should be addressed, that such major swap participants should come under this regulatory regime.

Mr. ELLISON. Mr. Hu?

Mr. HU. Yes, we believe it is important to have objective, somewhat narrower, verifiable standards in terms of what you mean, in terms of what you count as hedging in terms of this exclusion.

Mr. ELLISON. I have a question to follow that up, but before I do, let me ask you this: Chairman Gensler, you have indicated that any exemption should be limited to non-financial firms. Would that be an artificial distinction, given that some firms wear multiple hats?

Mr. GENSLER. It is a very good question. But what we are trying to address is a very real issue that end-users have raised about hedging their risk and the posting of collateral.

What we have suggested is that they be part of this. But if Congress decides not to have them be part of it, this is an alternative we recommend to address the many people in the real economy who are concerned about posting margin.

Mr. ELLISON. So what should we do about those firms that do have those multiple roles they play?

Mr. GENSLER. I believe that they should be part of this regime. I recognize the Congress, in grappling with this very real issue of end-users, may adopt some end-user exemption from this. That is not our preferred approach or what I am recommending, but if the Congress does, we would look forward to working with you in trying to get this language narrowed so the exemption doesn't swallow the rule.

Mr. ELLISON. This is my last question. Hopefully, we can get in under the time.

In addition to hedging and risk management—both are broad and subjective terms that can cover a wide range of transactions. Given that hedging and risk management are subject to different understandings by different people, different interests, should these terms be defined in the statute and how would you define them? What proposals would you have?

Mr. GENSLER. I think it would be best not to have the risk management exception in there at all. We have had years grappling with this at the CFTC, and unfortunately, you can drive a lot through those words.

Mr. MOORE OF KANSAS. The gentleman's time has expired.

We should have done this earlier, but I ask unanimous consent for Scott Murphy, a noncommittee member, to participate. Without objection.

Mr. PERLMUTTER. Objection.

No, I withdraw my objection.

The CHAIRMAN. Overruled.

Next, the Chair recognizes the gentleman from Illinois, Mr. Foster.

I will say, we have votes coming up. We will probably just have time for one more round of questions here. Then we are going to thank and excuse the first panel and the committee will be in recess for votes on the Floor, and then we will reconvene with the second panel right after votes.

You are on, sir.

Mr. FOSTER. It is my understanding that the major players in OTC derivatives reduced even their complex derivatives to algorithmic form for jamming into their risk evaluation computer programs. So my question is whether there is a potential benefit for having industry-wide standards for descriptions of even complex OTC derivatives, which would seem to address two concerns.

One is that if this is the format in which the repositories received the description of the OTC derivatives, as well as the systemic risk regulator, that there might be a chance for the systemic risk regulator to have an analogous system where their computers would also net out the industry-wide exposure.

It also might address Representative Murphy's questions about what it means to be an exchange for very complex derivatives; that what you do is, you have not a listing you can read in the newspaper, but you would have a listing of here are all the algorithmic definitions of all of these complex derivatives and what they have been selling for.

So I was wondering if you think that is something that is happening already in the industry, or is there a useful role for government in enforcing that standardization?

Mr. GENSLER. There is a natural tendency towards that naturalization of the defined terms. The discussion draft and the Administration proposal gives us rule-writing authority to set business conduct standards on processing, netting and, I broadly call it, back office.

But I think you are right, Congressman, it can go a little further in terms of also how the computers match up so that the regulators and the trade repositories and the clearinghouses have a consistent format, both domestically and internationally is very critical.

Mr. FOSTER. Okay. My second question is whether anyone has written down a draft, even a draft definition, of what is too complex to clear, or maybe a list of things: These are clearly too complex to clear, these are clearly clearable, and these are the gray area.

Is there anyone who has just had the courage to write down an operational definition?

Mr. GENSLER. I don't know if it has been written down, but conceptually it is why we think the clearinghouse should be the first place, if they can manage the risk, rather than a government agency pushing it upon them. But then the government agency should have a role to make sure that they are not so biased to take on risk that they shouldn't, or misprice them and so forth.

Generally, it has to have some liquidity to it, that they can manage the risk if the counterparty fails and you can get out of the trade in a several-day timeframe, not a several-month timeframe work. That is the conceptual frame.

Mr. FOSTER. But no one has even tried to define that?

Mr. GENSLER. No, actually the international regulators have, and even we have, received futures clearing, which is a derivatives clearing. We have a very real set of standards in that regard.

Mr. FOSTER. Okay.

And lastly, do you have any comments on what the European Commission did regarding the credit default swaps based on European entities and requiring them to be cleared on an European clearinghouse? What is the end game on that?

Mr. GENSLER. I was honored to be asked to speak before 400 people at the European Commission 2 weeks ago at the end of their consultation. And I spoke specifically on this and six other items and said, I think it would be a mistake to have a geographic mandate for clearing; that we should allow the clearinghouses, whether

they be in Europe, the United States or Asia, that the international regulators have full and unfettered access, not shortchanged by bank secrecy laws, but full and unfettered access to the information you vigorously regulated.

The largest swap clearinghouse right now is in London. That works for U.S. regulators, as long as we can regulate it and have full access.

Mr. FOSTER. And you don't see problems down the line with the United States giving up information to any country that might want to see every trade that happened?

Mr. GENSLER. No. I think we have to have work with those international regulators, the large ones, like the European Commission and the FSA in London and so forth. And we have very good working understandings with these international regulators.

Mr. FOSTER. Thank you.

I yield back.

Mr. MOORE OF KANSAS. Thank you.

The Chair will finally recognize the gentleman from Connecticut, Mr. Himes.

Mr. HIMES. Thank you, Mr. Chairman.

I thank you for being here.

Mr. MOORE OF KANSAS. I will remind folks that as you finish here, votes are going to be called and this panel will be excused. Thank you very much.

Mr. HIMES. Thank you. I am gratified that there seems to be an alignment now around the notion of really clearing everything that we can and, hopefully, creating as much of a standardized universe as we can. This obviously imposes quite a bit of burden as a risk manager upon the clearinghouses, and I have a couple of questions and observations related to that.

First, there is I think a danger associated with the fragmentation of clearinghouses, both here in the United States and internationally. I would like to ask you about that.

But I would also like to ask the chairman for unanimous consent to submit for the record some testimony by the Depository Trust and Clearing Corporation, which is just raising the question of whether there should be a central depository for this information that would be available to the regulators, if there is no objection.

Mr. MOORE OF KANSAS. Without objection, it is so ordered.

Mr. HIMES. Secondly, I guess just an open question: Are you comfortable, gentleman, that you have—we heard your comment on resources, but the culture and the intellectual capability within your organizations to really peer deep into the clearinghouses, to form judgments on how they are doing as risk managers?

Mr. GENSLER. First, I want to say it is really good to see you as a Congressman, because I should disclose we have worked with low-income housing issues at the Enterprise Foundation.

Mr. HIMES. Right, also under the jurisdiction of this committee.

Mr. GENSLER. I do think—one the things I found in coming to the CFTC is tremendous expertise. It is an agency that oversees risk management markets, derivatives markets and clearinghouses, multifaceted clearinghouses right now, and has tremendous expertise. But it is, unfortunately, sorely underresourced.

For instance, we are only right now able to go into the Chicago Mercantile Exchange once every 3 years to check on certain rule enforcement, rather than on an annual basis. So it is a resource-constrained, but well-educated, well-dedicated staff.

Mr. HU. We also have wonderful staff, very hardworking. In addition, we are hiring new people precisely because we need to better understand the new capital markets, these products, the need to keep up. I am totally confident that with sufficient resources, we are going to be able to make sure—not only make sure that these clearinghouses survive, but make damn sure these clearinghouses survive.

Mr. HIMES. Thank you.

Next, one of the concerns I have, and I am sure this is broadly shared, is, we do not want to set up a situation where there is a clear incentive for people who otherwise might use standardized contracts to, in fact, use tailored contracts, perhaps to escape some of the oversight or requirements of standardized clearing.

In your review of this legislation and as you think about the rulemaking that comes subsequently, are you confident, based on what you see here, that we will not be creating an incentive to send people into a customized universe?

Mr. GENSLER. I think there is some incentive to do that by Wall Street, who might want to have a little less transparency. I don't know that end-users would have that, but I do think it is there.

The European Commission and the U.S. regulators have come together and think that there should probably be a little higher capital standard if things are less liquid, so that sort of guards against that, if they are truly less liquid and they are not in central clearing.

Mr. HIMES. Thank you.

Actually, you anticipated my last question, which is the international dimension of this, European differences between the United States. Again, sort of based on what you see in the legislation and as you think about your institutions and your recent experience internationally, should we be mindful of the risk that there is a flight away from the better clearinghouses, perhaps, abroad?

Mr. GENSLER. Absolutely. Capital and risk does not know geographic boundaries. It will go globally. I am very optimistic, working with the European Commission, that we can achieve a coordinated approach. But there are different cultures and different political systems.

I believe they are making their next key announcement on this on October 20th, and so we should look at that very closely.

Mr. HIMES. Is there a risk that our efforts to see these instruments cleared—if the Europeans move more slowly than we do, is there a risk that we see, in fact, this clearing activity move offshore?

Mr. GENSLER. Right now, there is some clearing offshore, but it is regulated. Even this swap clearinghouse I mentioned in London is regulated by the CFTC, and then there are some exemptive things that the SEC does.

So I think that we can, through legislation in Congress, be able to regulate even if it is offshore. I would rather do it jointly with

the Europeans. I think we can achieve that. Their time scale is probably into next year.

Mr. HU. The only thing I would care to add to those excellent comments is that we work perhaps especially closely with the FSA, and it has been a remarkable relationship. They have deep knowledge in this area.

Mr. HIMES. Thank you.

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

Mr. MOORE OF KANSAS. Thank you. I want to thank the members of the panel for your testimony here today and for answering questions.

The committee will stand in recess for votes on the Floor, and then we will reconvene with the second panel.

We are in recess.

[recess]

Ms. BEAN. [presiding] We have the requisite number of members, so this hearing will resume.

We will begin with the testimony from Jon Hixson, director of Federal Government Relations, Cargill, Inc.

STATEMENT OF JON HIXSON, DIRECTOR, FEDERAL GOVERNMENT RELATIONS, CARGILL, INC.

Mr. HIXSON. Thank you. My name is Jon Hixson, and I am director of Federal Government relations at Cargill. I want to thank you for the opportunity to testify today.

Cargill is an international provider of food, agricultural, and risk-management products and services. As a merchandiser and processor of commodities, Cargill is an extensive end-user of derivatives on both regulated exchanges and in the OTC markets.

Cargill's activity in offering risk-management products and services to commercial customers and producers in the agriculture and energy markets can be highlighted with the following OTC examples: We offer customized hedges to help bakeries manage price volatility of their flour so that their retail prices for baked goods can be as stable as possible for consumers and grocery stores; we issue critical hedges to help regional New England heating oil distributors manage price spikes and volatility on their purchases so that they can offer families stable prices throughout the winter season; and we offer customized hedges to help a restaurant chain maintain stable prices on their chicken so the company can offer consistent prices and value for their retail customers when selling chicken sandwiches.

Chairman Frank's discussion draft is a positive step in addressing comprehensive market reforms of the OTC market. While we have some areas of concern, there are many well-supported elements included in this proposal.

The discussion draft would improve transparency with dealer registration and audit trails, the proposal would create a regulated trade data repository and has a stronger focus on reducing systemic risk and more rigorous requirements for inter-dealer transactions.

The bill also provides flexibility for end-users and traditional hedgers utilizing OTC risk-management products and clearly establishes regulatory authority to ban any swap deemed abusive.

Cargill supports these provisions and appreciates the work of the chairman and other members of the committee in developing this discussion draft.

The draft bill represents a significant improvement over many other proposals that, in our view, would overly restrict the use of OTC markets for hedging purposes.

Our main concerns with the discussion draft relate to two areas of the legislation: first, the application of capital and margin requirements. The discussion draft gives regulators discretion in whether to impose margining requirements in traditional hedging and risk-management transactions. We appreciate this flexibility. However, we are concerned that, given recent regulatory statements and testimony, the imposition of mandatory margining for hedging transactions would still likely occur. This will make it very difficult, if not unlikely, that firms would be able to affordably and efficiently hedge their flour, heating oil, and chicken risks as described earlier.

To ensure congressional intent, the legislation could include a list of factors and in a similar style as the provisions within the discussion draft that provide greater guidance on the clearing requirement. In addition, capital requirements should clearly recognize and reflect the risk-management processes utilized by dealers.

When Cargill offers tailored risk-management products to our customers like the bakery hedge, we offset a substantial amount of that risk by taking positions on a regulated, centrally cleared exchange, margined for daily mark-to-market exposure. We also use margin agreements with most of our customers.

These steps greatly reduce overall risks in the hedging transaction. Regulators should consider such prudent risk-management actions as they analyze and develop appropriate capital requirements to ensure that the charges are based on actual risk of loss.

Regulators are also given much discretion in setting margin and capital requirements for non-bank dealers. The provisions often call for requirements as strict or stricter than those a prudential regulator would establish for a systemically significant financial institution.

While we are very sensitive to the role played by a non-banking firm in last year's financial crisis, there should be some recognition that the bakery hedge, for example, did not cause systemic risks for the financial system. Excessive requirements on our segment will likely only result in less competition among dealers within the OTC segment.

Surrogation of assets is our second area of concern. We are sympathetic to those who lost initial margin money last year and would like to work with others, including members of this committee, to address this issue. However, restrictions around variation margining will have the unintended consequence of curtailing sound business practices that would otherwise minimize the risks of a hedging transaction.

We appreciate the opportunity to testify before the committee to offer examples of our use of OTC products in risk management and to highlight our areas of support and concern within the discussion draft.

We look forward to working together as this legislation continues to develop.

[The prepared statement of Mr. Hixson can be found on page 135 of the appendix.]

Ms. BEAN. Thank you for your testimony.

We are going to proceed to the next witness, Professor Rene Stulz, chair of banking and monetary economics at the Fisher College of Business at Ohio State University.

STATEMENT OF RENE M. STULZ, EVERETT D. REESE CHAIR OF BANKING AND MONETARY ECONOMICS, FISHER COLLEGE OF BUSINESS, THE OHIO STATE UNIVERSITY

Mr. STULZ. Madam Chairwoman, Ranking Member Bachus, and members of the committee, I thank you for providing me this opportunity to discuss with you draft legislation concerning the over-the-counter derivatives market. I am testifying in my individual capacity as an economic expert in risk management and derivatives. I would like my whole written testimony to be incorporated in the record.

In the time allocated to me, I want to focus on two points from that written testimony. First, the legislation should not erect obstacles to trading customized on illiquid derivatives in a way that would make it hard for firms to manage risk. Second, requiring clearing for some derivatives products could increase systemic risk, and it is important for the legislation to make sure that does not happen and that, instead, clearing be properly implemented to make the financial system safer.

Let me start with an example of how the use of derivatives can create jobs. Consider a firm in Ohio that exports machinery and considers bidding on a contract to export to Italy where it will be paid in euros. The moment the exporter makes a bid in euros, it takes on currency risk. The euro would depreciate between the time that it is made and a decision is rendered in such a way that all the profits of the exporter are lost. Because of this possibility, the exporter may decide not to bid because the currency risk is too large. With currency options, the exporter could hedge against a possible depreciation of the euro and lock in the profit margin after hedging costs. Hence, because of derivatives, the exporter could decide that it can bid on the contract, in which case jobs would be created as a contract is awarded.

In my example, the exporter would have to use the over-the-counter market to obtain the best hedge. The reason is straightforward: The contract would have to be tailored to the size of the bid and reference a date that a decision is made in order to be effective.

Often customized and infrequently traded derivatives are the most useful derivatives to resolve specific risk-management problems for non-financial firms. Such derivatives can only be sold on the over-the-counter market, and clearing of such derivatives, if feasible at all, is uneconomical. It is important that the proposed legislation does not make it more difficult and expensive for end-users to obtain customized derivatives by imposing reporting, margin, disclosure, and business conduct requirements that make it unprofitable for financial institutions to sell such derivatives.

An important concern from this perspective is the ability of regulators in the draft to impose margins on derivatives that are not cleared. With new or customized products, such a requirement is impractical and could essentially correspond to our regulatory preapproval process.

Clearinghouses assume counterparty risk. As long as clearinghouses are well-capitalized and manage risks well, there is no material counterparty risk with clearinghouses. However, clearing is not a panacea. Failure of a clearinghouse could have a much more dramatic impact on the financial system than failure of a derivatives dealer. It is therefore critical that clearinghouses be properly capitalized and that margins be sufficient to ensure a low probability of loss in the event of default.

The proposed legislation requires margins that cover risks in the ordinary course of business and requires the clearinghouse to hold capital that would cover the losses resulting from the failure of its largest participant. Neither requirement seems sufficient. The span margining system, which I understand to be industry best practice, is set up so that margins cover stress losses. This requirement should apply to over-the-counter clearinghouses generally. Further, the capital requirement should be such that a clearinghouse should still be able to operate properly if its largest member defaults. The capital requirement in the proposed draft does not appear sufficient for that purpose because such a default is likely to be correlated with other losses.

Academic research has shown that clearing could increase systemic risk if there are too many clearinghouses. It is therefore important that legislation does not lead to a plethora of clearinghouses. With few clearinghouses, the collapse of any clearinghouse would have a substantial impact on the financial system. Therefore, with few clearinghouses, the risk management capabilities of each clearinghouse becomes critical to the stability of the financial system.

Further is that with few clearinghouses, these clearinghouses will have some monopoly power, and they could abuse that power. It would be beneficial for the legislation to address explicitly the situation where a clearinghouse becomes a monopolist in clearing trades of a given type of derivative.

Finally, there has to be clarity for market participants as to when regulators are going to be able to require that a type of derivative be cleared. To make such a requirement regulators should be asked to show conclusively that the systemic risk benefits of requiring clearing exceeds the cost associated with it.

Thank you.

[The prepared statement of Mr. Stulz can be found on page 175 of the appendix.]

Ms. BEAN. Thank you for your testimony.

And we are now going to go to Scott Sleyster, CFA, chief investment officer, domestic, for Prudential Financial.

STATEMENT OF SCOTT SLEYSTER, CFA, CHIEF INVESTMENT OFFICER, DOMESTIC, PRUDENTIAL FINANCIAL, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS (ACLI)

Mr. SLEYSTER. Thank you. Members of the committee, my name is Scott Sleyster. I am the chief investment officer of Prudential Financial's U.S. operations, and I appear here today as a representative of the American Council of Life Insurers, also known as the ACLI. The ACLI is a national trade association of 340 member companies who serve as the leading providers of financial security and retirement products for both the individual and group insurance markets. Prudential Financial is a financial services leader, providing compelling asset growth and protection solutions for the ever-increasing retirement needs of individuals in businesses in the United States and abroad.

I would like to thank the committee for its invitation to appear today and to present the ACLI's view on the new discussion draft of the Over-the-Counter Derivatives Markets Act of 2009. In my capacity as Prudential's CIO, I am responsible for asset liability management, a critical function at all life insurance companies.

The business of selling life insurance policies and annuities contracts requires us to match our asset portfolios with those of our liabilities so that we have the future cash flows necessary to meet the long-term financial promises that we make to our policyholders. The protections we provide often cover an extensive time horizon that does not correspond neatly to available investments. OTC derivatives allow us to effectively tailor the payment streams of our assets to match those of our expected liabilities.

Customized derivatives in particular help to stabilize prices and mitigate risk within our industry's annuity business. For example, Prudential and other life insurers offer annuity products with custom guarantees that protect against downside risks of the underlying equity exposures of our clients. Our ability to provide principal guarantees, which are often accompanied with minimum retirement income guarantees, collectively protected retirees and consumers from an estimated $230 billion in losses during the most recent equity market collapse.

Given the critical role that OTC derivatives play in the life insurance industry's asset liability management, the ACLI would like to offer the following six observations regarding the discussion draft released last week.

First, we applaud the discussion draft's call for comprehensive Federal regulation of over-the-counter derivative markets. The proper operation of these markets and continued availability of OTC products remains a top priority to ACLI members. We remain concerned, however, that the draft's current definition of "swaps" and "security-based swaps" could be misunderstood to include certain insurance products such as annuities with optionlike features, which we feel should be explicitly excluded.

Second, we appreciate that the draft does not establish a hard distinction between so-called standardized and customized OTC derivatives. We agree that it makes sense for responsible agencies to develop rules governing which derivatives should be centrally clear and those that should remain OTC.

Third, we thank the committee for the significant improvement in the draft's new definitions of "major swap participant" and "major securities-based swap participant," which now exclude end-users employing OTC derivatives for nonspeculative reasons, such as hedging and risk management. State-regulated life insurers are required to limit our use of derivatives to nonspeculative activity, providing us comfort that we would fall outside of both definitions. This is in sharp contrast to AIG, whose Financial Products Division was an OTC derivative dealer functioning outside the limitations of a State-regulated insurance company.

Fourth, we strongly agree with the draft's proposal that non-cash assets should be acceptable collateral for derivatives transactions. As the largest class of investors of debt of U.S. corporations, insurers frequently use corporate securities as collateral subject to appropriate haircuts. The provision of the draft may need further refinement if the intent is to be fully realized, and we would welcome the opportunity to work with the committee on this matter.

Fifth, we do remain concerned that the draft bill adopts Treasury's recommendation that the CFTC and the SEC be stripped of their customary authority. Given the complexity of this legislation, coupled with the dynamic aspects of the insurance and derivatives markets, we believe that businesses and consumers will be best served if the CFTC and the SEC have the flexibility to deal with matters as they emerge in real time.

Finally, the ACLI endorses proposals to bring greater transparency to the OTC derivatives markets through trade reporting and centralized clearing of standardized products. Likewise, we support efforts to regulate derivatives dealers to ensure sound and efficient markets prevail.

We thank the committee for this opportunity to share our perspective, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Sleyster can be found on page 168 of the appendix.]

Ms. BEAN. Thank you very much.

And now Mr. David Hall, chief operating officer of Chatham Financial Corp.

STATEMENT OF DAVID HALL, CHIEF OPERATING OFFICER, CHATHAM FINANCIAL CORP.

Mr. HALL. Good afternoon. It is an honor and a responsibility to participate in this hearing today. Thank you for inviting me to testify regarding the regulation of over-the-counter derivatives.

To begin, it may be helpful to know the role of my firm in the OTC derivatives market. Chatham Financial is the largest independent advisor and service provider to businesses who use derivatives to reduce their interest rate and foreign currency risk. A global firm based in Pennsylvania, Chatham has over 1,000 end-user clients in 45 States, ranging from Fortune 100 companies to very small businesses. Chatham is employee-owned and independent. We do not accept compensation from dealer banks. We help our clients hedge risks, not speculate, and we do not advise on credit default swaps.

Given the events in the financial markets in recent years, we applaud the Administration and Congress for considering appropriate changes to our financial regulatory system, including the area of derivatives. We believe we should all work to reduce the risk to our financial system should one of our largest banks, insurance companies, hedge funds or any other of our largest financial institutions fail. While prudent policy changes are needed to address the problems that gave rise to AIG's failure in credit default swaps and in other areas, policymakers need to be careful to ensure that such policies do not harm the many areas of the OTC market that are functioning well.

OTC derivatives are very important tools for businesses to efficiently and effectively reduce risk. In fact, 94 percent of the 500 largest global companies and thousands of small businesses use derivatives to manage their business risks.

The main issue at hand is reducing systemic risk. The business end-users who use derivatives to hedge do not create systemic risk; rather they use derivatives to reduce their business risks, which in turn reduces systemic risk. Therefore, especially since business end-users only make up 10 to 15 percent of the overall OTC market, we believe derivatives regulation should be directed at trading activity between systemically significant institutions.

We are very pleased that Chairman Frank and his staff, Members, and others have developed this draft legislation which recognizes and differentiates business end-users from large financial institutions. Specifically, this draft focuses central clearing requirements on large market participants rather than on business end-users. Additionally, it precludes those who would use derivatives to prudently manage risk from being subject to high regulatory thresholds under the definition of major swap participants.

We are grateful for the opportunity to offer our suggestions for how the draft bill can be improved following our five recommendations for improvement. Number one, margin. Any requirement for business end-users to cash collateralize hedging transactions would create an extraordinary and unnecessary drain on working capital. This draft appropriately recognizes this cash burden by excluding end-users from the clearing requirement. Similarly, we believe this draft should also recognize this cash burden by excluding end-users from any margin requirement.

For trades with business end-users, we believe credit terms should be negotiated by the two parties. To illustrate this point a bank may choose to make a loan without collateral if the business is creditworthy; therefore, it is reasonable that a derivative should be allowed to be offered to a business end-user without margin if the business end-user is creditworthy.

Number two, capital charges. This draft calls for higher capital charges for noncleared derivatives. We believe this draft should be clarified so that regulators are instructed to set capital charges based on historical predicted loss, not as a penalty to discourage the use of OTC derivatives.

Three, systemic significance. This draft bill recognizes that systemically significant institutions should be subject to higher standards than those that cannot impose systemic risk. However, as currently written, it is possible that nonsystemically significant firms

could be subject to the same regulatory burden that applies to large financial institutions. For example, community banks that utilize OTC derivatives to hedge their balance sheet risk and offer risk management products to their borrowers could be deemed swap dealers and be subject to the same reporting, clearing, and margining requirements. Removing the burden for smaller, nonsystemically significant swap dealers will encourage competition and reduce prices for business end-users.

Number four, a major swap participant is largely defined by having a substantial net position, a term to be defined by regulators. We believe this term should either be defined by legislation, or, if it is not, we would like to see the intent be clear that this definition should target systemically significant institutions.

Number five, exemptive relief. As we make these historic changes to regulate the OTC derivatives market, we cannot now foresee many of the consequences resulting from this regulation; therefore, we should grant regulators the authority to provide exemptive relief where they deem necessary.

To conclude, even though we have identified several areas for proposed improvements, we want to be clear that we believe this draft is the most thoughtful proposal for regulation of the OTC derivatives market to date. Thank you for the opportunity to testify today.

[The prepared statement of Mr. Hall can be found on page 120 of the appendix.]

Ms. BEAN. Thank you for your testimony.

And we are now going to go to Mr. James Hill, managing director of Morgan Stanley, on behalf of SIFMA.

STATEMENT OF JAMES J. HILL, MANAGING DIRECTOR, MORGAN STANLEY, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. HILL. Thank you. My name is James Hill. I am a managing director at Morgan Stanley, and I am appearing today on behalf of the securities association known as SIFMA. We appreciate your invitation to testify.

There is much in the committee discussion draft that SIFMA and its members support, and we believe that it includes many significant improvements over the Administration's proposal relating to over-the-counter derivatives. We appreciate the thoughtful consideration that you and your committee colleagues, as well as your staff, have given to comments that industry participants have provided, in particular those of corporate end-users.

I would like to express SIFMA's support for legislative proposals to ensure that systemically significant market participants are subject to comprehensive regulatory oversight. It was lack of meaningful regulation of AIG's derivatives affiliate that allowed poor business practices to lead to a situation in which the Federal Government had to invest tens of billions of dollars in order to avert what would have been a systemically significant business failure. The discussion draft would address this regulatory shortcoming by creating a legislative and regulatory framework that ensures such a lapse would not likely occur again.

We also support measures that would improve regulatory transparency and thereby facilitate oversight of the derivatives markets and the activities of individual market participants. The discussion draft accomplishes this by requiring that swaps be submitted to a derivatives clearing organization or reporting to a swap repository.

We do, however, have concerns about some of the particular provisions in the discussion draft. I will briefly describe several.

Although the discussion draft generally excludes corporate end-users from the provisions that would require exchange trading or clearing of swap transactions, they would be covered by other provisions. For example, the discussion draft would authorize regulators to impose margin requirements on swaps in which one of the counterparties is a corporate end-user. We do not believe that counterparty credit exposure created through a swap transaction should be required to be collateralized when lending arrangements between the parties can be made on an unsecured basis. We believe the decision to require margin and the details of how it is handled should be left to an individual negotiation between the dealer and its end-user client.

The provisions of the discussion draft regarding security-based swaps are another area of concern. The draft gives the SEC jurisdiction over these swaps in part by amending the Securities Act of 1933 to include them in the definition of "security." This approach is expedient, but likely would have unintended consequences that would be difficult and time-consuming to resolve. This is because many of the concepts and requirements under Federal and State securities laws do not readily apply to securities-based swaps.

A better approach to providing for SEC oversight and regulation of securities-based swaps would be to give the SEC broad authority to adopt regulations that are consistent with the regulatory framework for other swaps. This would enable the SEC to address unforeseen issues without contorting the existing Federal securities laws and regulations to accommodate instruments for which they were not designed.

Finally, we have practical concerns about constraints on the SEC and the CFTC's exemptive authority and the Act's short implementation period. The legislation could well have unintended consequences, some of which may be adverse to the market and individual market participants. Rather than having to pass new legislation to address such consequences each time they arise, we believe it would be more practical to grant the CFTC and the SEC authority to create exemptions that are consistent with the purposes and intentions of the act.

With respect to implementation, we note the Act's provisions generally would become effective 180 days after enactment. We don't believe this would give derivatives dealers and other market participants, as well as corporate end-users, sufficient time to comply with the Act's complex and far-reaching provisions. We believe the effective date should be no less than 1 year after the date of enactment.

In conclusion, I would like to emphasize that SIFMA and its members support legislation to address the weaknesses in the current regulatory framework for derivatives. The events of the past year have made clear that improvements are needed. However, the

use of derivatives have become an integral part of our economy because they enable corporate end-users to effectively manage risk. As such, it is important that legislation intended to improve derivatives regulation and reduce systemic risk do not unnecessarily impair the usefulness of derivatives as an important risk management tool.

Thank you.

[The prepared statement of Mr. Hill can be found on page 124 of the appendix.]

Ms. BEAN. Thank you very much.

We move to Mr. Stuart Kaswell, executive vice president and managing director, general counsel, of the Managed Funds Association.

STATEMENT OF STUART J. KASWELL, EXECUTIVE VICE PRESIDENT & MANAGING DIRECTOR, GENERAL COUNSEL, MANAGED FUNDS ASSOCIATION (MFA)

Mr. KASWELL. Thank you, Madam Chairwoman, Ranking Member Bachus, and members of the committee. My name is Stuart Kaswell, and I am the executive vice president and general counsel of Managed Funds Association. MFA is the voice of the global alternative investment industry and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and industry service providers. Our members provide liquidity and price discovery to markets, capital to allow companies to grow or improve their businesses, and sophisticated risk management to investors such as pensions to allow those pensions to meet their obligations to their beneficiaries.

MFA appreciates the opportunity to provide its views on the Over-the-Counter Derivatives Markets Act of 2009. MFA's members are active participants in the OTC derivatives markets. As such, we have a strong interest in promoting the integrity and proper functioning of these markets and ensuring that there is no repetition of systemic events, like the collapse of AIG, which required Congress to use taxpayer funds to stabilize markets. Similarly, we wish to prevent another Lehman Brothers-like failure where a large portion of the money lost or tied up in bankruptcy belongs to Lehman customers, including swap customers who posted collateral on OTC swap positions. Both of these events raise significant counterparty and systemic risk concerns for our members and are why MFA is fully supportive of the goals of the committee's discussion draft.

MFA appreciates and commends the committee on the DMA. We believe it takes an important step in the right direction and addresses outstanding concerns with respect to the OTC derivatives markets. Particularly, we support: one, reducing systemic risk through the use of central clearinghouses; two, reducing counterparty risk by segregating customer collateral; and three, clarifying the definition of a major swap participant.

We would like to offer a few recommendations with respect to these three items. First, we believe that cleared OTC derivatives play an essential role in reducing systemic risk. It does so by reducing the interconnectedness that results from too much credit exposure flowing through a limited number of dealers. Clearing also

increases regulatory transparency and market efficiency with respect to cleared products. Because of the benefits of central clearing, we would like to see the DMA go further in promoting the use of clearing organizations by dealers to clear standardized products through capital incentives. The DMA does create capital incentives to clear swaps, but we believe it should ensure that dealers actually use central clearing. We also suggest that end-users that post cash collateral should have access to central clearing either through direct participation in the clearing organization or through a swap dealer.

Second, we believe that the DMA takes a number of important steps to address counterparty and systemic risk by first expressly requiring the segregation of collateral on cleared trades, and second by requiring that dealers offer customers the option to segregate collateral for customized contracts. Requiring a clearing organization to segregate customer collateral will protect customer assets and make it possible to transfer swaps out of a failing dealer and into a stable dealer, which should diminish financial contagion in a crisis.

With respect to customized swaps, MFA members, as end-users, post collateral with swap dealers as a safeguard for the dealer against customer failure. Currently, dealers are free to use this collateral as their own property. In the event of a dealer default, such as Lehman, customers are at risk of losing their collateral because it is not segregated from the dealer's proprietary assets.

We believe the DMA goes a long way in protecting customers by requiring dealers to make segregation of collateral available to their customers; however, we are concerned that Congress' intent in protecting end-users from a dealer failure may not be realized unless Congress makes corresponding changes to the bankruptcy laws, including those applicable to banks that act as swap dealers.

Third, we understand that the major swap participant category is meant to prevent a repetition of the AIG meltdown—entities with a substantial net position. We recommend that the committee provide clarity to the term "substantial net position." The DMA should direct the SEC and the CFTC, in defining the term, to consider the following factors: One, the relative net position of swap dealers, for example, a substantial net position should be measured with respect to the net position of swap dealers; two, a participant's average net position over a relative period, such as a year; three, whether a participant's counterparties have a substantial unsecured credit exposure to such participant from outstanding swaps; four, whether the participant holds assets belonging to retail customers; and five, whether the participant is an existing registrant with either the SEC or the CFTC. These steps could help prevent a repetition of future failures like those witnessed at AIG and Lehman.

My written statement provides additional recommendations for the ways we believe the committee draft could be strengthened consistent with its important objectives. For example, we suggest changes to the portions of the DMA that address position limits and reporting.

Thank you for the opportunity to testify. I would be happy to answer questions.

[The prepared statement of Mr. Kaswell can be found on page 157 of the appendix.]

Ms. BEAN. Thank you for your testimony.

We are now going to move to Mr. Steven Holmes, director of treasury operations, Deere & Company.

STATEMENT OF STEVEN A. HOLMES, DIRECTOR OF TREASURY OPERATIONS, DEERE & COMPANY

Mr. HOLMES. Madam Chairwoman, Ranking Member Bachus, and members of the committee, my name is Steven Holmes, and I am the director of treasury operations for Deere & Company, also known as John Deere. Thank you for inviting me today to testify at this hearing on reform of the over-the-counter derivatives market. I am here today in my capacity as an executive of Deere & Company. My testimony reflects the views of Deere and the views of the Business Roundtable, of which we are a member, and which represents leading companies with more than $5 trillion in revenues and more than 10 million employees.

Deere is a major U.S. company with significant overseas sales. We raise capital, manufacture products, and sell in the United States and in foreign markets. These international activities subject us to economic risk. To manage these risks, we use derivatives. We do not use them as speculative investments, but instead to convert transactions that carry inherent risk into ones that produce predictable cash flows. This enables us to offer competitively priced products and financing to our customers.

Let me give you an example of how we use foreign exchange derivatives to manage currency risk. Australian farmers are important producers of agricultural commodities. Deere has sales and credit operations in Australia, but no manufacturing. The products we sell there are manufactured mostly in the United States and Europe. Australian farmers place orders for equipment well in advance of the use season to ensure they will be ready for the spring planting or fall harvest. There is a significant lead time to manufacture a tractor to the farmer's specifications and ship it to Australia. Since our sales are in Australian dollars and our manufacturing costs are in U.S. dollars and euros, we are exposed to exchange rate risk. Without hedging this exposure with derivatives, we would not be able to offer a reasonable fixed price to the Australian farmer, and we would lose sales.

Let me provide one more example, this time of how we use interest rate swaps. We provide financing for our customers on a significant percentage of our sales. We offer both fixed- and variable-rate financing to meet the various long- and short-term needs of our customers. Derivatives enable us to match the interest rate characteristics of the funding available in the capital markets with our customers' requirements. This was especially critical during the credit crisis as capital was scarce. John Deere's volume of new loans increased during the credit crisis as we stepped in to replace other financial institutions that curtailed lending. We were able to issue long-term, fixed-rate debt and use interest rate swaps to match the shorter-term fixed and floating loans our customers required.

Many investment-grade companies like Deere have debt covenants that prohibit the posting of collateral for derivatives. If existing derivative contracts are not permitted a grandfather exemption from the clearing and collateral requirements of the regulations, we will have to terminate these transactions at significant cost.

Your bill takes key steps that accommodate the needs of derivative end-users like Deere. For example, your bill recognizes that many companies use derivatives for prudent risk management purposes. Your bill does not rely on clearinghouses to determine which transactions are accepted from central clearing. And your bill does not prohibit the use of non-cash assets to satisfy margin requirements.

At the same time, we have concerns about the derivatives legislation that the committee plans to consider next week. I would offer the following three observations. First, we are concerned that regulators will be ceded too much authority to determine which companies are subject to higher regulatory thresholds and higher margin requirements.

Second, we are concerned about the capital requirements for non-centrally cleared transactions. We believe that capital charges should be levied solely based on risk of loss and not as a means of forcing companies to centrally clear transactions.

And finally, while your bill does not rely on a hedge accounting definition to determine which end-users are major market participants, we are concerned by the bill's open-ended definition of "substantial net position," which creates uncertainty and again gives the regulators too much authority to determine which end-users are covered.

Deere & Company is committed to working with this committee, the Administration, and other congressional bodies to enact thoughtful derivatives regulation that facilitates, not hinders, well-functioning capital markets. At the same time, the regulation should not be a disincentive to companies to enter into prudent hedging transactions.

Thank you, and I am happy to respond to any questions you might have.

[The prepared statement of Mr. Holmes can be found on page 140 of the appendix.]

Ms. BEAN. Thank you for your testimony.

And now, we will hear from Christopher Ferreri, managing director of ICAP, on behalf of the Wholesale Markets Brokers Association.

STATEMENT OF CHRISTOPHER FERRERI, MANAGING DIRECTOR, ICAP, ON BEHALF OF THE WHOLESALE MARKETS BROKERS ASSOCIATION

Mr. FERRERI. Madam Chairwoman, members of the committee, thank you for inviting me to testify today on the reform of the over-the-counter derivatives market. My name is Chris Ferreri, and I am testifying today in my capacity as chairman of the Wholesale Markets Brokers Association, Americas, an independent industry body representing the largest wholesale and interdealer brokers operating in the North American markets across a broad range of fi-

nancial products. I am also managing director at ICAP, one of the founding member firms of the WMBA.

Interdealer brokers serve as intermediaries for broker-dealers and other financial institutions that facilitate access to a full range of OTC and exchange-traded products and their associated derivatives forms. For relevant markets interdealer brokers are registered broker-dealers and are regulated by numerous agencies, including the SEC, the Federal Reserve, and the CFTC. It is estimated that each day, IDBs handle on average 2 million OTC trades globally, corresponding to about $5 trillion in notional amounts across the range of FX securities, interest rate, credit, equity and commodity asset classes in both cash and derivative form.

Mr. Chairman, the WMBA is supportive of the efforts to more effectively oversee the OTC markets for derivative financial products. We believe that our current practices will integrate smoothly with many of the requirements in the discussion draft as well as the Treasury Department's proposal. We support the efforts taken thus far by the Administration and Congress to broaden the roles of the CFTC and the SEC in increasing the safety and soundness of the OTC markets.

Today, we would like to focus on two particular issues: the characteristics and responsibilities of the swap execution facilities; and the protection of open, neutral, and nondiscriminatory access to central clearing.

It is clear that the interdealer brokers would currently fulfill many of the criteria of the swap execution facilities described under the draft legislation or the alternative swap execution facilities under the Treasury Department's proposal. Much of what is contemplated for these facilities is already well within the capabilities of our member firms. Our technology-based reporting systems can provide the relevant regulators with real-time trading information.

The WMBA is concerned with the requirement that swap execution facilities must undertake certain SRO enforcement-type responsibilities, including discretionary supervision and approval of particular swap contracts as suitable for trading and the general oversight of the trading activities of our customers. This is not to diminish the capabilities we currently possess to monitor for suspicious or manipulative trading activity and to report such activity to regulators. This is consistent with our concerns about the requirements set forth in the Treasury Department's proposed legislation for alternative swap execution facilities to adopt position limitations or position accountability for our customers. We therefore appreciate the committee not including such a provision in the chairman's discussion draft, recognizing that each WMBA member firm can only monitor the activities taking place within its own execution facility.

Multiple and competitive execution platforms have demonstrated their ability to create efficient, liquid and innovative markets. Yet with the expansion and requirement of central clearing, there is serious risk that central clearinghouses will create, modify, and ultimately favor their own execution facilities over competing execution facilities by access fees, access technologies or cross-subsidization of execution and clearing fees. The WMBA would respectfully

ask that you consider whether this is sufficient to promote and protect competition among execution platforms.

As the Justice Department observed in a 2008 comment letter to the Treasury Department, a vertically integrated derivatives market, where a central counterparty providing clearing services also provides trade execution services, will limit competition, increase costs, and ultimately hurt end-users and larger market participants. One only needs to look at the securities and options markets compared to the futures markets.

The WMBA is encouraged that this is consistent with CFTC Chairman Gary Gensler, who remarked at a House Agriculture Committee several weeks ago that, "A clearinghouse should not be vertically integrated in such a way with an exchange or trading platform so that the only product they accept is from that exchange or trading platform."

Frankly, if the clearing entity also provides execution services, there is not only an opportunity, but also an incentive for them to structure their services to squeeze out competition. The WMBA would ask that the legislation include language to protect against such behavior.

In closing, Madam Chairwoman, we congratulate you on your work on the discussion draft and the Treasury Department's proposed legislation. The WMBA looks forward to working with you to achieve these goals. Thank you for the invitation to participate in today's hearing.

[The prepared statement of Mr. Ferreri can be found on page 79 of the appendix.]

Ms. BEAN. Thank you for your testimony.

And our final witness is Rob Johnson, director of economic policy for the Roosevelt Institute in New York, on behalf of Americans for Financial Reform.

STATEMENT OF ROB JOHNSON, DIRECTOR OF ECONOMIC POLICY FOR THE ROOSEVELT INSTITUTE IN NEW YORK, ON BEHALF OF AMERICANS FOR FINANCIAL REFORM

Mr. JOHNSON. Thank you, Congresswoman Bean, Chairman Frank, Ranking Member Bachus, and other members of the committee for including me here in your proceedings regarding derivatives reform.

First off, when I worked in the Senate Banking Committee years ago, the derivatives regulation was solely the province of the Agriculture Committee. But I believe in the current circumstance where derivatives regulation is really the centerpiece of financial reform, and that is because of the current market structure, I want to applaud you for undertaking this endeavor, because I believe in the challenge that you face following the crisis, this is the essential ingredient to restoring confidence in our financial system.

The upshot is that we have roughly five large financial intermediaries: Goldman Sachs; Morgan Stanley; Citibank; JPMorgan Chase; and Bank of America. About 95 percent of the derivatives activity undertaken by the largest 25 bank holding companies, according to the Comptroller of the Currency, takes place within the walls of those five firms, who are very likely to be categorized as Category 1 or "too-big-to-fail" firms. Ninety percent of their activi-

ties, according to the OCC, are OTC derivatives. Bloomberg and others have estimated that this year, those 5 firms will make roughly $35 billion in the OTC derivatives market.

The reason I feel this is the centerpiece of reform is the "too-big-to-fail" policy is eminently intertwined with derivatives reform. The American public is quite demoralized by what we might call the induced forbearance of the bailouts that we experienced last fall. And I know one other dimension that the financial committees are working on has to do with resolution powers so that financial services holding companies, insurance companies, and others can, in fact, undergo prompt corrective action, as the FDIC could do with a bank now. But in a world where the opaque and deeply intertwined and entangled derivative exposures are present, it is very, very difficult for me to imagine someone like Secretary Geithner or Lawrence Summers considering anything other than forbearance when these entanglements are present, because it is unknown; it is like sailing in the fog. You could really hit the rocks if you decide to resolve these institutions, yet the discipline of market capitalism requires that insolvent institutions be restructured and resolved not just in the financial sector, but across the entire spectrum.

The concern that I have is also that markets understand when things are too difficult to fail and unwind, and creditors of those firms, the people who hold the bonds, will actually diminish the amount they charge when they know that the firm can't go bankrupt; the so-called default risk will be diminished. What that does is it creates a very nasty feedback, because these large firms get a funding cost advantage, and they can drive competitors out of the market and increase their market share by virtue of being too complex and entangled to be able to bankrupt. And I think that is very distorting for our capital markets.

One goal, therefore, of policy, and as we come back to your particular work on derivatives, is to figure out ways to contribute to ending this "too-difficult-to-fail-or-unwind" regime. When we look back at the market crisis, two things really occurred that I thought were quite prominent. One was what you might call discontinuous pricing. When you had opaque or complex instruments that were not readily traded, and margin or capital and pricing were not readily measured, it set up the system for violent discontinuities in price. People talk about many things that were carried on the books, particularly collateralized debt obligations, being in the neighborhood of 100 cents on the dollar and then instantly 20 cents on the dollar. What this tends to do when it is opaque and when many large institutions are intertwined is it makes them afraid of each other, it makes them very, very anxious, and that compounds the fear and the breakdown of the capital markets.

Ms. BEAN. I am going to have to ask you to wrap up, because we are running out of time.

Mr. JOHNSON. So when I hear the testimony today that are largely two financial institutions and end-users, I believe that I represent a third group that comes to the table, which is the taxpayers, the working people of the United States. And while I expect if you put a proper structure in place in the derivatives markets, it will impose burden or cost at the margin, because we have had

too much incentive for private risk-taking relative to public risk-taking—

Ms. BEAN. I do need a final comment.

Mr. JOHNSON. What I will do, I was just called to this hearing last night, so I will provide detailed comments on your bill and a statement for the record that will finish my comments. Thank you for including me.

Ms. BEAN. All right. Thank you for your testimony.

I will recognize myself for 5 minutes to begin questions.

First, I would like to thank Chairman Frank for working with myself, and with the gentleman from New York, Mr. McMahon, permitting the new Democrats on the task force who have been studying derivatives and initiated a number of the ideas that were ultimately incorporated into the draft bill that we are discussing today.

My first question for Professor Stulz would be with the emphasis towards mandatory clearing, what is your expectation that the clearinghouses can handle the additional capacity?

Mr. STULZ. My expectation is that with proper regulation of the clearinghouses, they should be able to handle the capacity. The worry is that it will be an operational challenge for them, and that the regulatory authorities will have to be monitoring their ability to do so very carefully. I am not sure that the current draft gives them enough power to do so, and I think it will be helpful for them to have those powers.

Ms. BEAN. Thank you.

I also have a question for Mr. Kaswell. A company stock price can be responsive to changes in CDS spreads for their company. There have been allegations that some market participants bought CDS credit protection, and at the same time took large short positions of the same referenced company stock with the intent of increasing the cost of credit to and credit risk of the company, ultimately causing the stock to fall significantly. Congress is exploring how to root out that type of manipulative and predatory behavior.

Is it workable to ban short sales of a company stock when one is simultaneously purchasing CDS on the same referenced entity, or do you have some better ideas about deterring predatory or manipulative practices?

Mr. KASWELL. Thank you for that question. I think that it is important to think about the CDS market in conjunction with bankruptcy.

As far as anybody has been able to show, we think that when companies have failed, they failed on the merits; that companies went out of business because their fundamental business model was not working in the economy, and therefore we think that to suggest that the CDS somehow was related to that, I don't think that there is evidence to demonstrate that.

We think that CDS performs important functions in the economy. It helps provide an indication as to the value of the company. The price of CDS, I think, is a better indication than rating agencies, for example. It provides liquidity to market participants, and it also helps with the ability to hedge. And so we think that the benefits of CDS are important, and we don't see evidence that the bankruptcy scenario that you have described actually can occur.

Ms. BEAN. Also for Mr. Kaswell, does the draft legislation provide an effective medium to resolve the differences between the SEC and the CFTC?

Mr. KASWELL. I think it is a good start. I think that there has always been a tension between these two agencies. We operate in multiple markets. A product may fall on one side or the other legally, but as an economic matter, these products are often traded together with different trading strategies. So I think it is critical that if there is a joint regulatory responsibility, that there be joint rulemaking, joint interpretation. I think in some instances, interpretation can be as critical as the rulemaking itself, and I know that it can be a cumbersome process, but we think that the bill is a step in the right direction.

Ms. BEAN. I had a question for Mr. Hall. Do you think corporate end-users contributed to systemic risk in the economy at all?

Mr. HALL. I think my simple answer to that is no. Business end-users use derivatives to manage risk. They reduce their business risks, which reduces the likelihood that they will fail. And to the extent that any failure of a business would contribute to systemic risk, on a small scale, a business failing is tragic for that business and maybe for its customers, but it does not create systemic risk.

Ms. BEAN. Mr. Holmes, would you concur?

Mr. HOLMES. Yes, I would concur. In the cases where companies are using derivatives to hedge when the derivative reaches maturity, there is an offset in cash flow. For a liability position, we have a cash flow coming in to settle that position.

Actually, what could be a problem is if the company has to come up with cash in advance of the termination date, which would happen if collateral was required to be posted, and that can create a liquidity event for firms that aren't able to access the capital markets and raise the margin.

Ms. BEAN. Thank you. My time has expired, so I will recognize Mr. Bachus.

Mr. BACHUS. Thank you.

I received testimony from all of the witnesses except, Mr. Johnson, I didn't receive yours. You worked in the Senate prior to—

Mr. JOHNSON. I worked for Senator Pete Domenici of the Senate Budget Committee when they were in the Majority until 1986. And then I worked with Senator William Proxmire when he was in the Majority in 1987 and 1988 on the Senate Banking Committee.

Mr. BACHUS. Now, you testified at the request of the White House; are you aware of that?

Mr. JOHNSON. No, I am not. All I am aware of is that the committee members called me last night at 6:00 and asked me if I could join this panel today. So I am not aware of what the inspiration was.

Mr. BACHUS. The White House requested you testify, which is fine. I didn't know if you had—have you looked at the White House proposal as opposed to the chairman's draft?

Mr. JOHNSON. Yes, I have looked at the White House proposal in great detail. I have only looked at Chairman Frank's proposal in a cursory manner this morning.

Mr. BACHUS. The White House proposal, there has been a lot of testimony from these witnesses that the White House proposal as

it was offered would have actually made things a lot worse, I think is maybe a characterization I would use from some of the witnesses, not all. Do you agree?

Mr. JOHNSON. No I don't. Well, let me say I do and I don't. If forced to choose between the current discussion draft and the White House proposal, I would still prefer the White House proposal, but I can understand why the gentlemen on this panel with me who are describing primarily the impact on them rather than the overall impact on the market system—

Mr. BACHUS. Well, Cargill, Deere, manufacturers, all sorts of companies in transportation, it would increase their cost. You understand that?

Mr. JOHNSON. I do understand that, and I believe that is accurate; it would increase the cost.

Mr. BACHUS. That being accurate, if it increased it substantially, they would either have to lay employees off, or charge more for their products or take actions like that, right?

Mr. JOHNSON. Yes. But I think that has to be put into balance with the costs that we have incurred because we have had a malfunctioning capital market.

Mr. BACHUS. Also, it would also reduce profits, which would reduce government revenues, which would put us further behind. So there are some real downsides to the proposal. But you are saying there is an upside, too. And the upside is that, what, we would avoid an AIG?

Mr. JOHNSON. I believe by creating more discipline in the derivatives market in terms of pricing and margining, we would improve confidence, diminish volatility in many of those markets as well as other market segments, and we would also bail out fewer banks.

Mr. BACHUS. We didn't really have any problem with commodity derivatives. What we had problems with was basically the subprime market, that it was junk, and they put junk in derivatives, and if you put junk in, then the derivative is junk. And so if you regulate, if you put rules which the Congress has on subprime loans, and you—we have regulations on underwriting, and we had unregulated subprime lenders, but if we regulate those, and we try to have some credit-rating reform, and we have had subprime lending reform, that wouldn't be repeated hopefully, would it?

Mr. JOHNSON. I would agree with you that those reforms would be helpful and meaningful and that they were the triggering episode, but I believe that the opacity of the large intertwined markets which included a lot of derivative exposures added to the fear and the depth and the severity of the downturn. Another trigger could cause that.

Mr. BACHUS. Thank you. I appreciate that.

Mr. Hixson and Mr. Holmes, would you tell me if this bill passed as the President constituted and maybe as if it passed as proposed by the White House, what would be the effect on Deere and Cargill as far as your costs? And I am sure that—what is your best estimate?

Mr. HOLMES. It would be fairly material. It would affect us in a couple of ways. Our credit operations has the largest share of our derivatives outstanding, roughly $18 billion of derivatives, which

sounds like a large number, but in the context of the loans we make to customers in excess of $20 billion, it is reasonable. Many of those derivatives we would not be able to execute under the proposal, and that means our cost of funding would go up substantially, and we would have to increase those loan rates to customers, and there would be probably loss of revenues, loss of sales in that situation.

Mr. BACHUS. So either cost to farmers and those who bought industrial equipment more, or it would—their costs are borne—

Mr. HOLMES. The cost of acquiring equipment, the cost of financing it would increase and it would also make us less competitive in the international markets.

Mr. BACHUS. Thank you. Mr. Hixson?

Mr. HIXSON. For us, we have estimated it would cost approximately about a billion dollars depending upon market conditions, an additional amount of money we would have to borrow. For some local context, one of our largest investments—we have two members from Kansas City sitting here. We built a brand new oil facility, our largest in the United States, in Kansas City. So for us we would have to choose whether you put that money in margin or do you continue and build that plant. That is the type of thing we have to decide.

Mr. BACHUS. It would certainly impact the number of employees you have. Thank you.

Mr. MOORE OF KANSAS. Thank you. The gentleman from California, Mr. Sherman, is recognized.

Mr. SHERMAN. Thank you. The over-the-counter derivatives market is a $592 trillion casino. By comparison, Las Vegas is just a grain of sand. And it worked pretty well up until last year in large part because everybody at the casino thought that if the casino went under, the Federal Government would be there to bail them out. Those who played at the AIG casino were right. Those who played at the Lehman Brothers casino turned out to be wrong, they were surprised, the whole world was surprised, and we had people running for the exits when they discovered that the implicit Federal guarantee wasn't absolutely there. So the question going forward is whether we want to recreate a system that works only with some sort of implicit Federal guarantee. Now, if you look at the Treasury draft, it provides for unlimited, permanent TARP and when the Secretary of the Treasury was here, I asked him whether he was willing to limit that power to merely $1 trillion and he said no.

So the question we have is, not does this system help business, but is it worth multitrillion dollars of risk to the taxpayer to keep it going or alternatively, is there a way to design it that would allow it to work without any kind of implicit Federal guarantee? Mr. Holmes, you have used derivatives. Could you make it work if it was clear that your counterparties did not have an implicit Federal guarantee, that the taxpayers were not part of the system?

Mr. HOLMES. I believe so. You have to understand the counterparties that you are dealing with. We deal with the large commercial and investment banks that we have had relationships with for on average 30 years. Some of those relationships go back 100 years. Having said that, we still have credit limits that we place on our

exposures with those counterparties. And when we approach those limits, we curtail our activity. Certainly during the credit crisis we were concerned about some of those counterparties, but the failure of any one of them would not have been a major financial problem.

Mr. SHERMAN. So if we don't adopt proposed Section 1204 providing the Treasury with that unlimited bailout authority, you will still be okay? Mr. Johnson, you are the only person here representing a public interest entity. Do over-the-counter derivatives do this economy so much good that in order keep them going, the taxpayer should give to the Executive Branch unlimited bailout authority to bear whatever risk future Administrations decide is necessary under whatever exigencies occur in the future?

Mr. JOHNSON. The answer to your question is no.

Mr. SHERMAN. Okay. I would point out, I believe, you are here at the request of the Administration and you are helping me illustrate how that one section of the Administration's proposal is not helpful.

Mr. JOHNSON. Let me say that I was unaware that I was here at the request of the Administration.

Mr. SHERMAN. I know. Yes. And I should make a further comment based on the ranking member's comments. His comments seem to be on the order of, well, the old system was working just fine except for subprime. I would point out it was working fine because it had an implicit Federal guarantee and the market was shocked when Lehman Brothers was outside of what people thought was that umbrella. So it is hard to say the old system was working fine when it only worked with an implicit Federal guarantee that I think most of our colleagues on the other side of the aisle voted against. Mr. Hill, can Morgan Stanley do just fine without a code section that allows the Administration to bail you out without consulting Congress in the future?

Mr. HILL. Thanks for the question. I respectfully disagree with the characterization of the market as a giant casino, though. I would like to say that a healthy and robust financial market—

Mr. SHERMAN. Let me interrupt. Do we have any proof that a majority of the debts or derivatives placed were placed by people who had real business reasons as opposed to just folks who thought they could make money because they could guess which way the price of orange juice was going to go?

Mr. HILL. The foundation of any financial market is both hedgers and speculators. That has been the case for over 200 years with the advent of the futures markets, as well—

Mr. SHERMAN. Do we know how many of each we have?

Mr. HILL. I, off the top of my head, cannot tell you what percentage of the market is comprised of hedgers versus speculators but I assure you there are both.

Mr. SHERMAN. In Las Vegas, it is 100 percent speculators. And derivatives seems to be close. I yield back.

Mr. MOORE OF KANSAS. Thank you. The gentleman from Illinois, Mr. Manzullo, is recognized.

Mr. MANZULLO. Thank you. Let me ask probably the most simple question. I ask the same question just as Mr. Sherman asks the same question every time we have somebody talking about these instruments. If the subprime market had not gone sour, would

there have been any problems with the derivative markets? I know you are all anxious to jump into that one.

Mr. SLEYSTER. I would just pass along the experience that within the life insurance industry, we are restricted in the use of derivatives to two things: We can either replicate an asset that we could have otherwise bought, which is restricted in and of itself; or we can use it for hedging purposes. And I think we would say that our experience as people who use these for risk management and hedging tools was that even through this extraordinarily difficult cycle, derivatives served us very well and, in fact, served as significant risk mitigants so that we could stand behind the promises that we made while we have significant counterparty exposure risk that we have to manage.

As Mr. Holmes noted, we think about the credit exposure, the potential credit exposure that we can have with counterparties and we, in fact, post collateral and limit the amount of business that we do. So I think we would say it actually worked quite well for this cycle for most of the end-users, and certainly for the life of insurance companies.

Mr. MANZULLO. Mr. Holmes, and then Mr. Johnson. Go ahead.

Mr. HOLMES. Yes. Certainly our major concern through the credit crisis was the health of our counterparties. And it certainly didn't appear that any of the interest rate swaps in which end-users were participants or foreign exchange transactions were the things that created financial difficulties for our counterparties. It was the subprime market, as you indicated.

Mr. MANZULLO. Mr. Johnson?

Mr. JOHNSON. I believe that the subprime market was the catalyst, the trigger in this episode and the opacity that was associated with the collateralized debt obligations. The funny ratings from the rating agencies played a very large role. But I do not think that is the exclusive source of opacity in this very large scale derivatives markets. Nor, by the way, do I think that derivatives are—I think they play a meaningful role, but they have to be structured so that as the gentleman speaking before me said, counterparties can assess each other and not become afraid and not withdraw credit in times of crisis or shock that emanates from any source, domestic or foreign.

Mr. MANZULLO. Okay.

Mr. FERRERI. Could I add some insight to that, please? As an inter-dealer broker, when we hear stories from end-users, our customers are not end-users as the dealers that they deal with. The interest rate swap market, even during the crisis, the height of the crisis, operated very effectively and very efficiently. The foreign exchange market that our members operate, operated very effectively and very efficiently. The London Clearing House, in a report to the European Commission, made a case that after Lehman failed, $9 trillion in interest rate swaps with Lehman as a counterparty were in the Clearing House, more than 60,000 trades. Those trades settled through the Clearing House without a single dollar lost of member funds. So although there may be underlying problems in a certain aspect or a certain area, the breadth of the marketplace and the ability for the dealers to participate as market makers in-

stinctively for the inter-dealer market was certainly proven to be strong.

Mr. MANZULLO. Mr. Hill?

Mr. HILL. Yes. I would agree with what has been said. I think the key thing here is that with respect to all the markets we have been talking about, interest rates, currencies, and the corporate credit default swap market, the underlying instrument on which the derivative was based was a relatively liquid and transparent market. For example, with respect to the corporate CDS market, the underlying corporate credits were typically 34 reporting companies. So people who are transacting in the corporate credit default swaps understood the risks they were taking because the underlying credits were reporting companies that had financials, had to file periodic reports as their material events changed, and therefore the corporate credit default swap market actually performed very, very well during the financial crisis. In fact, it was far more liquid and far more transparent than the bond market. The problem with the subprime credit default swap market was not with the credit default swap itself, but how the underlying instrument that people were basing their derivatives on—

Mr. MANZULLO. Was crap.

Mr. HILL. Was misunderstood. Not only was it that—

Mr. MANZULLO. It was.

Mr. HILL. It was misunderstood. People assumed that borrowers disclosed their incomes correctly, people assumed lenders checked, people assumed the real estate appraisals were done accurately. And it turned out that a lot of those things weren't the case. So I have always felt the focus should be less so on the derivative and more so on what is the derivative on and is that market performing correctly. And I think in this case of the subprime, it clearly wasn't. In the case of the corporate bond market and the corporate CDS market, it certainly was.

Mr. MANZULLO. Thank you.

Mr. MOORE OF KANSAS. I have been asked by Chairman Frank to clarify for the record that the White House did not invite any witnesses. All the invitations came from the chairman. I have just been asked to state that for the record and I have done it. Thank you, Mr. Manzullo. And next, the gentleman from New York, Mr. Meeks, is recognized for questions.

Mr. MEEKS. Thank you. And I yield to Mr. Watt.

Mr. WATT. I thank the gentleman for yielding just long enough for me to apologize to the members of the panel for having to run out and not being here to ask questions. That is probably a blessing to you. But also second, to ask unanimous consent to submit for the record a statement of Shawn Dorsch, who is my constituent and the founder of Blackbird Holdings, Inc., on the subject matter of today.

Mr. MOORE OF KANSAS. Without objection, it is so ordered.

Mr. WATT. I yield back to the gentleman and I thank him profusely.

Mr. MEEKS. Thank you. One of the issues that I have been very focused on is what is taking place right now with the money that is still caught up in the U.K. with Lehman Brothers. And a lot of foundations and institutions and you are talking about money that

is really caught up there. So I was wondering in looking at the draft—but I guess I will address this to Mr. Kaswell—that if the key pillars of the discussion draft had been in place at the time of the Lehman's bankruptcy, how would things have—would things be the same? Would they have evolved differently? And particularly, I am interested in the two key pillars of the independent third-party custodians and the central clearing of trades by major-market participants. Would it have made a difference?

Mr. KASWELL. Thank you for your question, Congressman. I want to commend you for your leadership on this issue. The Lehman situation in the United States and the United Kingdom has been an unmitigated mess. And by focusing attention on it, shining a bright light on it, we think you are helping to resolve these issues. For my constituency, we are investors and we represent other investors, pension funds, college endowments and so on. And their money is tied up in Lehman, LBIE as they call it in the U.K., and also in LBI in the United States.

And the most recent effort to resolve it did not work out. I understand there is going to be another effort starting tomorrow perhaps. But this is our investors' money that is sitting there. So again, we appreciate the efforts you have made in that regard. The bill would go a long way toward addressing some of the concerns because of its protection of collateral by segregating it off into a central clearing facility, in some cases, if it is a centrally cleared derivative, or in the case of an OTC product, providing customers with the option of having it segregated.

So putting collateral and margin aside in a segregated account would have made a substantial difference in LBIE. And so that is one thing that we think is important. The Lehman administration, I think, is another issue. There are different approaches to that, and I think we could talk about that more at another time. Another issue I think is important is portability, the ability to move assets from a failing clearing member, if there were such clearing member, to another clearing member and to move those positions over quickly and efficiently. This would make a tremendous difference in avoiding the kind of nightmare we have had with LBIE. So thank you for the question.

Mr. MEEKS. Thank you. Let me jump now to Mr. Hall. The bill provides an exemption for swaps that did not involve dealers or so-called major swap participants, likely excluding anyone that uses swaps for hedging operational risks. This may mean that it is primarily contracted between dealers or between a dealer and fund managers that have to be cleared. Could you comment, if you will, on the amount of outstanding trade that this likely represents and whether this level of clearing will be enough to make a meaningful reduction in the level of systemic risk associated with the derivatives.

Mr. HALL. Sure. I would be happy to. Approximately somewhere between probably 85 and 90 percent of transactions are between major-market participants. So as this draft allows and can require, is that those transactions would need to be, first of all, cleared if the regulator requires that they would be cleared; and then second of all, it allows the regulators to set margin requirements. So that would address the vast majority of the—that would address the

systemic risk in the system. And we have some concerns with the definitions and the definition of major swap participants. The language around substantial net position is undefined.

We are actually concerned that threshold could be set too low so that it could require normal businesses who are using derivatives for risk management purposes, maybe they have other transactions that wouldn't qualify, they could get caught up in that definition. But to answer your question specifically, this language would catch the largest counterparties. In the previous panel—I should point out in the previous panel, it was pointed out that Government-Sponsored Enterprises such as Fannie Mae or Freddie Mac that are doing transactions that might broadly fall under the range of risk management may avoid being captured by this language. So we think there is still some work to be done on these paragraphs, but I think it is definitely moving in the right direction.

Mr. MEEKS. I am out of time already?

Mr. MOORE OF KANSAS. Yes, you are. The Chair recognizes Mr. Manzullo for a unanimous consent request.

Mr. MANZULLO. Thank you, Chairman. I ask unanimous consent that the statement of John Hollyer, principal and head risk management of strategy analysis at Vanguard, be made a part of the record.

Mr. MOORE OF KANSAS. Without objection, the statement will be made a part of the record.

And I recognize myself for a unanimous consent request, a statement on proposed reform of over-the-counter derivatives markets from the electric power and natural gas industries. Without objection, this will also be made a part of the record. Next, the Chair recognizes Mr. Garrett from New Jersey.

Mr. GARRETT. Thank you. And I thank the panel. In the last comment—we have heard before actually that this is a step in the right direction. We have heard a lot of people say that. The Administration had their plan here. The chairman has come out with his plan here, which is a step in the right direction. I guess as I hear that, I often think that had you all the opportunity to push that proverbial reset button on this debate—and we haven't passed legislation yet and we haven't had a markup yet—is the legislation or even the draft legislation that we have really the type of legislation that you think we need in order to address the problems that we need to have addressed here? I will open that to anyone who wants to. In other words, if you had your druthers, would this be the legislation even with the definitional changes and what have you that you have here if we do all those? Is this the legislation that you hope to have in place come January of next year to regulate the industry?

Mr. HALL. I will take a crack at it, if that is okay. I think the way we view this is we have been reviewing the issue and reviewing the situation. And we have been thinking about this ever since AIG, certainly as many of you have. The key issue in our minds is systemic risk. The way to address systemic risk is to identify who are the systemically significant institutions, require that when the systemically significant institutions trade with one another, they fully collateralize their trades. They can fully collateralize their trades either through collateral arrangements or clearing or

exchanges. So that would take care of the systemic risk issue. Now to the question of transparency. And if the regulators need access to information, certainly let us give regulators the access to information.

One of the provisions in this bill talks about central data repositories where trades can be reported. We think that is a very sound idea. So those two elements should be the key elements, the core elements. Then there should be a question of anything added to that, I think, should be examined for both of it costs and benefits.

Mr. GARRETT. I appreciate that. And I take it as significant when I said does anybody think this is what you want to have in the market and note there was no waving of hands saying, this is it. So I will ask Mr. Hixson. When you look at your company and industry, basically what you have is a Byzantine system of regulation that this draft is coming up with to address mainly just non-financial derivative dealers such as yourselves who don't have a prudential regulator out there already. So we are creating this massive regulation just to address this one little area basically. It goes with the other carve-outs that have now come in for the end-users and what have you. Couldn't we have done this in some other ways? And you addressed—Mr. Hall addressed some of it by dealing with the repository. And I guess even before that—here is a seminal question. Are you so systemically important and risky that we would have the same problems that we have dealt with over the last 9 months if we didn't do this, and you had a problem in your company?

Mr. HIXSON. I think as the first panel kind of mentioned and certainly in the statistics on the notion of outstanding derivatives, we are tiny. So I don't think—

Mr. GARRETT. Hoping to grow bigger, but still tiny.

Mr. HIXSON. Certainly a very small player. I would not think there is any systemic risk in what we do. And particularly given the nature of our transactions, we are providing hedges for our customers. So in essence they already have the risk on their books. They need to buy flour to run their operations, they are going to be selling the heating oil in the examples I used. So we are just trying to help them provide a product to manage that risk. So, no, we are not particularly viewed as systemic in nature. And we have a regulator. We certainly report all of our large trading positions that we do, both over-the-counter and on the exchange to the CFTC currently. That system exists for any large data amounts of transactions, we do provide that already.

Mr. GARRETT. It seems to me as we begin to get into this—maybe I am wrong—that you can deal with the transparency issues that I came in here to hear you talk about by the repository, you can deal with the other aspect that is in this draft that Chairman Frank has put in and that is dealing with the Lehman situation regarding the segregation of funds and what all brought us to that situation. We already know what is going on in the marketplace right now is that we are moving to this clearinghouse arrangement. We don't have to get into all the definitional problems I think Mr. Hall was raising by this Byzantine structure doing it because we are already moving in the right direction.

So if you did just a couple of those things, you seem like you would address a major portion of the problem. We will not, even if we pass this bill, or I think even if we pass the Administration's bill—correct me if I am wrong on this—deal with what got us here by some argument with the AIG situation because—will the AIG type of instruments be covered and be forced to be cleared through a clearinghouse? No, right? Because they are—Mr. Hall?

Mr. HALL. If I could. This bill does require that if you are deemed a major swap participant or if you are a swap dealer, then regulators can compel you to trade—do certain trades on exchange or clear and for other trades post margin.

Mr. GARRETT. But it wouldn't require for those types to actually go through it because they would be the unique type of product that wouldn't go through it, correct?

Mr. MOORE OF KANSAS. The gentleman's time has expired.

Mr. GARRETT. You can do a quick nod.

Mr. HALL. If it is a unique product, they still could require margins.

Mr. GARRETT. Margins only. Thanks.

Mr. MOORE OF KANSAS. The Chair next recognizes the gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman. How many of your associations or agencies are related to other associations or agencies at the table? How many of you are connected in any way?

Mr. KASWELL. I am not sure I understand the question. I represent the Managed Funds Association, which is the trade group.

Mr. CLEAVER. Yes, I understand. And so what trade groups that you represent are also connected with any of the other associations or groups that are represented at the table?

Mr. KASWELL. I don't believe we are connected.

Mr. CLEAVER. None of you are related in any way, not connected in any way? The people you represent are not—don't have any relationship at all?

Mr. HALL. An affiliate of Prudential is one of our clients, but that is the only connection I have.

Mr. KASWELL. There may be cross membership.

Mr. FERRERI. I was just going to add that. My company, ICAP, is a member of the WMBA and also a member of SIFMA.

Mr. CLEAVER. So if we really took a little time, we could probably come to the realization that most—there is some kind of connection with those companies you represent and others represented at the table? Am I right about it? We just took a little short period—we haven't taken lot of time. We have already seen that there are some crossovers.

Mr. KASWELL. Right. But there are different perspectives. We are—

Mr. CLEAVER. I understand. That is not where I am going. I wanted to just see what the relationships would be.

Mr. HOLMES. Certainly as an end-user, I am not aware of any direct relationships I have with these other associations, yes.

Mr. CLEAVER. No. That is not what—I am not saying you have a relationship with them. I am saying that in the industry that you represent, some of those members would have relationships with

the members of the agencies represented at the table. Is that clearer?

Mr. KASWELL. Yes.

Mr. JOHNSON. In my case, there are no cross affiliations.

Mr. CLEAVER. Yes. You are segregated. Earlier today, Mr. Gary Gensler, the Chairman of the Commodities Futures Trading Commission was here. He actually delivered a speech last month. And in his speech, he said that he believed that institutions are becoming "too-interconnected-to-fail" and not "too-big-to-fail," that the real problem is that we are developing a pyramid financial system in this country and so everybody is connected and so if one block falls it could conceivably knock down all the other blocks because of their connectivity. None of you agree with that, do you?

Mr. SLEYSTER. If I could. As representing insurance companies, we believe very strongly in diversification and we believe in posting collateral and the kinds of things that can protect you from concentrations. But clearly as the world gets smaller, as financial institutions, for example, merge—if you had holdings in two of those bonds and there is a merger, then suddenly your exposure to a single firm has gotten much larger and you have to work those down.

So I think certainly we are concerned about concentration and about using things like CDS and derivatives and OTC contracts quite frankly to help us mitigate and spread out that risk when those kind of events occur. But certainly they are real risks and real concerns.

Mr. CLEAVER. Yes, I appreciate that. You and I are on the same wavelength. That is a concern. When he expressed that, I have frankly thought a great deal about that and wonder whether or not the "too-big-to-fail" is really something we are concentrating on. And that even if we conclude that we have come up with a solution to that, we still have a problem because of this interconnectedness. And I think my time is running out just as I was—all right. Thank you, Mr. Chairman.

Mr. MOORE OF KANSAS. The Chair next recognizes himself for a question. As we consider where to draw the line of jurisdiction between the SEC and the CFTC, I think Chairman Frank has a very interesting perspective. If you can eat it, it should remain the CFTC and the Agriculture Committee that has jurisdiction; but if it is a financial matter, it should remain with the SEC. In the grey areas like interest rate swaps and currencies I would like to hear from the entire panel whether the SEC or the CFTC should have jurisdiction of these items. Are interest rate swaps and currencies a financial matter that should be under the SEC's jurisdiction? I will start with my fellow Kansan, Mr. Hixson, and just go down the line if we could, please.

Mr. HIXSON. We have really not waded into the jurisdictional dynamic if you will. We have really tried to focus on the use of the instrument and if you are a hedger and focus on kind of exemptive language and clarifying that segment. So I don't know that we really have a lot to offer on the dynamics of the various agencies.

Mr. MOORE OF KANSAS. Very good. Professor?

Mr. STULZ. I don't have much to offer on this. I was concerned this morning about the lack of selectivity of the CFTC to end-users.

I am much more concerned about focusing on exchanges and that would be a concern to me.

Mr. MOORE OF KANSAS. Very good. Next, sir, Mr. Sleyster?

Mr. SLEYSTER. The ACLI did not express a view on that, but I would reiterate our concern that we would like those agencies to have the ability to deal with issues as they emerge on a real-time basis.

Mr. MOORE OF KANSAS. Very good. Mr. Hall, sir?

Mr. HALL. We don't have experience with either agency. So this will need new—I think our concern is that the testimony this morning, they clearly want to move towards clearing and exchanges. So to the extent they have latitude, we are concerned at the implications of our clients.

Mr. MOORE OF KANSAS. Thank you, sir. Mr. Hill?

Mr. HILL. The system is agnostic under this jurisdiction. But I will point out that there are some unusual aspects of the way the current split is set up. So, for example, in the case of corporate credit default swaps, where if you do a single name corporate credit default swap, it would be with one agency. But if you did a corporate credit default swap of 25 names which is effectively just 25 of those single names combined, it is a different agency and that seems like an odd result to me.

Mr. MOORE OF KANSAS. Thank you. Mr. Kaswell?

Mr. KASWELL. We don't have a formal position on the issue. We think it is a decision for the Congress.

Mr. MOORE OF KANSAS. Right. Mr. Holmes, sir?

Mr. HOLMES. We have not done any exchange traded transactions that would give us experience with either organization, so we don't have an opinion at this time.

Mr. MOORE OF KANSAS. Mr. Ferreri?

Mr. FERRERI. As an operator of a marketplace, we are regulated by both the SEC and the CFTC. What we would hope would happen—the company I represent, ICAP, is a London-based company that operates under a single regulator. We operate regulated derivatives platforms. I think if there is enough harmonization between the trading transparency rules, between the two commissions, it would go a long way to making this an easier goal to achieve.

Mr. MOORE OF KANSAS. Thank you, sir. Finally, Mr. Johnson?

Mr. JOHNSON. I tend to concur with Mr. Ferreri, that making things easier and more harmonized would help market participants. In this particular year, I have had very good experience with Mr. Gensler's work. So as one particular chairman at one particular time, I think he is making a great deal of progress. I have less familiarity with the SEC.

Mr. MOORE OF KANSAS. My thanks to the panel. I yield back the balance of my time. Next, the Chair recognizes Mr. Adler of New Jersey.

Mr. ADLER. Thank you, Mr. Chairman. Gentlemen, thank you for your patience this afternoon. I was struck by a line of questioning by Mr. Garrett, my colleague from New Jersey, a few moments ago, who I think was trying to bait you into criticizing this legislation. My sense sitting by the previous sponsor of a similar bill, Mr. McMahon, is this particular piece of legislation recognizes the good

aspects of derivatives, is trying to avoid some of the systemic risk problems, offers an opportunity for greater transparency and relieving some of the opacity which was, I think, hurting but maintains the prudent risk management tools that all of you need and particularly the end-users here—I heard from Mr. Holmes and Mr. Hixson in particular talking about how this is a positive thing to preserve the good aspects of derivatives.

So I guess I would like to have the flip side of Mr. Garrett's question to you. If you could briefly tell me that this is good legislation that I should support, that by and large will preserve the good aspects of risk management for end-users, but also protect the American people from some of the disasters we heard about, even from your own testimony about AIG. And I welcome any of you jumping in on that one.

Mr. FERRERI. I would love to take the first shot at it. These are comprehensive bits of legislation. There are a lot of components, to them. I will speak to the components that my association would focus on, those being central clearing and transparency. We have the ability today in real-time to send trades between major financial institutions and the OTC derivatives market to a central repository in real-time. The U.S. Treasury market is an over-the-counter centrally cleared market. Trades are novated in milliseconds between counterparties hundreds of thousands of times a day. There are components of the bill that strengthen that on the derivatives side. Our association is fully supportive of those aspects of the bill. With regard to central clearing and the risk that mitigate, again centrally cleared products with a nondiscriminatory access to the clearinghouse gives us an opportunity to get these transactions done, get them into a clearinghouse and move onto the next trade. There are components that our association supports of the bill.

Mr. ADLER. And before you go, I also heard testimony or read testimony about your legitimate ongoing concerns about capital requirements and margin requirements and the segregation of assets for collateral. So you can reiterate that, but I at least have heard that clearly. But I would welcome other gentlemen speaking.

Mr. HOLMES. Well, I would like to comment on one really positive aspect, I think, of the regulation and that is the reporting and information gathering. There is quite a bit of information about derivatives that are disclosed by corporations today in the aggregate, but not at the transaction level. That information will be very useful in determining whether companies are truly hedging underlying risks or speculating. So I think that is very helpful. The margining and collateral requirements being a real concern for our particular firm.

Mr. ADLER. Understood. Mr. Johnson, you were patient.

Mr. JOHNSON. What I feel is that you are faced with a tension between wanting to standardize, harmonize, make things more transparent on the one hand and preserve the capacity for customization for end-users on the other. I think this is a real entrant into the dialogue, along with the Administration's bill and some of the work that Gary Gensler has done. But I think at this point, the danger of this particular draft after my first reading within the last 18 hours, is that some of the definitions of nonmajor market participants and so forth could end up spilling over to cre-

ate unintended what you might call laxity or benefit for some of the major "too-big-to-fail" financial institutions. And I would urge the committee—and I will put a written submission in on how to tighten that language.

Mr. ADLER. I would desperately urge you to do that, because we are going to be doing something on this measure very, very soon. So your written comments would be very helpful. I know Mr. Hall would like to comment that we want to make sure that we preserve the customized nature of derivatives as much as possible.

Mr. HALL. I think the question is, what is good about this bill and what do we like. I think you addressed some of the concerns, the margin and the capital. There is a couple of other kind of more definitional concerns that we had in our testimony. But I want to emphasize that we believe that this bill is the most thoughtful bill to date. And I think it has a lot of hope of trying to balance the needs for end-users with addressing the systemic risk issue.

Mr. ADLER. Since I am sitting next to a previous sponsor of a derivatives bill, I think the previous bill was also very thoughtful.

Mr. SLEYSTER. If I could. One observation with sympathy to sort of the expressed view, we felt like derivatives actually worked very well as a risk-management tool through the cycle. And when we reported to our own board about experiences of the cycle, that was actually one of the items we noted that worked well. The reason we think it worked well for the life insurance industry is that we already have a restricted use from our own State regulators that we can only use derivatives for hedging a replication. And so one of the observations I think I would make is that we don't think it is necessarily—we don't see why we would need to be regulated by the CFTC or the SEC on that. Thank you.

Mr. ADLER. Thank you, Mr. Chairman.

Mr. MOORE OF KANSAS. Thank you. I would ask unanimous consent that Mr. McMahon—who is not a member of this committee—be permitted to ask questions. Mr. McMahon, you are recognized sir.

Mr. MCMAHON. Thank you, Mr. Chairman, and to the ranking member and also to Mr. Adler for not objecting to allowing me to ask a few questions. I appreciate that very much. And also for the shout-out on the many portions of our bill which are part of the chairman's draft for discussion. We are very pleased about that. And we thank you for your great efforts in that regard as well.

Again, with the new Democrats, this for us is a very important issue and it is—all politics is local. So for me back home, as I mentioned this morning, so many people from my district work on Wall Street and for the City of New York. It is just an integral part of the City's budget. It is about policemen on the street, firefighters in the fire houses, teachers in the schools. And one of the things that we have tried to—have had to make clear with the meltdown at Lehman and AIG is when it comes to derivatives, is that—and you have done that very well, many of you today, that this is not just about speculation and people sitting around in a conference room or on a trading floor somewhere on a computer on a trading platform. This is a very important part of America's economy because we are able to produce fuels or things from grain or tractors that go around the world. And that is very important. We are glad

you are here. I would ask you—especially Mr. Hixson and Mr. Holmes but the others as well because I heard what you said to Mr. Adler, that we are in a pretty good place in a lot of the parts of the bill. But as end-users—and we need you to continue this dialogue so that people understand it is about the end-users, what that means to the American economy, not just for those who are using credit default swaps to speculate. As end-users, could you give us your perspectives? I know you talked a little bit about how the Administration's proposal requiring the end-users to clear and the post-margin obligations would specifically impact your business. If you would maybe start, Mr. Holmes. Tell me about the farmer in Australia and what would happen then if you had to then—if your credit was tighter and what that would mean to your business. And I know you just touched on this, but we have been in and out during the day. So if you could just for the record.

Mr. HOLMES. Well, if we weren't carved out as a nonmajor swap participant and we had to clear all of our transactions and post initial and variation margin or collateral, we would have to curtail significantly our hedging activities because—in my testimony, I indicated that our credit operation, which executes the majority of our derivatives, is prohibited from posting collateral under its indentures. And that prohibition will last as long as the debt is outstanding for up to 10 years.

So we would have to curtail our hedging activity and that would increase the volatility that we experience and ultimately the price of our goods that we sell internationally, as well as the cost of our financing for our customers both domestically and internationally.

Mr. MCMAHON. So the derivatives, the ability to hedge your risk is sort an oil in your tractor, so to speak, that allows it to run of your company, allows it—we are always looking for metaphors that we hope some reporter will write down. But it is your ability to function, to allow the goods and services to flow worldwide ultimately, right?

Mr. HOLMES. Absolutely. It helps us to smooth out our cash flows, which enables us to invest on a consistent basis. And that is a really important aspect.

Mr. MCMAHON. And there are some who think that you could—instead of using derivatives, you could do that by getting credit from a bank to—in lieu of—or at least post a margin by getting credit from a bank. What would that mean to your business?

Mr. HOLMES. Well—

Mr. MCMAHON. Could you get that credit in today's market? And what would it mean?

Mr. HOLMES. Certainly, credit availability and cost has changed since the credit crisis. So it would be very costly. We would have to raise hundreds of millions of dollars and keep cash on our balance sheet to meet margin requirements that instead could be productively employed in building factories and employing people.

Mr. MCMAHON. Thank you. Mr. Hixson?

Mr. HIXSON. I appreciate the chance to discuss this. In a local kind of example, maybe in your background or at least for your upstate brethren in their backyards. One, we have a large export grain facility in Albany, New York where we ship wheat out. Certainly when we ship wheat to Egypt out of there, we would want

to hedge the currency risk and the cost of doing that could be dramatically higher. And I think at times, we forget there are consumer benefits as well, particularly for the type of program I described in our kind of a distributor product for where we do a hedge for a heating oil.

Well, if you figure a small job where I may sell $1 million worth of heating oil in the northeast, the initial margin on that contract would typically be somewhere around 10 percent or so. So you have to post $100,000 of margin if you are that little guy out there doing this and you have the margin all the way through there. That would be expensive for that small business.

Mr. MCMAHON. Thank you very much. And thank you for your patience today. And just a shout-out to Mr. Ferreri who is a constituent of mine from Staten Island. Thank you, Mr. Chairman, for your indulgence and allowing me to be here today.

Mr. MOORE OF KANSAS. Thank you sir. And the Chair at this time recognizes Mr. Manzullo for a unanimous consent request.

Mr. MANZULLO. I ask unanimous consent that a statement from the International Swaps and Derivatives Association be made a part of the record.

Mr. MOORE OF KANSAS. Without objection, it will be received in the record. And I would like to thank each of the panelists for appearing here today and giving us your testimony, the benefit of your expertise and information on this subject that we are discussing here. 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 30 days for members to submit written questions to these witnesses and to place their responses in the record. Again, thanks to our panelists. And at this time, this hearing is adjourned.

[Whereupon, at 3:54 p.m., the hearing was adjourned.]

A P P E N D I X

October 7, 2009

EMBARGOED UNTIL DELIVERY
Wednesday, October 07, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Opening Statement for Derivatives Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services hearing entitled "Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness":**

"When viewed in the context of the proposal that had been previously put forward by the Administration on derivatives, Chairman Frank's discussion draft is an improvement in some respects.

"However, when viewed in the broader context of, "Exactly what problems are we trying to solve with several new layers of cumbersome bureaucracy over a huge part of our economy that had nothing to do with our recent financial troubles", the bill looks less attractive.

"The bill sets up a dual regulatory regime with the CFTC and SEC, two agencies which have a poor record of working together. Not only that, we're essentially setting them up to be prudential regulators, something they are not equipped to do, and which the SEC has already failed at, over non-financial companies that don't need prudential regulation.

"To me, that is a fundamental flaw with the basic structure of the bill.

"Rather than certainty, the clumsy multi-regulator approach to the derivatives market will breed widespread uncertainty – uncertainty that will reduce credit availability, hamper risk management, and cost jobs in the broader economy.

"And while end-users may like the direction this bill is headed from where it was, this legislation still sets up a regime with the authority to impose mandatory margin requirements.

"There is also still a mandatory clearing component that I fear could rush the cooperative buy-side, sell-side and regulatory efforts to responsibly address the central clearing issue, and could increase, rather than decrease the potential for systemic risk in the process.

"I have other concerns as well that I hope can be explored more thoroughly at today's hearing."

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Testimony of Christopher Ferreri
Chairman of the
Wholesale Markets Brokers' Association, Americas
Before the House Committee on Financial Services
October 7, 2009

Chairman Frank, Ranking Member Bachus, members of the Committee, thank you for inviting me to testify today on the reform of the over-the-counter (OTC) derivatives market. My name is Christopher Ferreri, and I am Chairman of the Wholesale Markets Brokers' Association, Americas (WMBA), an independent industry body representing the largest wholesale and inter-dealer brokers (IDBs) operating in the North American wholesale markets across a broad range of financial products. I am also Managing Director of ICAP, one of the founding member firms of the WMBA. I am testifying today in my capacity as Chairman and as a board member of WMBA.

Inter-dealer Brokers

Inter-dealer brokers provide a valuable service to the marketplace. We are, if you will, a broker's broker. We work with broker/dealers and other large financial institutions in the primary over-the-counter markets to execute their customers' orders, facilitate their proprietary/dealer trading and manage their exposure to risk. Inter-dealer brokers serve as intermediaries that facilitate access to OTC and exchange traded pools of liquidity across a full range of asset classes and their associated derivatives. Inter-dealer brokers also provide OTC market transparency through publication of unbiased and independent market data and pricing data before, during and after trades are executed. The information collected, maintained and generated by inter-dealer brokers provides a helpful tool to market regulators in monitoring for fraud and manipulation in the markets. Our members currently publish market information through a variety of readily accessible and subscription sources worldwide.

The inter-dealer broker markets operated with their usual efficiency during the worst days of the financial crisis, helping businesses access vital capital markets at a time of dire necessity. It is estimated that each day IDBs handle on average two million OTC trades globally corresponding to about $5 trillion in size across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms. Typical trading volume through inter-dealer brokers is approximately one-third of the total wholesale market volume in any given product type, with the remaining volume conducted directly between counterparties.

Chairman's Discussion Draft and the Treasury Department's Proposed Legislation

Mr. Chairman, we are supportive of the efforts to more effectively oversee the OTC markets for derivative financial products. No one knows better than us the unique challenge of aggregating liquidity and executing transactions in global markets for complex, non-commoditized financial instruments. We want to work with Congress and Regulators to ensure that the markets are functioning efficiently and fairly and that systemic risk in the overall marketplace can be adequately monitored. As the Committee considers how best to regulate the OTC derivatives market, we are confident that you will work carefully to be sure that there are not unintended, adverse consequences that could impede competition to the detriment of end users and other market participants.

We believe that the discussion draft and the Treasury Department's proposed legislation take an important step towards bringing additional regulation to the over-the-counter derivatives markets and that many of its requirements will integrate smoothly with the current practices of many inter-dealer brokers. We support the efforts taken thus far by the Administration and Congress to give the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") greater authority to implement new regulations for the over-the-counter markets.

As the Committee begins to formally consider the draft legislation, we have suggestions that we believe will enhance the OTC derivatives market to operate with enhanced safety and soundness protections without sacrificing the innovative and competitive environment that has fueled its growth. As an Association whose membership is comprised of rival inter-dealer brokers that make up over 90% of all inter-dealer broker trading with capital strength, technological framework and market sophistication, we agree that having robust competition in the trade execution sector brings advancement, improved quality of service and competitive pricing that ultimately benefits end users.

We would like to focus on two particular issues – the characteristics and responsibilities of what is termed a swap execution facility and the concept of open, neutral and non-discriminatory access to central counterparty clearing facilities.

Swap Execution Facility

Our objective as inter-dealer brokers is to continue to provide efficient and competitive wholesale intermediary services as we transition to a new regulatory structure. As we currently operate, it is clear that inter-dealer brokers would fulfill many of the criteria of the Swap Execution Facilities used for swap transactions under the draft legislation, or the Alternative Swap Execution Facilities under the Treasury Department's proposal.

The WMBA believes that the swap execution facility should exercise the same flexibility as do the various exchanges in terms of mode of execution, whether it be voice, 'hybrid', or fully electronic. The facility itself, and the products traded thereon, should have an equivalent status to that of an exchange for each mode of execution.

Much of what is contemplated for Swap Execution Facilities is already well within the advanced technological and record-keeping capabilities of our member firms. Our technology-based reporting systems can provide the CFTC, the SEC and banking regulators with real-time trading information, affording identification of: (i) suspicious trading activities, (ii) inappropriate levels of credit and market risk in given marketplaces and (iii) critical information on overall financial conditions and market dynamics. We also provide transparency into the over-the-counter markets through the publication of market and pricing data, facilitating enhanced audit trails, to monitor against market fraud and manipulation.

While WMBA members are certainly ready, willing and able to assist regulators in monitoring market activity and reporting suspicious trading activities within each inter-dealer broker, oversight of the market should occur at an institution with a more comprehensive view of the overall marketplace. The WMBA is concerned with the requirement that Swap Execution Facilities must undertake certain SRO (self regulatory organization) enforcement type responsibilities, including discretionary

supervision and approval of particular swap contracts as suitable for trading and the general oversight of the trading activities of our customers.

This is consistent with our concerns about the requirements set forth in the Treasury Department's proposed legislation for Alternative Swap Execution Facilities to adopt position limitations or position accountability for our customers. We therefore appreciate the Committee removing such a provision from the Chairman's discussion draft, because each WMBA member firm can only see the activities taking place on its platform.

Finally, we believe strongly that regulators or the relevant derivative clearing organization – and not swap execution facilities – should determine which swaps are "not readily susceptible to manipulation" and thus should be permitted to be traded on their platform. The "not readily susceptible to manipulation" standard comes from Section 2(a)(1)(C)(ii) of the Commodity Exchange Act ("CEA") and currently only applies to a limited group of futures contracts – namely security indices traded on both domestic and foreign boards of trade.[1] Under current law, both the SEC and the CFTC have to agree that this standard is met before an equity index future can trade, and both agencies typically consider a multitude of factors. Under the SEC's methodology, these factors include: (1) the number of securities off of which the price of the futures contract is derived; (2) the depth and liquidity of the secondary markets for these underlying reference securities and (3) the ability of the exchange or platform to conduct surveillance of the marketplace for the underlying securities.[2]

If such a determination is necessary before a swap trades, we recommend that the SEC and the CFTC - not a swap execution facility – make this determination. First, swap execution facilities are not capable of accessing or fully assessing comprehensive market data regarding the underlying rate, security, currency or commodity off of which comparable swaps are based. Furthermore, there are subjective judgments that would have to be made by competing execution facilities leading to different views about how susceptible various types of swap transactions may be to manipulation. As a result of these and other factors, having the SEC and the CFTC exercise this authority makes much more sense.

This is not to say that we cannot police activities on our platforms. We have the capabilities to monitor trading information for suspicious or manipulative trading activity and to report such activity to regulators or a third party that is able to develop a more comprehensive view of participants' activities in the aggregate. Additionally, our Members have each adopted procedures reasonably designed to detect and prevent violations of required trading practices. To use a simple metaphor, we can only supervise misbehavior in our own classrooms, but we cannot supervise misbehavior in other classrooms or on the playground.

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[1] The CFTC shares jurisdiction with the SEC over security futures products, but retains exclusive jurisdiction with regard to futures contracts on a group or index of securities that are not narrow-based under CEA Section 1a(25). *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 187 F.3d 713 (7th Cir. 1999) (noting that while both agencies participate in the process of reviewing applications to trade new financial futures contracts, and both must certify that it meets the statutory criteria, actual regulation of the trading process belongs exclusively to the CFTC).

[2] The CFTC's test is similar but more heavily weighs the requesting exchange's ability to access information regarding the stocks underlying the index.

Further, while all of our member firms have electronic platform capabilities, which assist in real time market control and oversight, the reality is that not all transactions benefit from being brokered and traded electronically. There are some products that require additional customer interaction to be brokered and traded due to their infrequent trading activity or particular product characteristics. This would include instances where more than one asset is traded simultaneously, such as circumstances where a bond future is executed on an exchange at the same time as the reference security itself, which is brokered OTC subject to securities laws, against an OTC interest rate derivative with similar maturity. This type of conditional cross-execution illustrates the range and complexity of the OTC environment and the absence in all cases of direct comparison with the exchange model - even though the two are interdependent.

Non-Discriminatory Access to Central Counterparty Clearing Facilities

To ensure that the markets remain efficient and liquid and that marketplaces continue to innovate, market participants need access to multiple execution platforms. We are encouraged that the legislation is now focusing on the suitability or eligibility of any given product for central counterparty clearing. Yet under a new regulatory regime that requires central counterparty clearing, there is a serious risk that central counterparty clearinghouses will create, modify and ultimately favor their own execution platforms over competing execution platforms by restricting access of competing execution facilities to their clearing operations. The Chairman's discussion draft and the Treasury Department's proposed legislation appear to have imported from the Securities Exchange Act of 1934 some of the competition and antitrust considerations relating to securities clearers in connection with the regulation of derivatives clearing organizations.

The WMBA would respectfully ask that you consider whether this is sufficient to promote and protect competition among execution platforms. A vertically integrated derivatives market, where a central counterparty providing clearing services also provides trade execution services, would be uncompetitive and ultimately hurt end users who need maximum liquidity in the market as well as other market participants. The differences between the securities and options markets on the one hand and the futures marketplaces on the other are a perfect illustration of the point.

As the Justice Department observed in a 2008 comment letter to the Treasury Department (included as an appendix to this statement), where a central counterparty clearing facility is affiliated with an execution exchange (such as in the case of US futures), that vertical integration has hindered competition in execution platforms that would otherwise have been expected to: result in greater innovation in exchange systems, lower trading fees, reduced ticket size, and tighter spreads, leading to increased trading volume and benefits to investors. As noted in the comment letter's summary, "the control exercised by futures exchanges over clearing services . . . has made it difficult for exchanges to enter and compete." In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. The absence of vertical integration has facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads, and high trading volume.

It seems clear from recent SEC/CFTC joint hearings that the agencies charged with oversight of these markets do not want to have a vertically integrated derivatives market. When appearing before the House Agriculture Committee, CFTC Chairman Gary Gensler said that the agencies are "trying to promote competition amongst exchanges and trading venues." He continued by saying "that a clearinghouse should not be vertically integrated in such a way with an exchange or trading platform

so that the only product they accept is from that exchange or trading platform." Establishing a regulatory framework that assures fungibility within the OTC derivatives market would ensure that this objective is attained.

To achieve this goal, the WMBA proposes that the resulting legislation will ensure that the central counterparty clearing companies who will be clearing derivatives trades must provide non-discriminatory access to all market participants. If the clearing entity also provides execution services, there is a tremendous opportunity and, quite frankly, an incentive for them to structure their services to squeeze out competition. Furthermore, competitors participating in the market for derivatives contracts will need access to the central counterparties to complete the transaction. If that central counterparty either directly or indirectly inhibits access to those firms, the ability to have a vibrant competitive marketplace will be severely restricted, to the detriment of end users, investors and the other market participants. In addition, such anti-competitive behavior would be very damaging to the members of the WMBA because they are in the trade execution business, and must rely on the clearinghouse to complete a cleared trade. In the equity and bond markets, the entity that provides clearing services does not provide execution services. That model has resulted in intense competition at the execution level to the benefit of all market participants.

In order to fully ensure that the central counter parties who will be clearing OTC swap transactions do not discriminate in providing access to its clearing services, the WMBA proposes that the legislation include a private right of action against any derivatives clearing organization that does not provide reasonable, non-discriminatory access to its clearing services or imposes any policy, procedure or process to the competitive disadvantage of any unaffiliated execution platform. Additionally, we would suggest that the legislation explicitly prevent any limitation on the right of any injured person to bring a civil action under the antitrust laws against a derivatives clearing organization for any anticompetitive act, practice or conduct. These would serve as effective deterrents to a derivatives clearing organization from unreasonably restraining trade or imposing an anticompetitive burden, and if such behavior were to happen, such a provision would permit a private party, whether it is an end-user, broker/dealer, inter-dealer broker, or other market participant, to prevent such unreasonable restraint from, in fact, taking place and causing irreparable harm.

Conclusion

Mr. Chairman, the discussion draft and the Treasury Department's proposed legislation are good steps towards bringing additional regulation to the over-the-counter markets and attempts to ensure that such regulation would be designed and implemented in a manner that helps to preserve the existence of a sound, efficient, liquid and more transparent OTC derivatives markets. Such a focused approach helps companies in the US and around the world to manage their risk in the safest and most cost efficient manner. We thank you and your committee for approaching this legislation with the serious attention it deserves, understanding that efficient capital and financial markets are essential for our nation's long-term prosperity. As the Committee progresses towards a new regulatory framework, we believe that the inter-dealer brokers can provide useful guidance, as we very effectively use clearing counterparties to effect our transactions and we have implemented robust record-keeping and reporting standards. The Wholesale Markets Brokers' Association, Americas looks forward to working with you to achieve these goals. Thank you for the invitation to participate in today's hearing.

APPENDIX

Comments of the Department of Justice before the Department of the Treasury
Review of the Regulatory Structure Associated With Financial Institutions
January 31, 2008

Before the
DEPARTMENT OF THE TREASURY
Washington, D.C.

Review of the Regulatory Structure Associated With Financial Institutions	:	TREAS-DO-2007-0018

Comments of
The United States Department of Justice

The Department of Justice ("Department") is pleased to submit these comments in response to the Department of the Treasury's ("Treasury's") request for comments on the Regulatory Structure Associated with Financial Institutions, 72 F.R. 58939, October 17, 2007.

SUMMARY

Based on its extensive experience investigating competitive conditions in various financial markets, including financial futures, options, and equities, the Department believes that certain regulatory policies governing financial futures may have inhibited competition among financial futures exchanges, potentially discouraging innovation and perpetuating high prices for exchange services.[1]

More specifically, the Department believes that the control exercised by futures exchanges over clearing services — including (a) where positions in a futures contract are held ("open interest"), and (b) whether positions may be treated as fungible or offset with positions held in contracts traded on other exchanges ("margin offsets") — has made it difficult for exchanges to enter and compete in the trading of financial futures contracts. If greater head-to-head competition for the exchange of futures contracts could develop, we would expect it to result in greater innovation in exchange systems, lower trading fees, reduced tick size, and tighter spreads, leading to increased trading volume.

In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. This lack of control appears to have facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads, and high trading volume.[2] Equities and options execution systems are also very sophisticated and feature-rich, more so than futures contract execution systems.

Although characteristics of the equities and options markets differ from those of financial futures markets, the clearing processes and related regulatory framework in equities and options markets appear to provide useful lessons in the futures arena. In light of the potential competitive benefits that could flow from regulatory changes that would facilitate competition in financial futures exchange markets, the Department recommends that Treasury propose a thorough review of futures clearing and its alternatives.

In these comments, the Department outlines its experience with competitive issues in financial markets and provides background information on futures markets. We then provide an overview of the competitive effects of exchange control of open interest, fungibility, and margin offsets, and how current policies may have inhibited execution competition. We specifically examine several failed efforts to enter financial futures markets and how efforts to enter were made more difficult by current clearing policies. We next discuss how options and equities clearing policies differ and have enabled beneficial trading venue competition. Finally, we consider whether there are significant benefits that can only be achieved under the current clearing arrangement.

I. THE DEPARTMENT OF JUSTICE'S EXPERIENCE WITH COMPETITIVE ISSUES IN FINANCIAL MARKETS

The Department's experience spans the spectrum of financial markets, including futures, over-the-counter derivatives, fixed income, foreign currency, equities and options. In various sectors, the Department has examined the underwriting process, front-end systems for delivering information and data to market participants, execution systems, clearing processes and settlement processes. We have conducted investigations of potentially anticompetitive behavior by market participants, analyzed the likely effect of proposed mergers, and reviewed claims relating to intellectual property rights. The following investigations are especially pertinent to the issues discussed herein.

Financial Futures. The Department recently conducted an exhaustive investigation of the competitive consequences of the Chicago Board of Trade's ("CBOT") acquisition by the Chicago Mercantile Exchange ("CME").[3] The investigation included examination of competition in futures markets, particularly financial futures where CBOT and CME both offered products.

Equities. In collaboration with the Securities Exchange Commission ("SEC"), the Department in 1996 investigated a quoting convention among Nasdaq market makers that had the effect of significantly increasing transaction costs.[4] Following these investigations, the SEC promulgated order-handling rules that made the securities order-execution process substantially more transparent.[5] The Department's recent experience also includes investigations of the Nasdaq/Instinet and NYSE/Archipelago mergers.

Options. Again in collaboration with the SEC, the Department in 2000 investigated and challenged an informal agreement among options exchanges not to list option contracts listed on another exchange.[6] That effort led to the

widespread listing of option contracts on multiple exchanges — spurring trading volume, increasing innovation, and significantly reducing trading costs in options. (7)

II. BACKGROUND ON FUTURES AND FUTURES TRADING AND THE ROLE PLAYED BY CLEARINGHOUSES

Futures were originally developed as a means of hedging risks in agricultural commodities. In the 1970's, CBOT and CME introduced the first futures contracts on interest rate products. Their products allowed purchasers to hedge against volatility in the cost of capital and, when equity index futures were first introduced in the 1980's, to hedge against volatility in stock indices. In the recent past, futures exchanges have developed new financial futures contracts that commoditize over-the-counter ("OTC") traded products, particularly interest rate swaps and credit default swaps.

These uses of futures contracts continue today. While some traders use futures to speculate on future price movements, many others buy futures to hedge various types of risk, taking positions in futures to balance a portfolio or to minimize the risk to their portfolio from future price changes. Such hedgers seek futures products that closely match the risk profile of the positions they hold, and for them the differences between OTC products and futures in terms of cost, transparency, accessibility, and liquidity means that OTC products are only rarely good alternatives. As a result, futures contracts that address a given risk profile, the 10-year Treasury note future, for example, cater to a distinct market demand.

For buyers and sellers, the most important aspect of trading cost in futures is a contract's bid/ask spread, which is primarily a function of the availability of ready and willing buyers and sellers. All else being equal, the more buyers and sellers, the more liquid a market, and the tighter the bid/ask spread. Such "spread costs" are several orders of magnitude greater than other costs buyers and sellers incur, including separate fees paid to exchanges for executing transactions.

Once a buyer or seller has executed against a price quoted on an exchange, contract novation occurs, with the clearinghouse stepping in to be the counterparty to both sides of the transaction. This clearing process,(8) in futures as well as equities and options, involves several steps. First, unless the trade is "locked in," the clearinghouse will compare the details of the transaction between buyers and sellers (or their brokers) to ensure the terms match.(9) The clearinghouse then aggregates related transactions of each member and identifies offsetting commitments, *e.g.*, buys and sells in the same instrument, to establish a member's net liability and the net liability of the clearinghouse. Futures (and options) clearinghouses also ensure satisfaction of the terms of the contract by becoming the counterparty on each side of every trade, thus guaranteeing contract performance.(10) Clearinghouses also ensure transactions are settled.(11) Futures clearinghouses protect themselves from loss by requiring a good faith deposit (initial margin) to the clearinghouse of the member firm, and additional deposits (maintenance margin) as the value of the underlying position varies.(12) Maintenance margin is set by calculating the value of outstanding contracts and

recording the value of maturing contracts. This process of "marking to market" effectively results in a revaluation (and settlement) of profits and losses of outstanding futures contracts on at least a daily basis.(13) By collecting additional margin, clearinghouses are able to cover prospective changes in the value of the portfolio.(14)

III. THE EFFECT OF CURRENT RULES AND POLICIES RELATING TO CLEARING OF FINANCIAL FUTURES ON COMPETITION AND CONSUMERS

Under the current regulatory regime, an exchange controls where a financial futures contract is cleared and whether the clearinghouse may treat contracts as fungible or eligible for margin offset. There is reason to believe that this structure, interacting with the importance to traders of exchange liquidity, makes it more difficult for exchanges to introduce new financial futures products capable of providing sustained head-to-head competition against existing products. Competition in futures markets has tended to be limited to the introduction of new products, with the competition occurring only briefly as multiple exchanges attempt to establish themselves. The typical pattern has involved one of these exchanges attracting almost all liquidity in the product, leading the other exchange to cease offering a directly competitive futures product.

If exchanges did not control clearing, an appropriately regulated clearinghouse could treat contracts with identical terms from different exchanges as interchangeable, *i.e.,* fungible. The incentives of such a clearinghouse would be to maximize its own profits, and it thus likely would treat identical contracts as fungible.(15) In a world of fungible financial futures contracts, multiple exchanges could simultaneously attract liquidity in the same or similar futures contract, facilitating sustained head-to-head competition. A trader could open a position on one exchange and close it on another.(16) In such a world, a trader could execute against the best price wherever offered without fear of being unable to exit the position because there is insufficient trading interest (or of being forced to exit at a poor price) on the new entrant trading venue when a trader chooses to exit.(17)

In addition, if exchanges did not control clearing, an appropriately regulated clearinghouse could reduce member margin obligations by recognizing offsetting positions in correlated financial futures contracts traded on different exchanges. The ability to offset correlated positions in a futures clearinghouse can significantly reduce the capital required to trade. For example, CME's clearing division — where the vast majority of statistically price-correlated financial futures positions are currently consolidated — offers its members margin offsets for related asset classes, thereby reducing risk collateral requirements, which results in savings to buyers and sellers unavailable on other exchanges.(18)

Accordingly, we would expect that a change in the regulatory regime that eliminated exchange control of the clearing function would facilitate the emergence of greater competition between exchanges. The CFTC's regulatory policies, which have permitted exchange control of clearing, are not mandated by the Commodities Futures Modernization Act of 2000 ("CFMA"). We therefore

urge Treasury to propose a thorough review of futures clearing and its alternatives, including a careful examination into whether a regime more similar to that in the equities or options markets is feasible and would lead to significant consumer benefits.

A. Current Regulation and Policy on Financial Futures Clearing

Today, exchanges control clearing of financial futures contracts. The current structure of financial futures markets in the United States was put in place in the early 20th century when the Chicago Board of Trade Clearing Corporation ("BOTCC") began intermediating agricultural futures contracts on behalf of CBOT, thus assuming the risk of non-delivery from the exchange.[19] When futures exchanges subsequently were subject to regulation with the enactment of the Commodities Exchange Act ("CEA"), no provision of that statute expressly granted CFTC authority to regulate futures clearing. What regulation there was of clearing had developed indirectly through the CFTC's oversight of those futures exchanges that had affiliated with clearing systems.[20] When financial futures products were introduced in the 1970's, the CFTC maintained its approach to clearing and thereby did not prohibit the application of the then-prevailing exchange-controlled clearing model to financial futures.

The CFMA[21] revamped the futures regulatory structure, giving the CFTC explicit authority over clearing in futures markets and creating a new requirement that clearinghouses register with the CFTC. As a result, the CFMA, for the first time, provided for the separate regulation of execution and clearing.

The CFMA required the CFTC to conduct a study of the CEA and the Commission's rules and orders governing the conduct of registrants under the Act.[22] In its Report, the CFTC noted that a number of commenters had raised issues relating to clearing, including the desirability of changes in regulatory policy that would permit futures contract fungbility and require clearinghouses to be independent of the exchanges for which they clear.[23] The CFTC concluded that the CFMA did not mandate a change in its traditional policy of exchange-controlled clearing.[24] Recognizing the importance of the issue, however, the CFTC did announce a plan to conduct a roundtable of industry participants, at which the CFTC's role in encouraging competition in the futures industry, including common clearing and fungibility were to be primary issues.[25] At those hearings, a variety of industry participants, including representatives of the Futures Industry Association, major futures firms, and some exchanges called for an end to exchange control of clearing.[26] The CFTC did not take formal action in response to these requests to end exchange control of clearing, but it has since approved CBOT Rule 701.01, which required CBOT members to transfer open interest from BOTCC to CME Clearing and thereby gave CBOT ongoing control of futures contracts.[27]

The Department believes that adopting a regulatory policy that fosters exchange competition by, *inter alia*, ending exchange control of financial futures clearing would be consistent with the objectives of the CFMA. The CFMA directs the

CFTC to prevent the adoption of exchange or clearinghouse rules that unreasonably restrain trade or impose a material anticompetitive burden on the markets,[28] and directs the CFTC to facilitate the linking of futures clearinghouses with other regulated clearance facilities.[29] In the Department's view, these provisions reflect Congress' desire to stimulate competition between exchanges and between clearing organizations.

B. The Current Market Structure Has Impeded Successful Entry.

Under the current clearing framework, competition tends to be limited to that which occurs when a new contract, *i.e.*, one addressing a market risk not addressed or not adequately addressed by existing products, is introduced. The introduction of a new contract by one futures exchange frequently prompts another exchange to offer a similar contract, and a battle to garner all the liquidity in the contract ensues. After one exchange wins most of the liquidity in the contract, the other exchange usually exits. In its investigations, the Department has found that, in each significant financial futures contract traded in the United States, one exchange has virtually all of the liquidity. Using the 10-year Treasury note future as an example, CME has a market share of essentially 100%. The "winner-takes-all" character of futures exchange competition is a function of liquidity: the more liquid the market, the greater the chance of execution at favorable prices. As a result, the market for a particular contract will tend to concentrate on a single exchange. This in turn gives the exchange a marked advantage over smaller firms and new entrants.[30]

While network effects provide a significant impetus toward the concentration of trading in any particular type of futures contract on a single exchange, they are not by themselves an insurmountable barrier to competition. Liquidity network effects of this sort have been successfully overcome in financial markets where regulatory policy facilitates competition among exchanges.[31] In financial futures markets, however, efforts by competitors to overcome an initial liquidity disadvantage are further handicapped by the liquidity advantages of incumbent exchanges that flow from their control of clearing. Specifically, the Department believes that the control of clearing by incumbent futures exchanges prevents buyers and sellers from accessing *existing* liquidity if they trade the same (or highly correlated) contract on another exchange, thereby making it significantly more difficult for entrants to gain sufficient liquidity to provide sustained competition with the incumbent.

Efforts over the last decade by exchanges to enter the U.S. financial futures markets with products that competed head-to-head with existing products, all of which failed, show the effect of exchange-controlled clearing and the potential competitive benefits of successful entry. In a number of instances where entry has been attempted, the prospect of entry forced a substantial, but only temporary, competitive response from the incumbent exchange. These competitive responses benefitted the market, but those benefits proved transitory because, under the existing regime of clearing, the entrant was unable to establish sufficient liquidity to maintain a sustained competitive presence and exited the market.

BrokerTec's entry into Treasury futures.

BrokerTec Futures Exchange ("BTEX") was formed in 2000 as a joint venture of several large investment banks.[32] It listed futures and options on futures electronically in the Treasury bond and note complex, competing directly against the CBOT. An affiliated company, BrokerTec Clearing Company, cleared its transactions. BrokerTec Clearing members were allowed margin offsets for positions opened at CBOT in U.S. Treasury futures at CBOT, but CBOT did not respond to BTEX's request that it amend its margin rules to permit its clearinghouse, BOTCC, to reciprocate.[33] As a result, buyers and sellers on BTEX were required to bear the increased costs of posting capital for offsetting CBOT and BTEX positions when those positions were held on BOTCC, but not when those positions were held in BrokerTec Clearing. The prospect of electronic competition from BTEX spurred CBOT to enter into a joint venture with Eurex on an electronic futures trading platform in the United States, causing a significant shift to electronic trading in Treasury futures contracts, and reducing fees.[34] The shift to electronic trading, in turn, resulted in increased trading volume.[35] BTEX failed to attain any meaningful share of the Treasury futures market and was subsequently purchased by Eurex US.[36]

Eurex US' entry into Treasury futures.

In January 2003, CBOT announced its plan to dissolve its electronic trading platform joint venture with Eurex and obtain platform services from another vendor. Eurex in turn announced its intention to provide an electronic Treasury futures exchange in competition with CBOT once the parties' non-compete agreement expired in February 2004.[37] To facilitate this entry, Eurex was widely believed to be in discussions with BOTCC, which was CBOT's clearinghouse at the time, to clear its futures contracts.[38] This ultimately resulted in CBOT entering into an agreement with CME for clearing of CBOT traded futures.[39] That contract required the transfer of open interest from BOTCC to CME Clearing.[40] This requirement was transmitted to the CFTC on July 2, 2003, in the form of a rule proposal and approved shortly thereafter.[41]

Against this backdrop, Eurex's attempted entry was unsuccessful. Eurex's subsidiary, U.S. Futures Exchange, LLC. ("USFE"), was approved by the CFTC as a new exchange in February 2004 and began listing futures and options on futures on Treasury bonds and notes shortly thereafter.[42] Eurex invested significant funds into the Treasury product — in the form of market making and other trading incentives — in an attempt to attract liquidity to its platform.[43] While USFE's application to offer exchange services was pending before the CFTC, CBOT announced that it was cutting transaction fees 54% for members and 20% for non-members.[44] Subsequently, CBOT reduced its electronic trading fees for its U.S. Treasury complex even further — exchange members received a six-month fee waiver (effectively taking their fee to zero), and non-member fees were reduced to 30 cents per side for futures and fifty cents per side for options on futures, a reduction of about 65%.[45] CBOT also announced a liberalization of

membership requirements to allow more firms to qualify as members and receive the lower membership fees.[46]

Despite these procompetitive responses by CBOT, USFE had some initial success, gaining about five percent of the market. By mid-2005, however, USFE admitted defeat, stating that its window of opportunity for Treasury products had passed and that it was turning its attention to foreign exchange futures.[47] Shortly after USFE's announcement, CBOT raised its fees for non-member trades by 50% and its fees for electronic transactions from three to five cents a contract.[48] In July 2006, CBOT raised clearing fees for its financial futures contracts.[49] CBOT raised exchange fees again in October 2006 for non-member trading of its Treasury complex.[50]

Euronext.Liffe's entry into Eurodollars

In late 2003, it was widely believed that CME would face competition from a European futures exchange in its core Eurodollar futures contract.[51] In anticipation of this entry, CME reduced its electronic system trading fees by 60% for CME members, clearing members and their affiliates.[52] It also established a market maker program on Globex — its electronic trading system — to provide market quotes after business hours, which it extended to regular business hours in March 2004.[53] Later it waived fees for certain large traders.[54] In March 2004, Euronext.Liffe announced that it planned to enter the market. Euronext's Eurodollar contracts would be available world-wide on Liffe.Connect — its electronic trading platform — and cleared through LCH-Clearnet, a London-based clearinghouse.[55] Margin offsets would be available with Euronext's principal contract — the European equivalent to the Eurodollar.[56]

By June 2004, Euronext appeared to have achieved significant success, with the execution of several large block trades that amounted to a large scale transfer of open interest in Eurodollar contracts from CME to LCH.[57] However, CME was able to block further transfers by adopting a rule, under its authority as a self-regulatory organization, that forbade such trades as "fictitious."[58] The rule was certified as consistent with the CEA by the CME, such that it went into effect immediately. Liffe challenged CME's action before the CFTC; the CFTC sought information from the parties to the dispute, but has not ruled on the merits.

Euronext.Liffe's failure illustrates the difficulty of entering U.S. futures markets against an established incumbent with entrenched liquidity. Despite Euronext.Liffe's substantial European presence and margin offset opportunities in a comparable product, its entry failed because the U.S. incumbent was able to prevent the transfer of open interest. Nevertheless, the temporary benefits of its attempted entry were substantial. In addition to a significant lowering of trading fees, Euronext-Liffe's entry resulted in significantly reduced bid-ask spreads and increased trading volume.[59] It also resulted in a substantial shift to electronic trading in Eurodollars.[60]

While Euronext continues to list Eurodollar contracts, since early 2005 it has not had a significant competitive presence in Eurodollar products, as there has been almost no open interest in Euronext's contracts and no trading volume. CME was able to raise both clearing and execution fees on August 1, 2005.[61]

* * *

One lesson of this brief history is that when entry into an existing product by a second exchange has occurred, there have been substantial beneficial effects — whether in lower prices, increased innovation, or expanded choice. Another lesson is that exchange control over open interest and clearing have impeded entry and the development of meaningful competition in execution services.[62] Given the benefits of exchange competition, examining potential changes in regulatory policy appears warranted, unless it were clear that there are no viable alternatives to the current financial futures structure or that the current structure provides overriding benefits that justify its retention. Whether there are equally good alternatives can be informed by examination of the equities and options markets, which we examine in the next section. Section D below considers whether there are clear benefits that are achievable only under the current clearing framework.

C. Equities and Options Exchanges Have Different Execution/Clearing Structures That Have Facilitated Exchange Competition

Clearing arrangements in other financial sectors facilitate exchange competition.

Options. The options market has a single regulated utility — the OCC — which serves as the clearinghouse for all exchanges and their members. The OCC was formed in 1973 when the Chicago Board Options Exchange listed the first stock option. In 1975, when the American Stock Exchange sought to offer an option on other stocks, the SEC directed that the OCC clear its trades. As a result of SEC policy, the OCC, jointly owned by the options exchanges, clears all option trades. In addition, in 1990, the SEC adopted Rule 19c-5, which permitted option exchanges to list equities options listed on another exchange.[63] The listing of options by multiple exchanges was (and is) possible because the OCC substitutes its capital and resources for those of the parties in every transaction — becoming the buyer to every seller and the seller to every buyer. Because the clearinghouse serves as the universal counterparty, market participants can open a position on one exchange and close it on another. Because contract terms are generally set by the OCC,[64] options contracts traded on one exchange are completely fungible with those traded on another.

Rather than conform to the directives of Rule 19c-5, the then-four options exchanges reached an understanding with one another to refrain from listing equity options classes that were already listed on another exchange. As a result, many frequently traded equity options were traded only on one exchange for most of the 1990s, like futures contracts are today. Since the summer of 1999, when SEC and Department investigations became public,[65] options exchanges have actively competed in the listing of equity options. The benefits of this competition have been substantial and lasting.

Two new options exchanges have entered the market, one of which — the International Stock Exchange — has become the largest options venue. Spreads narrowed by 30-40% within six months of its entry,[66] and have continued to fall since.[67] With this competition, options volume is growing rapidly. Approximately 200 million contracts trade per month, more than four times the average monthly volume in mid-1999,[68] and, as of 2006, all of the six options exchanges were experiencing increased growth with no single exchange having more than a third of the total volume. In addition, the average trade size has been increasing, suggesting increased involvement of institutional investors in what historically was a market dominated by retail investors.[69] Increases in trading volume have even occurred in times of decreasing market volatility — times when options trading historically has decreased.[70] Moreover, new trading systems have proliferated, execution fees have been substantially reduced, and exchanges have developed a host of service and system innovations to expedite order execution and settlement.[71]

Equities. In the 1960s, when regional exchanges provided alternate venues for trading stocks listed on NYSE, clearing functions were operated by each exchange, as they are now in futures markets. With the Securities Act Amendments of 1975, the SEC was directed to facilitate a national system for clearance and settlement of securities transactions. Congress' objective was that the several clearing systems be interconnected and operate under uniform rules.[72] Shortly after the amendments, the NYSE, Amex and NASD agreed to establish a jointly owned entity to take over their clearing operations, which led to the incorporation of the NSCC. In approving the NSCC's application for registration as a clearing agency, the SEC imposed a number of conditions, including requiring NSCC to establish appropriate links to the regional exchanges' clearing agencies.[73] Over time, regional exchanges have discontinued their clearing operations in favor of clearing through the NSCC.[74] In addition, at the SEC's direction, exchanges submitted rules which provided for the recision of any rules tying the clearance and settlement of transactions to clearing agencies affiliated with the marketplace.[75]

Like options market clearing, equities clearing facilitates exchange competition. When a trade occurs, the parties to the trade provide the exchange or electronic venue with the name of their registered clearing brokers who are, in the first instance, responsible for contract performance.[76] The transaction is then sent to the NSCC which clears for almost all equity exchanges and electronic trading venues in the U.S. Securities held by NSCC members that can be transferred within the Depositary Trust Co. are eligible for continuous net settlement at the NSCC. NSCC then becomes the counterparty to each trade, guaranteeing that both the obligation to deliver securities and the obligation to make payment. As a result, once listed on an exchange, a stock may be traded on multiple trading venues, with a market participant purchasing it on one venue and selling it on another.[77] The process is subject to SEC regulation.

This structure — and its regulatory overlay — permits multiple exchanges and electronic trading venues to offer the same or equivalent instruments. There is

significant competition among multiple equity trading venues, with low execution fees, narrow spreads, and widespread system innovation — all to the benefit of consumers.[78] One study found that the NYSE's entry into trading of ETFs led to double-digit percentage declines in bid-ask spreads.[79]

The Department recognizes that there are significant differences in equities, options and futures trading. Nevertheless, the experience in options and equities markets appears to provide useful lessons for the potential role of exchange competition if regulatory policy relating to clearing by a futures exchange were changed.

D. There Do Not Appear to Be Any Overriding Benefits of Preserving the Current Regime of Futures Clearing.

The Department is aware of three principal arguments in favor of the current regime of exchange controlled clearing in futures markets: (1) that sufficient reward to promote innovation can only be assured if replica contracts are kept off the market and that exchange controlled clearing helps achieve that objective;[80] (2) trading of futures on multiple exchanges could adversely affect traders by fracturing liquidity and diminishing market depth; and (3) the current system minimizes the risk of default.

The first contention, that the current structure is necessary to provide exchanges an incentive to innovate new futures contracts, boils down to the contention that competition is inconsistent with incentives to innovate. In fact, however, experience indicates that competition can spur firms to innovate by developing new products or making their existing products more attractive (including though product change as well as reduced prices and improved quality).[81] Thus, any study of regulatory change that would eliminate exchange control of clearing would need to consider the important incentives that may be created by competition.

A second argument offered in favor of preserving the current regime is that a change in regulatory policy that would facilitate the trading of futures contracts on multiple exchanges would adversely impact buyers and sellers by fracturing liquidity, diminishing market depth and price transparency, and by making it more difficult for buyers and sellers to find the best price to execute transactions. The market response to Eurex's and Euronext.Liffe's suggests that such concerns are not well founded. In both cases, new entry coincided with substantial *increases* in trading activity in the products traded.[82] Experience with new entrants in the options and equities markets is to the same effect. In each case, market volumes increased and all indicators of market performance — fees, volume, spreads — either improved or did not change. Indeed, experience in options markets suggests that the likely effect of a change would be significantly lower exchange fees, narrower spreads, and greater trading volume.

A third argument is that the current system reduces risk to the market of participant default as transparency of market exposure is enhanced when related market positions of individual customers can be captured in one place. Exchange

control of where products are cleared, however, does not appear necessary to achieve this result. Both the options and equities models have successfully protected investors from default.[83]

IV. CONCLUSION

The Department believes that current rules and policies related to clearing futures contracts may be unnecessarily inhibiting competition among futures exchanges in the development and trading of financial futures contracts, to the detriment of the economy and consumers. Unnecessary restraints on competition threaten the ability of the U.S. financial markets to adapt to changing dynamics, including the increasingly global nature of those markets.

The Department believes that significant benefits might be achieved if regulatory policy were changed so as to foster exchange competition by, *inter alia*, ending exchange control of clearing (in conjunction with appropriate regulation to ensure that clearinghouses could not in turn exercise market power). The clearing structure and regulatory framework in the equities and options markets are instructive. If regulatory policies that encourage and facilitate exchange competition were adopted, futures clearinghouses would likely clear for multiple exchanges and treat identical contracts as fungible.[84] Futures exchanges would, in turn, compete in terms of price, quality of execution systems and the speed and completeness of information available to market participants. Futures markets would become more transparent and market risk would likely be more widely distributed as new participants are attracted to trading opportunities in the futures markets. The Department therefore recommends that Treasury undertake a careful and objective review of exchange-controlled clearing of financial futures, the regulatory structure that underlies it, and its alternatives.

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FOOTNOTES

1. Our comments are directed solely at competitive issues raised by financial futures markets. Markets for commodities futures, such as energy futures markets, are outside the scope of this comment.

2. As discussed below, clearing in options is through the Options Clearing Corp. ("OCC") and clearing in equities is largely through the National Securities Clearing Corp. ("NSCC"). The Department, in filing this comment, does not address the competitiveness of *clearing markets* in equities, options, or futures. Rather, the focus of this comment is on the effect current futures clearing policy has on the competitiveness of trade execution markets.

3. The Department ultimately determined that, although the two exchanges account for most financial futures (and, in particular, interest rate futures) traded on exchanges in the United States, their products are not close substitutes, seldom competed head-to-head, and that the parties were unlikely to introduce new products that competed directly with the other's existing products. *See Statement of the Department of Justice Antitrust Division on its Decision to Close Its Investigation of Chicago Mercantile Exchange Holdings Inc.'s Acquisition of CBOT Holdings, Inc.*, June 11, 2007 (http://www.usdoj.gov/atr/public/press_releases/ 2007/223853.htm).

4. *United States v. Alex Brown & Sons, Inc. et al.*, Civ. No. 96-5313 (S.D.N.Y. filed July 17, 1996). U.S. Securities Exchange Commission, *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 regarding the NASD and Nasdaq Market* August 8, 1996.

5. S.E.C. Release 34-37619A, *Order Execution Obligations* 1996 WL 506154 at 9 and 27 (S.E.C. Sept. 6, 1996) (discussing the investigations). The Limit Order Display Rule requires that market makers display investors' limit orders when they are priced better than the market maker's quote. The Quote Rule requires market makers to publically display their most competitive quotes.

6. *United States v. American Stock Exchange, LLP, et al.*, Civ. No. 00-2174 (D.D.C. filed September 11, 2000) and SEC Release 43,268 *Order Instituting Public Administrative Proceedings Pursuant To Section 19(h)(1) Of the Securities Exchange Act Of 1934* (S.E.C. Sept. 11, 2000).

7. *See* Patrick De Fontnouvelle, Raymond P.H. Fishe, and Jeffrey H. Harris, *The Behavior of Bid Ask Spreads and Volume in Options Markets During the Competition for Listings in 1999* 58 J.of Fin. No. 6 (Dec. 2003) and S.E.C. Release 34-49175, *Concept Release: Competitive Developments in the Options Markets* 69 FR 6124 (S.E.C. Feb. 3, 2004).

8. Clearing is performed by an organization (or clearing division of an exchange) created to clear and settle all the transactions within a market or on an exchange. Its members (usually large securities firms) deal directly with the clearinghouse but also act as intermediaries for other securities firms in clearing their trades.

9. Matching is unnecessary for locked in trades. Almost all equities trades are locked in when reported to the clearinghouse, because the terms of trade are captured by the electronic system on which the trade occurs. Many options trades and futures trades are also locked in.

10. To fulfill this role, the clearinghouse maintains a list of traded products, trade terms and persons eligible to trade each product.

11. Settlement is a reference to completion of a transaction by, in equities, delivery of securities to the buyer and payment to the seller or, in futures and options, carrying out the terms of the contract or offsetting it. The vast majority of futures contracts are closed out before they reach expiration as the risk exposure of the holder changes and settled for the difference in cash value between the future and the underlying asset. For those that expire, *i.e.,* mature, they may be either cash settled, like the Eurodollar futures contract, or require delivery, like various Treasury futures, depending on contract terms.

12. In futures markets, both the buyer and seller must provide initial and maintenance margin. In options markets, only the writer of the option must do so. Clearinghouses will engage in various forms of market surveillance to manage and contain risk to the market.

13. By comparing a commodity's settlement price yesterday versus its settlement price today a clearinghouse can establish a value for outstanding futures contracts and determine whether changes in market value require further contributions to a member's margin account.

14. CME's clearing division alone held more than $46 billion in performance bonds in 2005. Whereas security deposits serve as a back-up source of funding in the event of a clearing member default, margin or performance bond requirements are the principal guarantor of performance

15. Indeed, in 2003, the Board of Trade Clearing Corporation ("BOTCC") sought to position itself to clear futures contracts for more than one exchange. *See* note 39, *infra.* One way in which regulators have fostered independent clearing is by prohibiting tying of clearing services to trade execution services, as the SEC has done with equities. *See* note 75 and accompanying text, *infra.*

16. When a clearinghouse assumes the performance obligation, by substituting its capital and resources for those of the parties to the initial transaction, market participants become indifferent to the creditworthiness of the opposite party to the trade and can base their buy or sell decision on other considerations. Because the clearinghouse serves as the universal counterparty, market participants can close out their positions and exit the market without having to seek out the original parties (or the original exchange) to their opening trades. This buying and selling of contracts that have not matured — the "open interest" in that instrument — constitutes the secondary market for that instrument.

17. The liquidity advantage has been made less significant in equities markets by trading venue guarantees to route transactions to markets with the best prices.

These sophisticated routing systems have effectively linked the liquidity on different venues creating a single "virtual" liquidity pool.

18. When CME and CBOT combined their open interest in 2003, they claimed that the combination resulted in $1.4 billion reduction in performance guarantees for its members and $200 million in reduced security deposits. *Q3 2003 Chicago Mercantile Holdings, Inc. Earnings Conference Call,* Fin. Disclosure Wire, Nov. 5, 2003, at 8. Consolidated clearing offers other efficiencies, including reductions in clearing fees, the cost and frequency of collateral movements, the number of bank transfers, the cost of intraday funding, systems development and maintenance, and employee training costs associated with having to interface with multiple, discrete clearing systems.

19. *See* James T. Moser, *Contracting Innovations and the Evolution of Clearing and Settlement Methods at Futures Exchanges* Federal Reserve Bank of Chicago, Working Paper 98-26 (August 1998).

20. The President's Working Group on Financial Markets Report, *Over-the Counter Derivatives Markets and the Commodity Exchange Act* Nov. 1999 at 15.

21. The CFMA generally followed the recommendations contained in the Working Group's report. Congressional Research Service Report, *The Commodities Futures Modernization Act (P.L. 106-554)* Cong.R.S. 20560 (Feb. 3, 2003) (http://www.assets.opencrs/rpts/RS20560-20030203.pdf).

22. 7 U.S.C. §1 *et seq.* (2000).

23. U.S. C.F.T.C., *Report on the Study of the Commodity Exchange Act and the Commission's Rules and Orders Governing the Conduct of Registrants Under the Act* (C.F.T.C. June 2002) at 23-24 (http://www.cftc.gov/files/opa/opaintermidiarystudy.pdf).

24. *Id.* at 24. It concluded that: "The Act and Commission rules do not prevent the adoption of fungibility or common clearing. Nor do they require that the Commission mandate them."

25. *Id.* at 24. The CFTC Chairman at the time, James Newsome, saw efforts to move the industry to common clearing and fungibility as a business issue that he preferred the opposing sides (futures commission merchants and futures exchanges) work out between themselves. Richard Tsuhara and John McPartland, *Clearing Structure of the Derivatives Markets: We're Not in Kansas Anymore* 23 Futures & Derv.L.R.1, 4, Oct. 2003.

26. U.S. C.F.T.C., *Roundtable on Derivatives Clearing Organizations* (C.F.T.C. Aug. 1, 2002) (http://www.cftc.gov/stellent/groups/public/@aboutcftc/doocument/file/gmac_060604_transcript.pdf).

27. C.F.T.C. Release 4821-03, *CFTC Announces Approval of Exchange Rules Implementing CME/CBOT Common Clearing Link* (C.F.T.C. July 15, 2003)

(http://www.cftc.gov/opa/press03/opa4821-03.htm).

28. Core Principle 18: Antitrust Considerations — Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid —

A. adopting any rules or taking any actions that result in any unreasonable restraints of trade; or

B. imposing any material anticompetitive burden on trading on the contract market.

29. The CFMA added Sec. 5b(f)(1) to the CEA Act which provides: "The Commission shall facilitate the linking or coordination of designated clearing organizations registered under this Act with other regulated clearing facilities for the coordinated settlement of cleared transactions."

30. Trading on a single exchange can also reduce market participant costs by facilitating "spread trading," the taking of simultaneous offsetting positions in two correlated products, in effect betting on the relative price movements (or "spread") between the two products. Currently, traders can conduct spread trades across different exchanges' products by using third-party trading software. Such third-party supported spread trading entails, however, "execution risk," the possibility that one leg of the spread trade will not find a counterparty. When both products that compose the spread are offered on a single exchange, execution risk can be eliminated by allowing the offsetting transactions to trade as a single product, such that neither leg executes unless both execute.

31. In two years, BATS has acquired approximately 10% of equities trading volume. Luke Jeffs, *BATS Eyes European Markets* FinancialNewsOnlineUS, Oct. 29, 2007 (http://www. financialnews-us.com/? contentid=2449054173&page=ushome). In the options markets, the International Stock Exchange entered in 2000 and by April 2003 had become the largest U.S. equities options exchange. *ISE Secures Position As Largest US Options Exchange* Mondo Visione, May 2, 2003 (http://www.mondovisione.com index.cfm? section=news&action detail&id=423113)

32. Richard Tsuhara and John McPartland, *Clearing Structure of the Derivatives Markets: We're Not in Kansas Anymore* 23 Futures & Derv.L.R.1, 3-4,Oct. 2003.

33. Christopher Faillo, *New Leaders at BrokerTec Clearing Co.* Hedgeworld Oct. 2, 2002, (2002 WL 276971). BOTCC processed trades for BTEX members on a contract basis, but did not guarantee performance. *BrokerTec To Launch Futures Trading* Secs. Week Vol. 28 Issue 45 Nov. 12, 2001 (2001 WLNR 2076105). BOTCC is now known as The Clearing Corporation.

34. *BrokerTec Futures Shuts Down After Two Years* Secs. Week Vol. 30 No. 46 Nov. 17, 2003 (2003 WL 3215306). Electronic trading accounted for only about 20% of the volume of CBOT Treasury bond and note futures in late 2000. By the end of 2001, almost 45% was electronically traded. Gordon Platt, *Chicago faces*

bleak future as online trading deposes open outcry system Global Finance Vol. 16. Issue 2 Feb. 1, 2002 (2002 WLNR 11583314).

35. Electronic execution makes futures trading more attractive because it increases the certainty of a trade at a desired price, thus making it easier to hedge. Gordon Platt, *Chicago faces bleak future as online trading deposes open outcry system* Global Finance Vol. 16. Issue 2 Feb. 1, 2002 (2002 WLNR 11583314).

36. *See* John Lothian, *Eurex US's Great Trade that Benefitted the Industry*, June 24, 2005 (http://www.pricegroup.com/newsletter/062405.htm).

37. Jeremy Grant, *Eurex to launch new derivatives exchange in U.S.* Financial Times UK, Jan. 10, 2003 (2003 WLNR 8225039). Euronext.Liffe was announced as the new platform provider for CBOT. *Id.*

38. Nothing prevented BOTCC from treating Eurex products as fungible with CBOT's, or from allowing members to offset, in their margin accounts, positions taken in Eurex contracts with those taken in CBOT Treasury contracts. *CBOT in talks with BOTCC over Contract* FT Investor Feb. 14, 2003.

39. CBOT demanded BOTCC enter into an exclusive clearing agreement (thereby protecting the open interest that had originally been executed on the CBOT exchange). When BOTCC did not respond, CBOT began negotiating with CME. *Eurex is said to be 'in talks' with almost everyone — but nobody's talking* Secs. Week Vol. 30 Issue 19 May 12, 2003 (2003 WLNR 3220693).

40. Sections 8 and 10.5 of the Clearing Services Agreement, April 16, 2003. (Available, in redacted form, as Exhibit 10.3 to Chicago Mercantile Exchange Holdings, Inc. Form 10-Q (http://www.sec.gov/archives/edgar/data/1156375/000104746903027031/a2116188zex-10_3.htm). Section 3.3 of that agreement gave CBOT sole authority to determine whether contracts initially traded on CBOT could be risk offset or treated as fungible with any other exchange's contracts.

41. C.F.T.C. Release 4821-03, *CFTC Announces Approval of Exchange Rules Implementing CME/CBOT Common Clearing Link* (C.F.T.C. July 15, 2003) (http://www.cftc.gov/opa/press03/opa4821-03.htm).

42. C.F.T.C. Release 4886-04, *CFTC Designates New Exchange* (C.F.T.C. Feb. 4, 2004) (http;//www.cftc.gov/opa/press04/opa4886-04.htm). Eurex went forward with its plans, notwithstanding the transfer of CBOT's open interest to CME, apparently on the expectation that it would be able to undercut CBOT's execution fees and offer market participants the ability to offset its U.S. product offerings with its European parent's product offerings. Its proposal to create a single collateral pool for U.S. and European products was never approved by the CFTC. Terry Stanton, *Eurex to offer FX Futures* Hedgeworld Daily News June 16, 2005 (2005 WLNR 9582048).

43. David Roeder, *Eurex Planning to Take on Merc in Currency Trade* Chicago Sun Times June 17, 2005.

44. Jeremy Grant,*CBOT to cut fees to fend off Eurex* Financial Times Oct. 21, 2003 (2003 WL 64595399).

45. Daniel Collins, *Eurex US is approved; Chicago operation launched* Futures Vol. 33 Issue 4 Mar. 1, 2004 (2004 WLNR 14802623).

46. *New CBOT Rule Allows CPOs and Large Funds to Become Exchange Members* Sec. Week Vol. 30 Issue 36 Sept. 8, 2003 (2003 WLNR 3171430).

47. Yesenia Salcedo and Daniel Collins,*Eurex US Moving Into Forex* U.S. Futures Magazine Vol.34 No. 10 Aug. 1, 2005 (2005 WLNR 13603573). In August 2006, Eurex sold 70% of USFE to ManGroup PLC. In announcing the deal, executives of ManGroup stated that they planned to focus USFE trading on new products, not traded elsewhere. US Futures Exchange Press Release, *Media Release of Man Group plc and Eurex* July 27, 2006 (http:// www.usfe.com/press.html).

48. Andrei Postelnicu,*CBOT lifts fees for US Treasury Contracts* FinancialTimes UK Aug. 30, 2005 (2005 WLNR 13587617).

49. *CBOT raising grain trading, clearing fees* Chicago Tribune June 1, 2006 (2006 WLNR 9380499).

50. CBOT Press Release, *CBOT announces Modifications to fee Schedule* Aug. 21, 2006 (http://cmegroup.mediaroom.com/index.php??s=43item=487).

51. Eurex was the exchange most thought would begin offering a Eurodollar futures contract. *Eurex v. Chicago at FIA Expo* Sec. Week Vol. 81 Issue 229 Nov. 10, 2003 (2003 WLNR 3183626). *See also,* Alex Skorecki, *Eurex plans US Treasury Trades*, FinancialTimes UK Sept. 11, 2003 (2003 WLNR 8179406). A Eurodollar future is based on a $1 million three-month deposit of U.S. dollars in overseas financial institutions, paying interest at the London Interbank Offered Rate.

52. Alex Skorecki, *Capital Markets & Commodities* FinancialTimes UK Dec. 4, 2003 (2003 WLNR 8218591).

53. Yiuman Tse and Paramita Bandyopadhyay, *Multi-market trading in the Eurodollar futures market* 26 Rev.Quant.Finan.Acc. (2006) 321, 325.

54. *Id.*

55. Isabelle Clary, *Liffe Launches Euodollars* Sec. Industry News March 15, 2004 (2004 WLNR 3349887)

56. Alex Skorecki, *Capital Markets & Commodities* FinancialTimes UK Mar. 16, 2004 (2004 WLNR 9741215).

57. The trades involved essentially simultaneous, equal and opposite transactions to close a Eurodollar position on CME and to open a Eurodollar position on Euronext.

58. CME Submission No. 04-61a, *Rule 432.D Interpretation* July 9, 2004 (http://www.cftc. gov/files/submissions/rules/selfcertifications/2004/rul070904cme001.pdf).

59. *See* Tse and Bandyopadhyay, *supra,* note 53. Effective bid-ask spreads on Globex, CME's electronic platform, were reduced by approximately 30% in the seven months after Euronext's entry. *Id.* at 335. Average effective bid-ask spread for the period June 2003 to February 2004 were 7.43 percent, using one mechanism for calculation, and 7.52, using another. For the period March 2004 through September 2004, the effective bid-ask spreads were 5.23 and 5.24, respectively. *Id.* In addition, monthly average trading volume increased by 44 percent on CME, with a significant shift of trading volume to electronic systems. *Id.* at 329. Floor trading volume actually decreased 22%, while Globex trading volume increased 860%. *Id.*

60. In January 2004, 9.6% of Eurodollar contracts were traded electronically at CME. In November 2004, eight months after Euronext's entry, 75% were traded electronically. Jeremy Grant, *Capital Markets & Commodities* FinancialTimes UK Nov. 25, 2004 (2004 WLNR 12196384).

61. Sarah Rudolph, *CME Stock Prices Jump After Fee Hikes, Record Volumes* Sec. Week Vol. 32 Sec. 23 June 6, 2005 (2005 WLNR 12839370). In discussing the increase, a member said the move was a sign CME "feels pretty confident about beating Liffe at Eurodollars." *Id.*

62. These issues were also addressed by the European Competition Commission during its review of Deutsche Borse AG and Euronext AV proposals to acquire the London Stock Exchange plc. It concluded that full fungible access to an incumbent exchange's clearing services is critical to successful entry into trade execution. Competition Commission, *A Report on the Proposed Acquisition of the London Stock Exchange plc by Deutsche Borse AG or Euronext AV* Nov. 26, 2005 at 6.

63. 17 C.F.R. §240.19c-5.

64. The terms of stock options contracts are effectively standardized. The terms of other options — like those on indices and on exchange traded funds — are established in consultation with the first exchange listing the option. Absent protected intellectual property rights, other exchanges may offer an option contract on the same terms.

65. The Department's investigation led to the filing of a complaint against those exchanges for violations of the Sherman Act, 15 U.S.C. § 1, and a settlement through the filing of a consent decree. *United States v. American Stock Exchange, LLC, et al.*, Civ. No. 00-02174 (D.D.C. filed Sept. 11, 2000). The complementary SEC action may be found at SEC Release 43,268, *Order Instituting Public Administrative Proceedings Pursuant To Section 19(h)(1) Of the Securities Exchange Act Of 1934* (S.E.C. Sept. 11, 2000).

66. Patrick De Fontnouvelle, Raymond P.H. Fishe, and Jeffrey H. Harris, *The*

Behavior of Bid Ask Spreads and Volume in Options Markets During the Competition for Listings in 1999 58 J.of Fin. No. 6 (Dec. 2003);

67. Battalio, Robert, Brian Hatch and Robert Jennings, *Toward a National Market System for U.S. Exchange Listed Stock Options* 59 J.of Fin. No 2 (April 2004). Multiple listing was followed by regulatory changes that have furthered competition in options trading, including rules that have linked option markets and moved the industry from fractions of a dollar to decimals. Equity options markets are in the final phases of a transition to pennies as the minimum trading increment, down from five cents. *See* U.S. Gov't Accountability Office Report 05-535, *Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment* (U.S. G.A.O. May 2005) at 60.

68. *The Options Clearing Corporation Announces Options Trading Volume Surpasses 2006 Annual Record* Market Wire Oct. 2, 2007. (More than 2 billion contracts traded in the first nine months of 2007).

69. Jim Binder,*Raising the Volume: The Explosive Growth of Exchange-Listed Options in the U.S.* Futures Industry Sept./Oct. 2006 at 36.

70. *Id.* at 38.

71. *See* S.E.C. Release 34-49175, *Concept Release: Competitive Developments in the Options Markets* 69 FR 6124 (S.E.C. Feb. 3, 2004). Competition in option trading was further increased by the move to decimal trading increments and a series of order handling reforms imposed by the SEC as a consequence of its investigation.

72. Section 17A(a)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §78q1(a)(1).

73. S.E.C. Release No. 13,163, *In re the Application of Nat'l Securities Exchange Corp. For Registration* 42 Fed. Reg. 3916 (S.E.C. Jan. 13, 1977).

74. The clearing registrations of a number of regional clearing firms, that of the Philadelphia Stock Exchange, for example, remain outstanding, but are effectively dormant.

75. S.E.C. Release No. 14636, *Order Approving Rule Changes Amending Transaction Completion Rules* 1978 WL 196700 (S.E.C. April 7, 1978).

76. Major electronic equity trading venues provide trade anonymity which requires that they interpose themselves as the counterparty to both sides of every transaction. For these trades, a clearing name is provided by the trading venue.

77. The terms of contracts in specialized securities — like shares of an exchange traded fund — are controlled by the originating fund, subject to SEC approval of the listing and contract terms. Once established, any exchange can list the ETF for trading, absent intellectual property rights that would permit listing constraints.

78. *See* Commissioner Annette L. Nazareth, Speech, *Remarks Before the Securities Industry Association Options Market Structure Conference* (New York, N.Y. Oct. 24, 2006) (http://www. sec.gov/news/speech/2006/spch102406aln.htm).

79. *See* Beatrice Boehmer and Ekkehart Boehmer, *Trading Your Neighbor's ETFs: Competition or Fragmentation?* AFA 2003 Washington, D.C. Meetings Discussion Paper (January 2003).

80. Neal Wolkoff, Speech, *Customer Choice" in the Selection of a Clearing House*, Futures Industry Association's International Futures Industry Conference Mar. 13, 2003 (http://www.nymex.com/cur_article_031303.aspx).

81. *See* Dennis W. Carlton and Jeffrey M. Perloff, *Modern Industrial Organization*, Fourth Edition (2005) Chapter 16 Pearson (Addison Wesley): Boston.

82. *See* Tse and Bandyopadhyay, *infra*, note 53, and *Eurex US to Charge Flat Fee For Treasury Futures Trades* Oster Dow Jones Select Dec. 3, 2004. (CBOT Treasury futures trading volume increased 65.4%, Nov. 2003 to Nov. 2004).

83. Although exchanges have argued that they have an interest in selecting a sound clearinghouse to protect the public's faith in their contracts, an exchange has, at best, a secondary interest in the issue. Clearinghouses act as every trader's counterparty and, as a result, the clearinghouse has the greatest interest in protecting against trader defaults.

84. As discussed below, the options regulatory policy has resulted in the mandated use of a single clearinghouse by all options exchanges. In equities, SEC policy has permitted use of multiple, linked clearinghouses, and allowed clearing intermediaries a more substantial role.

STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

October 7, 2009

Good morning Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for inviting me to testify today regarding the regulation of over-the-counter (OTC) derivatives and, specifically, this Committee's OTC Derivatives Markets Act of 2009 Discussion Draft.

I would like to address much-needed regulatory reform of OTC derivatives in the context of two principal goals: lowering risk to the American public and promoting transparency of the markets.

We embark upon this reform effort as the financial industry has become ever more concentrated. Given the events of the last decade, there are fewer providers of financial services today. There may be 15 to 20 large complex financial institutions that are at the center of today's global derivatives marketplace. Five to ten years from now, it is quite possible that the financial system will become even more concentrated. With fewer actors on the stage, it is especially important that we lower the risk of these participants and bring sunshine to the activities in which they are involved.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. Exhibit A of these twin failures was the collapse of AIG. Every single taxpayer in this room – both the members of this Committee and the audience – put money into a company that most Americans had never even heard of. Approximately $180 billion of our tax dollars went into AIG – that is nearly $414 million per each of your Congressional districts. While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in our regulatory structure.

Lowering Risk

To lower risk to the American public, the Administration proposed four essential components of reform.

First, those financial institutions that deal in derivatives should be required to have sufficient capital. Capital requirements reduce the risk that losses incurred by one particular dealer or the insolvency of one of its customers will threaten the financial stability of other institutions in the system. While many of these dealers, being financial institutions, are currently regulated for capital, I believe that we should explicitly – both in statute and by rule – require capital for their derivatives exposure. This is particularly important for nonbank dealers who are not currently regulated or subject to capital requirements.

Second, swap dealers should be required to post and collect margin for individual transactions. Margin requirements reduce the risk that either counterparty to a trade will fail to perform its obligations under the contract. This would protect end-users of derivatives from a dealer's failure as well as guard dealers from end-users' failures.

Third, regulators should be able to mandate robust business conduct standards to protect market integrity and lower risk. Business conduct standards should ensure the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions. Implementation of standards for what are commonly referred to as "back office" functions will help reduce risks by ensuring derivatives dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks. "Back office" standards are currently voluntarily implemented by individual firms. I believe that comprehensive regulation requires mandatory business conduct standards for all derivatives dealers.

Fourth, where possible, OTC transactions should be required to be cleared by robustly regulated central counterparties. By guaranteeing the performance of contracts submitted for clearing, the clearing process significantly reduces systemic risks. Through the discipline of a daily mark-to-market process, the settling of gains and losses and the imposition of independently calculated margin requirements, regulated clearinghouses strive to ensure that the failure of one party to OTC derivatives contracts will not result in losses to its counterparties. Right now, however, trades mostly remain on the books of large complex financial institutions. These institutions engage in many other businesses, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other

hand, are solely in the business of clearing trades. To reduce systemic risk, it is critical that we move trades off of the books of large financial institutions and into well-regulated clearinghouses.

Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdictions. This well-established practice of having the agency which regulates an exchange or trade execution facility also regulate the clearinghouses for that market should continue as we extend regulations to cover the OTC derivatives market.

AIG highlights the need for each of these four priorities. AIG was not required to meet capital standards or post margin for individual transactions. It was not subject to business conduct standards for its back office functions. AIG's failure was essentially a failure of a central counterparty in the sense that it internalized the credit risks of its trades. By moving bilateral trades into regulated clearinghouses, we will reduce the risk that a failure of one firm will cause other firms to fail as well. Ineffective regulation allowed the failure of AIG Financial Products and the derivative dealers affiliated with Lehman Brothers, Bear Stearns and investment banks to affect the entire financial system. We must ensure that this never happens again. We cannot afford any more multi-billion-dollar bailouts.

Improving Transparency

The second principal goal as we discuss proposals to regulate OTC derivatives is to promote transparency. Economists have for decades recognized that transparency benefits the marketplace. After the last great financial crisis facing the nation, President Roosevelt called for transparency in the futures and securities marketplaces. It is now time to promote similar transparency in the relatively new marketplace for OTC derivatives. Lack of regulation in these markets has created significant information deficits:

- Information deficits for regulators who cannot see and police the markets;

- Information deficits for the public who cannot see the aggregate scope and scale of the markets; and

- Information deficits for market participants who cannot observe transactions as they occur and, thus, cannot benefit from the transparent price discovery function of the marketplace.

To address information deficits in the OTC derivatives markets, the Administration has proposed – and I fully support – the following priorities:

First, stringent recordkeeping and reporting requirements should be established and vigorously enforced. This includes an audit trail so that regulators can observe all trading activity in real time and guard against fraud, manipulation and other abuses.

Second, all non-cleared transactions should be reported to a trade repository that makes the data available to regulators. This will complement regulators' ability to obtain transaction data on trades conducted in a central clearinghouse. U.S. regulators and foreign regulators should both have unfettered access to see all transactions, regardless of whether the physical locations of the trade repositories and clearinghouses are in the United States or elsewhere.

Third, data on OTC derivatives transactions should be aggregated and made available to the public. The CFTC currently collects and aggregates large trader position data and releases it to the public. We should apply the same transparency standards to OTC derivatives. This will promote market integrity and protect the American public.

Fourth, all standardized OTC products should be moved onto regulated exchanges or regulated trade execution facilities. I believe that this is the only way that we can best address information deficits for market participants. Exchanges greatly improve the functioning of the existing securities and futures markets. This is through the transparency they provide both before and after a trade. We should shine the same light on the OTC swaps markets. Increasing transparency – including a timely consolidated reporting system – for standardized derivatives should enable both large and small end-users to obtain better pricing on standard and customized products. A municipality, for example, could better decide whether or not to hedge an interest rate risk based upon the reported pricing from exchanges. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will benefit all end-users, whether trading with standardized or customized swaps.

G-20 Heads of State Agreement

At the conclusion of the G-20 summit held in Pittsburgh last month, President Obama, along with other heads of state, made lowering risk and promoting transparency in the OTC derivatives marketplace a key goal. The leaders concurred that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements." It is now our challenge, working with Congress, to achieve that goal.

Working with the SEC

Comprehensive regulation of OTC derivatives will require ongoing cooperation between the CFTC and the SEC. The President asked that our agencies provide recommendations to Congress and the Administration on how to best tailor our regulations in the interest of protecting the American public. Last month, we held two unprecedented joint public meetings to look into gaps that exist between the two agencies' financial regulatory authorities, overlap of regulatory authority and inconsistencies when the two agencies' regulate similar products, practices and markets. We intend to release a report next week that will highlight how both agencies can adapt regulations to the evolving financial markets and best protect the American public. These proposals will be available to Congress as we bring reform to financial regulation.

OTC Derivative Markets Act of 2009 Discussion Draft

I will now turn to six issues raised by the Discussion Draft released last week by this Committee. I believe that the draft is an important contribution to the process of moving toward comprehensive regulation of the OTC derivatives markets. I look forward to working with this Committee to ensure that we cover the entire marketplace without exception.

Clearing

First, in the Administration proposal, there is a presumption that any contract that would be accepted for clearing must be cleared. This is essential to lowering risk. While the Discussion Draft endorses a requirement for central clearing, it shifts from the presumption that all standardized derivatives must be cleared to one where products would be cleared only if required by market regulators. The Discussion Draft then puts the burden on the regulators to determine whether specific contracts, according to specific criteria, should be cleared. The Draft also is unclear as to whether the CFTC would have to determine the necessity for mandatory clearing of swaps on a contract-by-contract basis.

Though there must be appropriate regulation of the clearing process, I believe it is best for a clearinghouse that is managing its risk to determine if a particular product should be cleared. The market regulators would oversee those determinations. If Congress decides to shift from the presumption of mandatory clearing, the market regulators should be given the authority to determine that broad classes of swaps must be cleared rather than be required to make such determinations on a swap-by-swap basis.

Clearing Requirements for End-Users

Second, with regard to a clearing requirement, a number of end-users that use OTC derivatives for hedging have asked whether their contracts would be required to be cleared. I believe that such end-users should be allowed to fully use customized or tailored contracts to meet their particular hedging needs and that these would not need to be centrally cleared.

Thus, the only question that remains is: should the end-users' standard, or clearable, contracts be subject to a clearing requirement? The CFTC has recommended that the swap dealers should bring those transactions to a central clearinghouse to lower risk. The end-users would be allowed to enter into individualized credit arrangements with the financial institutions that enter into transactions for them, i.e., their clearing firm. End-users would not be required to post cash collateral or any other particular form of collateral – they would simply be required to work with the clearing firm to determine the most appropriate credit arrangement. Clearing firms would thus intermediate credit for an end-user while concurrently bringing the end-user's transactions to a clearinghouse. This will both lower risk and accommodate the end-users' concerns.

To the extent that Congress decides not to follow this approach, I believe that any clearing exception for end-users should be very narrowly defined to only include nonfinancial entities that use swaps incidental to their business to hedge actual commercial risks. We would not want an unintended consequence of an end-user exception to be that hedge funds, financial firms or other investment funds would be able to evade the clearing requirement.

Major Swap Participant

Third, the Discussion Draft departs from the proposal submitted by the Administration in its definitions of "major swap participant" and "major security-based swap participant." The Administration recognized that some entities enter into swaps to comply with generally accepted accounting principles. The Discussion Draft, perhaps inadvertently, widened this exception such that the "major swap participant" category would exclude any entity entering into a swap for "risk management" purposes. I am concerned that a great number of swaps could be characterized as risk-management, or hedging, swaps. This could have the unintended consequence of exempting a broad range of entities from the definition of a "major swap participant" and, thus, exempt such entities from regulatory requirements outlined in the proposal. For example, it may be possible for major swap users to avoid regulation by claiming that their swaps were entered into for the purpose of "risk management."

Exchange Trading

Fourth, the Discussion Draft makes trading on regulated exchanges or regulated trading platforms available to swap dealers, but not required. I believe, however, that it should be required for all cleared swaps. Market participants and the public would benefit greatly from the transparency and better pricing afforded by regulated exchanges and trade execution facilities. Transactions should be reported on a real time basis similar to how reporting functions in the corporate bond world work. Congress could authorize the CFTC and the SEC, by rule, to allow transactions to be voice brokered, but still affirmed through the execution facility. This would be similar to the process by which block trades and certain other transactions that might not have

sufficient liquidity on a trading platform are traded subject to the rules of registered futures exchanges. Post-trade reporting should be required. Thus, the public would get the benefit of transparency, but Congress would address the concern of whether sufficient liquidity exists on all contracts that are cleared for them to be traded on exchanges or trade execution facilities.

Foreign Regulation

Fifth, it is essential that the CFTC and SEC as market regulators work cooperatively with foreign regulators on a routine basis to ensure that traders cannot evade U.S. regulation by trading overseas. Two weeks ago, I travelled to Brussels to press for comprehensive regulation of the OTC markets by the European Commission. I know that Chairman Schapiro is in Basel today also working on regulatory issues. The Discussion Draft includes provisions that require coordination with international regulators.

As U.S. regulators, we must have complete and unfettered access to data that bears on U.S. commerce, regardless of whether it is kept overseas. If a foreign entity or a foreign subsidiary of a U.S. entity is trading with an American counterparty, we should know about it. I am concerned that the Discussion Draft could allow foreign financial institutions to be exempted from our requirements. We must ensure that we do not inadvertently create gaps in our regulatory system through exemptions for foreign regulations.

Moreover, we need to ensure that our efforts to accommodate foreign regulatory standards do not generate unintended consequences. For example, I share the Committee's goal of promoting post-trade transparency, as outlined in section 6 of the Discussion Draft, but I

worry that the specific provisions might inadvertently permit market participants to shop for lax foreign regulators. Market participants should only be exempt from American regulation through compliance with foreign standards where there has been a determination by U.S. regulators that the foreign regulatory scheme is comprehensive and comparable to our standards.

Agriculture Swaps

Sixth, I am concerned about the possible unintended consequences the Discussion Draft may have with respect to off-exchange trading of standardized agricultural swaps. Under current law, swaps in agricultural commodities are not considered either an exempt or excluded commodity. Thus, standardized swaps involving agricultural commodities may not be traded in over-the-counter markets. The Administration's bill would remove the distinctions between the various types of commodity swaps, as well as the various exclusions and exemptions for these swaps. At the same time, though, the proposal would impose a requirement that standardized commodity swaps be cleared and traded either on an exchange or trade execution facility.

The Discussion Draft, like the Administration's bill, would eliminate the distinctions between the various types of commodity swaps. It does not, however, include all of the protections provided in the Administration's bill for these OTC markets. With respect to swaps involving agricultural commodities, the Discussion Draft enables, for the first time, standardized agricultural swaps to be traded bilaterally off-exchange, but does not impose the protections that we believe are necessary for this market.

Technical Assistance

In addition to the six points outlined above, the CFTC will work with this Committee to provide further technical assistance. Specifically, the Discussion Draft provides that exchanges and trade execution facilities should have open access to clearinghouses for standardized products. We will work with this Committee to ensure that access is provided in a nondiscriminatory way.

Further, we are pleased that the Discussion Draft supports the goal of segregating customer margin from a dealer's own funds. We will work with this Committee to ensure that Bankruptcy Code provisions that apply to segregated funds for futures and options on futures would also apply to swaps.

Lastly, as I have previously noted for this Committee, I believe that any exception for foreign currency forwards should not allow for evasion of the goal of bringing all interest rate and currency swaps under regulation to protect the investing public. We will work with the committee on this as well.

Conclusion

I look forward to working with the Congress and other federal regulators to apply comprehensive regulation to the OTC derivatives marketplace and to secure additional resources so that the CFTC can effectively regulate the markets. The United States thrives in a regulated market economy. This requires innovation and competition, but also regulation, to ensure that

our markets are fair and orderly. We have a tough job ahead of us, but it is essential that we get it done to protect the American public.

Thank you for inviting me to testify today. I would be happy to answer any questions you may have.

STATEMENT OF DAVE HALL

CHIEF OPERATING OFFICER, CHATHAM FINANCIAL CORP.

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

October 7, 2009

Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. It is an honor and great responsibility to participate in this hearing today. Thank you for inviting me to testify regarding the regulation of over-the-counter derivatives.

To begin, it may be helpful to know the role of my firm in the OTC derivatives market. Chatham Financial is the largest independent advisor and service provider to businesses who use derivatives to reduce their interest rate and foreign currency risks. A global firm based in Pennsylvania, Chatham has over 1,000 end-user clients in 45 states – ranging from Fortune 100 companies to very small businesses. Chatham is employee-owned and independent – we do not accept compensation from dealer banks. We help our clients hedge risk, not speculate, and we do not advise on credit default swaps.

Given the events in the financial markets in recent years, we applaud the Administration and Congress for considering appropriate changes to our financial regulatory framework, including the area of derivatives. We believe we should all work to reduce the risk to our financial system should one of our largest banks, insurance companies, hedge funds or any other of our largest institutions fail.

While prudent policy changes are needed to address the problems that gave rise to AIG's failure in credit default swaps and in other areas, policymakers need to be careful to ensure that such policies do not harm the many areas of the OTC market that are functioning well.

OTC derivatives are very important tools for businesses to efficiently and effectively reduce risk. Their use is now accepted for many good reasons and is now common – in fact, 94% of Fortune 500 companies and thousands of small businesses use derivatives to manage business risks.

The main issue at hand is reducing systemic risk. The business end users who use derivatives to hedge do not create systemic risk – rather, they use derivatives to reduce business risks which, in turn, reduces systemic risk. Therefore, especially since business end users only make up 10-15% of the overall OTC market, we believe derivatives regulation should be directed at trading activity between systemically significant institutions.

We are very pleased that Chairman Frank and his staff, Members, and others have developed this draft legislation which recognizes and differentiates business end users from large financial institutions. Specifically, this draft focuses central clearing requirements on large market participants, rather than on business end users. Additionally, it precludes those who use OTC derivatives to prudently manage risk from being subject to higher regulatory thresholds under the definition of major swap participant.

We are grateful for the opportunity to offer our suggestions for how the draft bill could be improved. Following are five recommendations for improvement:

1. Margin – Any requirement for business end users to cash collateralize hedging transactions would create an extraordinary and unnecessary drain on working capital. This draft appropriately recognizes this cash burden by excluding end users from the central clearing requirement (page 29). Similarly, we believe this draft should also recognize this cash burden by excluding end users from any margin requirement (page 61). For trades with business end users, we believe credit terms (e.g., margin, collateral) should be negotiated by the two parties. To illustrate this point, a bank may choose to make a *loan* without collateral if the business is creditworthy, therefore it is reasonable that a *derivative* should be allowed to be offered to a business end user without margin if the business end user is creditworthy.

2. Capital Charges – This draft calls for higher capital charges for non-cleared derivatives. We believe this draft should be clarified so that regulators are instructed to set capital charges based on historic or predicted loss, and not as a penalty to discourage the use of OTC derivatives.

3. Systemic Significance. This draft bill recognizes that systemically significant institutions should be subject to higher standards than those that cannot impose systemic risk. However, as currently written, it is possible that non-systemically significant firms could be subject to the same regulatory burden that applies to large financial institutions. For example, community banks that utilize OTC derivatives to hedge their balance sheet risks and offer risk management products to their borrowers, could be deemed "Swap Dealers"

and be subject to the same reporting, clearing and margining requirements. In addition, with the removal of Bear Stearns, Lehman, Wachovia, and Merrill Lynch from the market, there are now too few OTC derivative counterparties. Removing the burden for smaller, non-systemically significant swap dealers will encourage competition and reduce prices for business end users.

4. Major Swap Participant is largely defined by having a "substantial net position", a term to be defined by regulators. We believe this term should be defined by legislation. If it is not, we would like to see the intent be clear that this definition should target systemically significant institutions.

5. Exemptive Relief. As we make these historic changes to regulate the OTC derivatives market, we cannot now foresee many of the consequences resulting from this regulation. Therefore, we should grant regulators the authority to provide exemptive relief where they deem necessary.

To conclude, even though we have identified several areas for proposed improvements, we want to be clear that we believe this draft is the most thoughtful proposal for regulation of the OTC derivatives market to date.

Thank you again for the opportunity to testify today. I am happy to address any questions that you may have.

TESTIMONY OF
JAMES J. HILL
MANAGING DIRECTOR OF MORGAN STANLEY & CO. INCORPORATED
ON BEHALF OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON
REFORM OF THE OVER-THE-COUNTER DERIVATIVE MARKET:
LIMITING RISK AND ENSURING FAIRNESS

OCTOBER 7, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee:

My name is Jim Hill and I am a Managing Director of Morgan Stanley. I am appearing on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1] and its members. Thank you for your invitation to testify today.

The membership of SIFMA is diverse and includes financial firms of different sizes as well as firms that are active in different parts of the financial services business. Although my testimony today is being presented on behalf of firms that provide financial services, it also is focused on the interests and concerns of those firms' customers, the end users that benefit directly from the broad availability of

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, DC, and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

derivatives transactions to manage various risks that arise in connection with their day-to-day business and other activities.[2] SIFMA's members have built successful derivatives businesses by offering products that meet important needs of their customers, and it is in their interest to support legislative and regulatory measures that will improve the integrity and functioning of the derivatives products and markets. Such measures serve the interests of all participants, the dealers *and* their customers. At the same time, SIFMA's members are concerned about proposals that may unnecessarily limit the availability or usefulness of derivatives transactions, or impose significant new costs in connection with their use. We believe that a guiding principle for congressional action should be not to impose new regulations that will limit the availability or usefulness of derivatives or increase their cost unless there is a compelling reason to do so.

There is much in the Committee's Discussion Draft of the Over-the-Counter Derivatives Markets Act of 2009 (the "Act") that SIFMA and its members support and we believe it includes many significant improvements over the Administration's proposed legislation from last August. We appreciate the thoughtful consideration that you and your committee colleagues and staff have given to comments on the Administration's proposal that you have received from interested parties on all sides, including in particular those of end users.

[2] On October 2, 2009 the Coalition for Derivatives End Users circulated to Members of Congress a letter signed by 171 companies and business organizations from across the country noting the importance of OTC derivatives for risk management.

I would like to begin by expressing SIFMA's support for legislative proposals to ensure that systemically significant market participants are subject to comprehensive regulatory oversight. It was the lack of meaningful regulation of AIG's derivatives affiliate that allowed poor business practices to lead to a situation in which the federal government had to invest tens of billions of dollars in that enterprise in order to avert what could possibly have been a systemically significant business failure. The Act would address this regulatory shortcoming by creating a legislative and regulatory framework that ensures such a lapse should not occur again.

We also support measures that will improve regulatory transparency and thereby facilitate oversight of derivatives markets and the activities of individual market participants. The Act accomplishes this by requiring that swaps either be submitted to a derivatives clearing organization (the CFTC is authorized to determine which swaps are required to be cleared) or be reported to a swap repository or the CFTC. Similar requirements are imposed with respect to security-based swaps (with the SEC making the determination).

Centralized clearing of swaps has numerous benefits, and we support efforts to encourage more clearing. In fact, derivatives dealers have been actively working

toward, and providing commitments to ensure, increased levels of clearing.[3] Over the course of the last few years, financial firms have collectively worked to increase standardization in the derivatives market, which – along with appropriate liquidity – is one of the necessary predicates to effective clearing. Furthermore, last month 15 of the largest OTC derivatives dealers set specific goals for expanding central clearing of credit and interest rate derivatives in a letter to New York Federal Reserve Bank President William C. Dudley. These initial goals involve clearing a greater percentage of new trades and historical trades, and will be increased as clearing infrastructure expands and a greater range of products become suitable for clearing. These directives build upon earlier commitments to implement changes to risk management, enhance reporting of non-cleared trades, and improve governance – all tools that increase the transparency of the derivatives markets.

We believe that by combining complete regulatory transparency with meaningful, comprehensive oversight, the Act corrects the situation that allowed the AIG problem to develop. The Act, though, would do more than this and its provisions are both extensive and complex. SIFMA and its members have identified a number of concerns regarding the Act's effects on various aspects of the derivatives market and its consequences for dealers and, in particular, their customers.

[3] As of October 1, 2009, $ 3 trillion in U.S. CDS had been cleared and major dealers have committed to individually submitting 90% of new eligible trades in interest rate derivatives beginning December 2009 and 95% of new eligible trades in credit default swaps beginning October 2009.

Although the Act generally excludes corporate end users from provisions that would require exchange trading or clearing of swap transactions, they *would* be covered by other provisions. For example, the Act would authorize regulators to impose margin requirements on swaps in which one of the counterparties is an end user. It is difficult to understand why counterparty credit exposure created through a swap transaction should be required to be collateralized when lending arrangements between the parties can be made on an unsecured basis. The Act would direct regulators to allow parties to post non-cash collateral, but even that carries a cost, including reducing the end user's borrowing capacity and potentially causing an end user to violate negative pledge covenants. Another provision concerns dealer segregation of funds or other property posted as margin. We believe it is important for end users to have that option in connection with over-the-counter swaps, but both the decision to require margin and the details of how it is handled should be left to negotiation between the dealer and the end user in the ordinary course of their lending and risk management processes.

The Act is appropriately focused, in particular, on the activities of swap dealers and major swap participants. We believe, however, that the definition of "swap dealer" may be overly broad in that it could capture entities that would not traditionally be considered "dealers." While a fund that buys and sells significant levels of derivatives for investment purposes could fall within the definition of "major swap participant" (or "major security-based swap participant"), the

determination of whether that fund was also a swap dealer should depend on whether the fund held itself out as willing to make two-way markets in swaps.

SIFMA members also are concerned about the business conduct rules in the Act that would require the disclosure of fees, as well as potential conflicts of interest in connection with derivatives transactions. These are not retail transactions. They are institutional transactions between sophisticated parties that are well equipped to negotiate and have considerable bargaining power in a competitive market. In this context, highly specific disclosure rules are unnecessary and could constitute significant new and unnecessary impediments to economically useful transactions that are beneficial for end users.

In addition, SIFMA members are concerned about the imposition of new capital requirements with respect to their cleared swaps. The clearing process makes these transactions less risky because it provides a well-capitalized clearinghouse as a counterparty. The clearinghouse's requirement that all of its transactions be secured by margin also reduces risk. The addition of a further safeguard by imposing the requirement of incremental capital for cleared transactions is unnecessary and unwise, in particular because the cost of each of these layers of protection is directly borne by the dealers and ultimately by their customers. Policymakers should be careful about increasing the cost of these transactions, because doing so may discourage their use for risk management

purposes. Giving the CFTC, the SEC, and prudential regulators the general authority to establish appropriate capital requirements would seem to be enough.

The provisions of the Act regarding security-based swaps are another aspect of the proposed legislation that we believe could be improved by taking a different approach. The Act gives the SEC jurisdiction over security-based swaps, in part, by amending the Securities Act of 1933 to include those products in the definition of "security," a term that is already broadly drafted and which has been broadly interpreted by our courts. This approach is expedient and straightforward, but likely would have unintended adverse consequences that would be difficult and time-consuming to resolve because many of the concepts and requirements under the federal and state securities and other laws do not readily apply to security-based swaps.

For example, under the Securities Act, the issuer of a security has certain disclosure obligations to purchasers of the security. However, swaps are bilateral contracts in which either or both parties to the contract might well be viewed as the issuer. This could lead to a number of anomalous results, including, for example, mutual simultaneous disclosure requirements for both parties. Identifying a central clearing party as the formal "issuer" for cleared swaps might solve the technical issue but would do little to advance the investor protection goals of the Securities

Act's registration scheme. Plus, this would not work for customized, non-cleared swaps.

In addition, most state courts have assumed that the term "security" should have the same meaning under both federal and state law. Simply sweeping swaps into the definition of "security" might subject swap end-users – who are entering into swaps to hedge business risks – to blue sky filings and merit review by state securities regulators unfamiliar with derivatives. While there are certain exceptions in these state laws for various types of offerings, they are neither uniform nor drafted with swaps in mind and would need to be parsed on a state-by-state basis.

Finally, the term "security" is used in a large number of sections in the Internal Revenue Code, and an expansion of the term will result in unintended consequences. For example, the receipt of stock and securities in reorganizations under subchapter C of the Code is treated as tax-free. The broadening of the definition of "security" to include security-based swaps is clearly inconsistent with the legislative purpose and policy underlying the reorganization sections of the Code. Similar inconsistencies would arise in other laws that cover securities, such as ERISA.

A better approach to providing SEC oversight and regulation of security-based swaps would be to give the SEC broad authority to adopt regulations regarding those swaps to the extent it determines that additional measures,

consistent with the regulatory framework established by the Act for other swaps, are needed. This approach would enable the SEC to address unforeseen issues raised by security-based swaps without contorting existing federal securities laws and regulations to accommodate instruments for which they were not designed.

Another aspect of the security-based swap provisions in the Act that concerns SIFMA and its members is the potential application of sections 13 and 16 of the Securities Exchange Act of 1934[4] on the basis of one or more positions in security-based swaps. These provisions of the Exchange Act serve completely different purposes, neither of which would be advanced by broadening their application in this manner. Section 13 is intended to alert the market to accumulations of stock that might indicate a potential shift in corporate control. Entering into a security-based swap does not, in itself, give a party to that swap the rights of a shareholder (such as the right to vote) and as such creates no potential for a change in control. If public disclosure of large net equity swap positions is thought necessary for some other reason, that disclosure could be accomplished by creating a specific requirement that would be directly applicable to such swaps, rather than inappropriately applying section 13.

[4] Section 13 requires public disclosure by owners of more than 5% of a class of a company's equity securities. Section 16 provides that profits realized by corporate insiders, including owners of more than 10% of a class of a company's equity securities, from purchases and sales of a company's stock within a six-month period inure to the benefit of the company.

Section 16 is intended to address unfair trading by corporate insiders who by virtue of their insider status are deemed to have special access to information about the company. But because a party to a security-based swap does not thereby gain the rights of a shareholder, there is no reason to assign insider status on the basis of one or more of such swaps. Doing so would serve no useful purpose and likely prevent swap dealers and other parties from entering into economically useful transactions that rely on the availability of such swaps, including transactions that enable corporations to raise additional capital.

Finally, we have practical concerns about the short implementation time provided in the Act and about the severe constraints on the SEC's and CFTC's exemptive authority. The Act's provisions generally would become effective 180 days after the date of enactment. We do not believe this would give derivatives dealers and other market participants sufficient time to comply with the Act's complex and far-reaching provisions. We believe that the effective date for the various provisions in the Act should be no less than one year after the date of enactment. Also, as with much other legislation, the Act will have unintended consequences, some of which may be adverse, for dealers, end users, and other market participants, including state and local government and not-for-profit end users. Rather than having to pass legislation to address such consequences each time they arise, we believe it would be much more practical and beneficial to grant the CFTC and SEC exemptive authority so long as they consult with each other and

with the Treasury Department and make a determination that the exemption is consistent with the purposes of the Act.

In conclusion, Mr. Chairman, I would like to emphasize that SIFMA and its members support legislation to address weaknesses in the current regulatory framework for derivatives transactions. The events of the past year have made it clear that improvements are needed. However, the use of derivatives has become an integral part of our economy because they enable end users, including most of our country's leading non-financial corporations, to effectively manage risk, and most have done so without creating new risks or adverse consequences. As such, it is important that legislation intended to improve derivatives regulation and reduce systemic risk does not unnecessarily impair the usefulness of derivatives and thereby increase risk exposure of the many companies that have come to depend on them.

Testimony

Before the House Committee on Financial Services

On

Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness

October 7, 2009

Mr. Jon Hixson
Cargill

My name is Jon Hixson, Director of Federal Government Relations at Cargill. I am pleased to testify today on behalf of Cargill, Incorporated. My testimony will focus on the discussion draft of the Over-The-Counter Derivatives Markets Act of 2009, as released late last week. Thank you for the opportunity to testify.

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

Cargill is an extensive end-user of derivatives products on both regulated exchanges and in the OTC markets. We are also active in offering risk management products and services to commercial customers and producers in the agriculture and energy markets.

Examples of OTC Products
Cargill's activity in offering risk management products and services to commercial customers and producers in the agriculture and energy markets can be highlighted with the following OTC examples:

- Customized hedges to help bakeries manage price volatility, so that their retail prices for baked goods can be as stable as possible for consumers and grocery stores.

- Hedges to help regional New England heating oil distributors avoid price spikes and volatility, so that they can offer individual households stable prices throughout the winter season.

- Customized hedges to help a restaurant chain receive stable prices on chicken, so that the company can offer consistent prices and value for their retail customers when selling chicken sandwiches.

Highlights of the Over-The-Counter Derivatives Markets Act of 2009
The discussion draft of Over-The-Counter Derivatives Markets Act of 2009, as released by Chairman Frank, is a very positive step in addressing comprehensive market reforms of the OTC market. While we have some areas of concern, there are many well-supported elements included in this proposal.

The discussion draft includes improved transparency, including dealer registration and audit trails. In addition, the proposal would create a regulated trade data repository and has a stronger focus on reducing systemic risk, by setting clearer direction for regulators and more rigorous requirements for inter-dealer transactions. The bill also provides for flexibility of end-users and traditional hedgers utilizing OTC risk management products, and clearly establishes regulatory authority to ban any swaps deemed abusive. Cargill supports these provisions and appreciates the work of the chairman and other members of the committee in developing the discussion draft.

In many respects, the discussion draft represents a significant improvement over many other proposals that, in our view, would overly restrict the use of OTC markets for hedging purposes.

Our main concerns with the discussion draft relate to two areas of the legislation:

1. The application of capital and margin requirements; and
2. Provisions relating to the segregation of assets for collateral.

The discussion draft gives regulators discretion in whether to impose margining requirements in traditional hedging and risk management transactions.

> We appreciate this flexibility, but have some concerns that, given recent regulatory statements and testimony, the imposition of mandatory margining for hedging transactions would still occur.
>
> To ensure Congressional intent, the legislation could include a list of factors, in a similar style, as the provisions within the discussion draft that provide guidance on the "Clearing Requirement." (p. 24, line 14, Oct 2 Draft)

Capital requirements should clearly recognize and reflect the internal risk management processes utilized by dealers.

> When Cargill offers tailored risk products to our customers, like the bakery hedge described above, we offset a substantial amount of the risk by taking positions on a regulated, centrally cleared exchange. Offsetting risk positions taken on a regulated exchange are fully margined for daily mark-to-market exposure. We also use margin agreements with most of our customers. These steps greatly reduce risks in the overall hedging transaction and should be encouraged.
>
> Regulators should consider such prudent risk management actions as they analyze and develop appropriate capital requirements, to ensure that the charges are based on actual risk of loss.

Segregation of assets is also a critical issue.

> A variation margin payment is made because the customer has an unrealized loss on their hedge. The variation payment is an offset to the loss. To prudently manage risks, dealers take offsetting positions to customers OTC positions. If the customer's position has a loss and is required to post variation margining, it means that the offsetting hedges also have a loss. This provision should be clarified to offer a customer greater protection for margin money they are owed, but to not impede the application of margin payments needed to reduce risks throughout the entire transaction.
>
> Diversion of segregated collateral, or margin, for activities other than those taken to manage the underlying risks of a customer's hedging transaction should not be allowed.

The chairman's proposal also clarifies authority for position limit enforcement. Cargill testified before Congress earlier this year calling for better reporting and transparency, as well as enforceable position limits. We continue to support those views, and would like to call to the Committee's attention a few regulatory steps already taken in this area since we first testified.

- Commitments of Traders (COT) Report – On September 4, 2009, the Commodity Futures Trading Commission (CFTC) issued its first new COT that covers the major agriculture and energy contracts. The COT Reports currently break traders into two broad categories: commercial and noncommercial. The new reports will break the data into four categories of traders: Producer/Merchant/Processor/User; Swap Dealers; Managed Money; and Other Reportables.

- OTC Reporting and Transparency - The CFTC continues to collect data on OTC transactions through its Special Call authority. The CFTC will begin publishing this data, which highlights index fund activity, on a quarterly basis with a goal of eventually releasing this data on a monthly basis.

Conclusion

We appreciate the opportunity to testify before the Committee, to offer examples of our use of OTC products in risk management, and to highlight our areas of support and concern within the discussion draft. Again, I thank the Chairman, and all the members of this committee for their work on this important issue. We look forward to working together as this legislation continues to develop.

Thank you.

BIOGRAPHY
Jon Hixson
Director, Federal Government Relations
Cargill - Corporate Affairs

Mr. Hixson works for Corporate Affairs in Washington, and supports a range of Cargill Businesses, including Cargill Cotton and the Cargill Agriculture Supply Chain Platform.

Jon's background includes operating experience with Cargill Flour Milling in Albany, New York, and with ConAgra Flour Milling in Denver, Colorado.

A native Kansan with a background in crop and livestock production, Jon has been in Washington since 1994 and spent nine years working in both the US Senate and the US House of Representatives for members of the Kansas congressional delegation.

In 2005, he joined Cargill as a Director of Federal Government Relations.

Jon has a Bachelors of Science Degree from Kansas State University and a Masters in Business Administration from George Washington University in Washington, DC.

Testimony before House Committee on Financial Services
"Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness"

Steven A. Holmes
Director, Treasury Operations
Deere & Company
On Behalf of the Business Roundtable
October 7, 2009

Chairman Frank, Ranking Member Bachus, members of the Committee, my name is Steven Holmes and I am the Director of Treasury Operations for Deere & Company (also known as John Deere). I want to thank you for inviting me to testify today at this hearing on Reform of the Over-the-Counter Derivatives Market. I am here today in my capacity as an executive of Deere & Company. My testimony reflects the views of Deere and the views of the Business Roundtable, of which we are a member, and which represents leading U.S. companies with more than $5 trillion in annual revenues and more than 10 million employees.

Deere & Company is a world leader in providing advanced products and services for agriculture, forestry, construction, lawn and turf care, landscaping and irrigation. John Deere also provides financial services worldwide and manufactures and markets engines used in heavy equipment. Since it was founded in 1837, the company has grown into a global enterprise with sales in over 100 countries and employing over 56,000 people.

You have asked that I provide my perspective on the 187-page discussion draft that was circulated this past Friday evening. While I will comment on certain aspects of the draft legislation, I can best contribute to the debate on derivatives regulation by explaining how Deere & Company employs derivatives to manage risks to achieve stable

earnings and cash flows in the increasingly volatile global economy. According to a recent survey of the world's top 500 corporations, 94% use derivatives to manage risks. I hope my testimony will help you understand how companies like Deere use derivatives to manage risk.

I am not a lawyer and I am not a government relations specialist. I have 32 years of finance experience at Deere, and I direct a group of highly trained finance professionals that are responsible for the funding activities of the Company's equipment and captive finance operations, and the management of the Company's interest rate risks. I have also directed the team that manages Deere's currency risks.

Although Deere is a major U.S. company with significant overseas sales, the risks we encounter and manage every day are no different than the risks faced by hundreds of companies large and small throughout the U.S. that compete in the global economy. We raise capital, manufacture products, and sell in the U.S. and in foreign markets and compete against foreign manufacturers of equipment. Our international activities and competition subject us to economic risks.

To manage such risks that arise out of the normal course of business, we use derivatives. We do not use derivatives as speculative investments, nor to bet on the ebbs and flows of different sectors of the economy, but instead to convert transactions that carry inherent risk into ones that produce predictable earnings and cash flows. This enables us to offer stable and competitively priced products and financing to our customers, and effectively compete with foreign equipment manufacturers.

Let me give you an example of how we use foreign exchange derivatives to manage currency risk.

Australian farmers are important producers of agricultural commodities. Deere has sales and credit operations in Australia, but no manufacturing. The products we sell in Australia are manufactured mostly in the U.S. and Europe. Australian farmers place orders for equipment well in advance of the use season to ensure they will be ready for spring planting or fall harvest. There is a significant lead time to manufacture a tractor to the farmer's specifications and ship it to Australia. We set a price in Australian dollars well in advance of making the loan and collecting payments, and our manufacturing costs are primarily in U.S. dollars and Euros. This exposes the Company to Australian dollar exchange rate movements. Without hedging this exposure, we would not be able to lock in a reasonable price for the Australian farmer and we would lose the sale. We use foreign exchange forwards, options, and swaps to manage these sales and financing risks.

The discussion draft's exclusion of foreign exchange swaps and forwards from regulation, will enable exporting companies like Deere to continue to cost effectively manage foreign exchange using simple derivative instruments that pose minimal risk to the financial system.

Foreign exchange derivatives are essential to Deere & Company's ability to offer the products and services that our customers rely on, but these are not the only types of derivatives we use. Let me provide one more example – this time, of an interest rate swap – to give you a better sense of why derivatives are so important to Deere's day-to-day business.

We provide financing for our customers on a significant percentage of our sales in both good and bad economic times. Our credit operations have over $20 billion in assets. We offer fixed and variable rate financing to meet the various long and short-term

financing needs of our customers. We issue debt in the commercial paper, medium term note, and asset-backed securitization markets to fund our loan and lease portfolios. Institutional debt investors purchase the majority of our debt securities, and the demand for these securities varies as economic conditions change. Derivatives enable us to match the interest rate characteristics of the funding available in the capital markets with the financing needs of our customers. This was especially critical during the credit crisis, as capital was scarce. John Deere's volume of new loans to customers and dealers increased during the credit crisis as we stepped in to replace other financial institutions that curtailed lending. During the crisis, we were able to issue long-term fixed rate notes in the capital markets and use interest rate swaps to match the fixed and floating rate loans and leases that we offered to our customers. We employ this strategy of issuing longer-termed debt even in good economic times to reduce our refunding risk.

For a swap to be effective, it must match the timing and amount of the cash flows of the hedged exposure. Therefore, the terms of our interest rate swaps are customized to match the terms of the debt we issue. They will match the currency, principal or notional amount, interest rates, and maturity dates. Standardized contracts with predetermined terms would be far less effective.

Investment grade companies like Deere and its finance subsidiary John Deere Capital Corporation are able to issue debt securities or borrow from banks on an unsecured basis, which is a flexible form of financing. Many investment grade companies, including John Deere Capital Corporation, also have debt covenants that prohibit the posting of collateral for derivatives or other borrowings. We have a number of swap contracts that extend well into the future. If these existing contracts are not

permitted an exemption from clearing and collateral requirements, we would have to terminate the transactions at significant cost.

Deere's interest rate swaps are transacted with fifteen commercial and investment banks that underwrite our debt securities, extend loans to us around the world, and provide us with commercial banking services. These banks enter into derivatives trades with us without requiring margin or collateral; however, they do impose credit limits on our derivative trades that take into consideration Deere's overall credit risk and their total credit exposure to the Company.

Derivatives provide stability to our business. At the end of our most recent third quarter, Deere had over $18 billion notional amount of derivative transactions outstanding. That is a large number, but it corresponds directly to the $20 billion of credit we have extended to our customers and dealers to purchase the equipment they need to help drive the economy. The fair value of these derivatives, which represents the price to terminate or settle the positions, was approximately $600 million, and was a receivable for Deere - the banks would owe us that amount if we terminated the derivatives.

As Congress considers how to regulate the over-the-counter derivatives market, we ask that you bear in mind how what you do could affect the thousands of customers that rely on John Deere equipment to work the land on farms, construction sites, forests, and homes across the country.

The Administration released a proposal for derivatives regulation in August, and you, Chairman Frank, offered a proposal of your own this past Friday. Deere & Company welcomes derivatives reform legislation and commends both the

Administration and you, Chairman Frank, for advancing the debate on this important subject. The current regulatory structure has proved ill-suited to prevent the abuses that contributed to the financial markets crisis, and reform is needed. However, reform must not tie the hands of end-user companies that rely on derivatives to manage risk, and whose customers rely on us to provide the products and financing they need to do their jobs.

Chairman Frank, your bill appears to take key steps that positively acknowledge and accommodate the needs of derivative end-users like Deere. For example:

- Your bill recognizes that many companies use derivatives for prudent risk management purposes, independent of the accounting treatment for the derivatives;
- Your bill does not rely on clearinghouses to determine what transactions are excepted from central clearing;
- Your bill does not prohibit the use of non-cash assets to satisfy margin requirements on customized trades.

At the same time, we continue to have outstanding concerns about the derivatives legislation that the committee plans to consider next week. While I have not conducted an exhaustive review of your bill and the Administration's proposal, I would offer the following three observations:

- First, we are concerned that regulators will be ceded too much authority to determine what companies are subject to higher regulatory thresholds associated with being a major swap participant and higher margin requirements imposed on end-user companies like Deere;

- Second, we are concerned about the capital requirements for non-centrally cleared transactions with end-users. We believe that capital charges should be levied solely based on actual risk of loss and not as a means of forcing companies to centrally clear transactions;
- And third, while your bill does not rely on a hedge accounting definition to determine which end-users are major market participants, we are concerned by the bill's open ended definition of "substantial net position" which creates a high degree of uncertainty and again gives the regulators too much authority to determine which end-users are covered.

Deere & Company is committed to working with this Committee, the Administration, and other Congressional bodies to enact thoughtful derivatives regulation that facilitates – not hinders – well-functioning capital markets. At that same time, the regulations should not be a disincentive to Companies to enter into prudent hedging transactions.

You can count on us to stand shoulder-to-shoulder with you to achieve that goal. Thank you, and I am happy to respond to any questions you might have.

Testimony Concerning the Over-the-Counter Derivatives Markets Act of 2009

by Henry T. C. Hu, Director of the Division of Risk, Strategy, and Financial Innovation
U.S. Securities and Exchange Commission

Before the House Committee on Financial Services

October 7, 2009

I. Introduction

Chairman Frank, Ranking Member Bachus, Members of the Committee:

Thank you for the opportunity to testify on behalf of the Securities and Exchange Commission concerning the regulation of over-the-counter ("OTC") derivatives and, in particular, the Over-the-Counter Derivatives Markets Act of 2009, which was proposed in August by the Department of the Treasury (the "Treasury's proposal") and revised in a discussion draft circulated by the Chairman a few days ago (the "discussion draft").

The recent financial crisis has revealed serious weaknesses in U.S. financial regulation. Among them are gaps in the existing regulatory structure; failures to enforce existing standards; and failures to adapt the existing regulatory framework and provide effective regulation over traditionally siloed markets that had grown interconnected. One very significant gap in the regulatory structure is the inadequate regulation of OTC derivatives, which were largely excluded from the regulatory framework in 2000 by the Commodity Futures Modernization Act. Fixing these weaknesses is vital, particularly in the current market environment. The SEC is committed to working closely with policy makers to develop appropriate regulation and restore a sound structure for U.S. financial regulation.

It is critical that we work together to enact legislation that will bring greater transparency and oversight to the OTC derivatives market. The derivatives market has grown enormously since the late 1990s to approximately $450 trillion of outstanding notional amount in June 2009.

This market presents a number of risks. Chief among these is systemic risk. OTC derivatives can facilitate significant leverage, result in concentrations of risk, and behave unexpectedly in times of crisis. Some derivatives, like credit default swaps ("CDS"), can reduce certain types of risk, while causing others. For example, CDS permit individual firms to obtain or reduce credit risk exposure to a single company or a sector, thereby reducing or increasing that risk. In addition to obtaining or reducing exposure to credit risk, a CDS contract participant will take on counterparty and liquidity risk from the other side of the CDS. Through CDS, financial institutions and other market participants can shift credit risk from one party to another. Thus, the CDS market may be relevant to a particular financial institution's willingness to participate in an issuer's securities offering or to lend to a firm, or the ability of derivatives dealers to engage in market-making.

However, CDS can also lead to greater systemic risk by, among other things, concentrating risk in a small number of large institutions and facilitating lax lending standards more generally.

These risks are heightened by the lack of regulatory oversight of dealers and other participants in this market. This combination can lead to inadequate capital and risk management standards. Associated failures can cascade through the global financial system.

Moreover, OTC derivatives markets directly affect the regulated securities and futures markets by serving as a less regulated alternative for engaging in economically equivalent activity. An OTC derivative is an incredibly versatile product that can essentially be engineered to achieve almost any financial purpose. Any number of OTC derivatives or strategies based on such derivatives can, for instance, allow market participants to enjoy the benefits of owning the shares of a company without having to purchase any shares.

Indeed, OTC derivative contracts custom-tailored to the highly individualized desires of a market participant can allow the participant to obtain economic exposure to as large or small a portion of the market as the participant desires. Perhaps surprisingly, exposure to the fortunes of a single company can be attained through strategies involving derivatives that reference a broad index of companies. The ability to custom-tailor OTC derivatives is one of these contracts' strengths, for it allows hedging particularized to the precise risk management needs of the client. Regulatory reform of OTC derivatives needs to not only consider the concerns OTC derivatives raise, but also the benefits OTC derivatives provide to companies, investors and the markets as a whole.

The ability to custom-tailor OTC derivatives, however, can also create regulatory arbitrage possibilities that can facilitate a flow of funds out of the regulated markets and into the less regulated markets. The lack of transparency and oversight also enables bad actors to hide trading activities that would be more easily detected if done in the regulated markets. Because of the link to regulated securities markets and the SEC's responsibility for the integrity of those markets, it is important that the SEC also have the tools to see all related activity so that it is in the best position possible to detect and deter market abuses that can disrupt the integrity of the market. These issues must be addressed.

The discussion draft helps to establish a framework for regulating OTC derivatives. The original proposal was designed to achieve four broad objectives: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system; (2) promoting efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. Importantly, it emphasizes that the securities and commodities laws should be amended to ensure that the SEC and CFTC, consistent with their respective missions, have the authority to achieve – together with the efforts of other regulators – the four policy objectives for OTC derivatives regulation.

The proposed legislation is an important step forward. It would bring currently unregulated swaps, swaps dealers, and swaps markets under a regulatory framework, thereby improving transparency and regulatory oversight. It also would facilitate central clearing of swaps, thereby fostering a "better" market and reducing counterparty risk.

II. Strengthening the Proposal

The discussion draft is a step in the right direction towards bringing OTC derivatives under a regulatory framework. However, certain aspects of the discussion draft could unintentionally preserve existing regulatory gaps. As described below, certain draft provisions would not apply the full panoply of securities law protections to products that are the functional equivalent of securities and in some cases, products that currently are regulated as such. Relatively simple changes to the discussion draft would ensure that the legislation results in the improved supervision of the OTC derivatives market that all of us are seeking to achieve.

A. Minimize Regulatory Arbitrage Opportunities by Regulating Swaps Like Their Underlying "References"

Market participants often view derivatives and the "underlying" assets they reference almost interchangeably. Thus, a participant may well decide to take a position in the fortunes of a company by entering into transactions in OTC derivatives like equity swaps rather than through the purchase of common stock. When carefully structured, the economic payoffs could be similar, if not virtually identical. Yet the legal consequences attached to these alternatives may be different.

Regulatory arbitrage possibilities abound when economically equivalent alternatives are subject to different regulatory regimes. An individual market participant can have incentives to migrate to products that are subject to lighter regulatory oversight.

The proposal would for the first time bring the OTC derivatives market under a regulatory umbrella by establishing a new regulatory framework for OTC derivatives. The discussion draft would divide regulatory responsibility for securities-related OTC derivatives between the SEC and the CFTC, and provide regulatory responsibility for other OTC derivatives to the CFTC.

The proposal, however, would appear to enable significant regulatory arbitrage opportunities that warrant additional consideration as the legislation moves forward.

As to securities-related OTC derivatives, the discussion draft adopts a distinction between derivatives referencing a single security or a narrow-based index of securities and derivatives referencing a broad-based index of securities. This distinction is not meaningful in the context of the OTC derivatives market. A market participant can conceivably use a broad-based swap as part of a strategy to gain highly targeted exposure to a single company or a narrow group of companies. One way of doing this would be by taking the long side of an equity derivative referencing one broad index (e.g., S&P 500 index) while simultaneously taking the short side of an equity derivative referencing a

different broad index (e.g., a subset of the S&P 500 index) customized to the client's desires, such that the net economic exposure is to a narrow-based index or single stock.

In addition, the discussion draft could result in significant regulatory differences between "swaps" products and the currently "regulated" securities and futures products. For example, energy swaps would not be regulated in the same way as energy futures, and securities swaps would not be regulated in the same way as securities. The differences would result because the discussion draft establishes a new regulatory framework for swaps and securities swaps. This framework, which is focused principally on minimizing differences in the regulation of swaps and security-based swaps, would be different from the regulations applicable to either securities or futures. This is significant because, in evaluating whether to engage in a swap transaction, market participants are far more likely to focus on the choice between a swap and regulated alternatives (e.g., between a Microsoft swap on the one hand and a Microsoft option or Microsoft stock on the other), than between swaps involving different "underlying" assets (e.g., a Microsoft swap and an oil swap). Thus, these regulatory differences could perpetuate existing regulatory arbitrage opportunities that encourage the migration of activities from the traditional regulated markets into the differently regulated swaps market. Accordingly, Congress should consider modifying the discussion draft so that all securities-related OTC derivatives are regulated more like securities; and commodity and other non-securities-related OTC derivatives are regulated more like futures.

The concern is compounded if security-based swaps are not considered securities under both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). The discussion draft revises the Securities Act to include "security-based swaps" in the definition of "security," but does not make the corresponding change to the Exchange Act. Including security-based swaps in the Exchange Act definition of security is necessary to reduce the risk of regulatory arbitrage and ensure that securities law protections apply to security-based swaps markets and investors in these markets, including the anti-fraud protections of Exchange Act Section 10(b) and Rule 10b-5, the key anti-fraud provisions – including the insider trading prohibitions – of the federal securities laws.

Unfortunately, the provisions of the discussion draft calling for the SEC to adopt certain "business conduct" rules do not fill the gap. The rules would relate only to the conduct of security-based swap dealers and major security-based swap participants. The rules would not reach brokers who sell security-based swaps to retail investors, and as drafted such brokers would not be required to register with the SEC as broker-dealers nor would they be required to be members of FINRA. Including "security-based swaps" in the definition of "security" in the Exchange Act is also important for ensuring that the SEC has the tools needed to oversee security-based swaps trading on exchanges, which would not be required to register with the SEC because "security-based swaps" would not be securities under the discussion draft.

Similarly, so-called inter-dealer brokers, another group of important participants in the OTC derivatives market today, would remain outside of any regulatory framework. Indeed, it is our understanding that most credit default swap trading in this country are

done through interdealer brokers. Adding "security-based swaps" to the definition of "security" would ensure that the SEC can oversee the activities of these important market participants.

The longstanding regulatory regime applicable to securities is specifically designed to promote vibrant capital markets through the protection of investors, the maintenance of fair and orderly markets, and the facilitation of capital formation. These objectives apply with no less force to securities-related OTC derivatives. In addition, simply including security-based swap agreements within the definition of "security" is a straightforward approach that would make real progress toward ensuring that securities-related OTC derivatives – which can be used to establish either synthetic "long" or "short" exposures to an underlying security or group of securities – and the underlying securities themselves are being regulated consistently. A single regulatory regime should reduce regulatory arbitrage and the likelihood of manipulation in interconnected markets. Similarly, commodity-related OTC derivatives, such as swap contracts for oil and natural gas, would be regulated in a similar manner as the underlying oil or natural gas futures.

This approach also would be simpler to implement. Congress should extend the federal securities laws to all securities-related OTC derivatives and extend the Commodity Exchange Act to all commodity-related and non-securities related OTC derivatives. Moreover, by including security-based swaps in the definition of "security" in both the Securities Act and the Exchange Act, Congress could build off an existing regulatory regime, rather than building a new one from scratch. Treating OTC derivatives differently from the underlying security or commodity future has been ineffective. Again, treating security-based swaps like any other OTC security, such as OTC security options, would significantly reduce the arbitrage opportunities between the regulated markets (securities or futures) and the swaps market, as well as between narrow-based security index swaps and broad-based security index swaps, while building off the existing regulatory framework. Although some differences likely would remain (as they currently do between the SEC and CFTC regimes), where appropriate, these differences could be addressed through the harmonization process that is already underway.

B. "Abusive Swap" Provision

The discussion draft contains a new provision that would permit the CFTC and SEC to jointly prohibit transactions in swaps or security-based swaps which they find would be detrimental to the stability of a financial market or of participants in the market.

This tool, or a variation of it, might be useful for regulators protecting participants and market stability, but requires careful consideration. The Commission has begun analyzing the impact and workability of the provision. Our initial thoughts are that this provision raises a number of questions and potential concerns about regulation of financial products and systemic risk more generally. In considering this language, policymakers should consider how regulators would: quantify the destabilizing effects of products on financial stability and participants; balance the possible tension between destabilizing effects on the system as a whole and large individual participants; and make determinations for products that are both "useful" and potentially destabilizing.

Given the likely reaction from other regulators and policymakers who might disagree with a finding, processes may also need to be considered. For example: how should agencies make this determination; what findings would need to be made; and what would happen if there were a conflict between the SEC/CFTC and other regulators that also play an important role in this area?

Given this, Congress may want to consider (1) whether this is an authority that should be provided jointly to the SEC/CFTC or instead to another forum like the Financial Stability Oversight Council; and (2) the consequences of limiting this type of authority to swaps, as opposed to other financial products. We look forward to working with the Congress as it considers these issues.

C. Strengthen Existing Anti-Fraud and Anti-Manipulation Authority and Extend Necessary Tools

It appears the new discussion draft may inadvertently weaken the SEC's anti-fraud and anti-manipulation authority over security-based swaps. The SEC would continue to have anti-fraud authority over those securities-related OTC derivatives over which the SEC would not have regulatory authority. However, security-based swaps over which the SEC would have regulatory authority would not be subject to all anti-fraud prohibitions under the federal securities laws.

The SEC must have the necessary tools to effectively exercise its authority. In this regard, the discussion draft recognizes the importance of inspections and examinations of swap dealers and major swap participants to the SEC's ability to enforce the securities laws. This authority should be expanded to include central counterparties and swap repositories, so that the SEC can have quick access to comprehensive data on all securities-related OTC derivatives. In addition to inspections and examination, effective enforcement also requires direct access to real-time data on these securities-related derivatives and comprehensive anti-fraud and anti-manipulation rulemaking authority for these derivatives.

For example, in investigating possible market manipulation during the financial crisis, the SEC sought to use its anti-fraud authority to gather information about transactions both in securities-related OTC derivatives and in the underlying securities. Investigations of securities-related OTC derivative transactions, however, were far more difficult and time-consuming than those involving cash equities and options. In contrast to the audit trail data available in the equity markets, data on securities-related OTC derivative transactions were not readily available and needed to be reconstructed manually. The SEC's enforcement efforts were seriously complicated by the lack of a mechanism for promptly obtaining critical information – who traded, how much, and when – that is complete and accurate.

Even if Congress determines to split regulatory responsibility over securities-related OTC derivatives, Congress should provide all tools needed for effective anti-fraud enforcement over all securities-related OTC derivatives.

D. "Major Swap Participant" and "Major Security-Based Swap Participant"

Regulation of major swap participants and dealers is a vital part of the OTC regulatory regime. We understand that there may be entities that use swaps as risk management tools that should not fall into this new framework. The Treasury proposal defined "major security-based swap participant" as any non-dealer who maintains a substantial net position in outstanding swaps "other than to create and maintain *an effective hedge under generally accepted accounting principles"* (emphasis added). The current discussion draft's exclusion is substantially broader and excludes those who, among other things, hold positions *"for risk management purposes."* The term "risk management" is ambiguous and this wording could cause a large number of important entities to fall outside this new needed regulation.

A narrower, objective and verifiable standard would be more consistent with the purposes of the legislation.

E. Ensure that Existing Rules for "Securities" are not Weakened

The discussion draft's overly broad "swap" definition could include a number of products or transactions already subject to the federal and state securities laws. These include investment contracts, certain security options, security forwards and certain contracts involving government securities. There is no benefit to including instruments already subject to the full panoply of securities laws within the definition of "swap."

By including currently regulated securities within the definition of "swap," these instruments would either be regulated as "swaps" under the CFTC's "exclusive jurisdiction," or as "security based swaps," which change the regulatory framework applicable to these instruments. Thus, real legal uncertainty would be created by including currently regulated securities within the definition of "swap" without any clear benefit.

To avoid this possibility, Congress should make clear that products or transactions already subject to the federal securities laws do not fall within the definition of "swap."

F. Credit Default Swaps and Regulatory Arbitrage

As we saw first hand during the financial crisis, trading practices in the CDS market have a direct effect on the underlying securities markets. Both narrow- and broad-based index CDS can be used as synthetic alternatives to debt – and even equity – securities of one or more companies. In addition, market participants may use CDS to establish a short position with respect to the fortunes of a specific company. In particular, a market participant may be able even to use a broad-based index CDS that includes the company as a way to short that company's debt or equity. In brief, debt and equity securities and single-name and narrow- and broad-based index CDS are all economic substitutes, and therefore ripe for regulatory arbitrage.

Under current law, the Commission has stated that exchange-traded CDS on securities, whether on one security or a basket of securities, are securities. Congress should clarify

that the definition of "security-based swap" includes not only single-name and narrow-based index CDS, but also broad-based index CDS. This is particularly important when payment on a CDS, even one characterized as a "broad-based index CDS," is triggered by a single security or issuer or narrow-based index of securities or issuers. This clarification would reduce opportunities for regulatory arbitrage.

G. Clarify the Definitions of "Mixed Swap" and "Security-Based Swap"

The discussion draft would create a new category of "mixed swaps" where dual SEC and CFTC regulation would apply to swaps that are both "security-based" and "non-security based." We have concerns with this new "mixed swap" category.

Under the discussion draft, even quintessentially security-based swaps could be considered "mixed swaps." For example, a swap referencing IBM shares offers a synthetic substitute for owning IBM shares. A market participant entering into such an equity swap will often have to make, in effect, interest payments to the derivatives dealer providing the swap. Those interest payments can be either on a fixed rate basis or a floating rate basis. Under the proposed "mixed swap" definition, the mere and incidental fact of the interest rate payments being on a floating rate basis could cause the IBM swap to be considered a "mixed swap," subject to joint SEC-CFTC jurisdiction. Congress should clarify that a swap is not considered a "mixed swap" merely because the swap has a floating interest rate component or, for similar reasons, a foreign currency component.

H. Ensure an Effective Joint Rulewriting Process

The discussion draft would establish a joint rulemaking process between the CFTC and the SEC that may be difficult to implement. The discussion draft places important definitions on the securities side, such as the definition of "security-based swap," within the Commodity Exchange Act. This would establish a rulemaking and oversight process that undercuts the ability of the SEC to interpret terms as necessary to be responsive to market and regulatory developments, and could compound the difficulties inherent in joint rulemaking. If Congress determines to use joint rulemaking rather than a clear securities/non-securities-based line and individual rulemakings, we believe Congress should put all definitions into the text of the legislation itself, cross-referencing as necessary from both the securities laws and the Commodity Exchange Act.

I. Business Conduct Standards and Eligible Contract Participants

One of the lessons learned from the most recent financial crisis is that certain smaller and less sophisticated institutions need protections from abusive practices by their swaps intermediaries. In some circumstances, there is a need for improved business conduct standards. Treasury's proposal would require the SEC, the CFTC, and other regulators to adopt business conduct rules for dealers and major participants in the OTC derivatives markets. This is an important component of regulatory reform, but these provisions should be improved. We believe that Congress should direct that SEC and CFTC adopt more protective rules in certain situations – for example, where a swaps dealer is selling OTC derivatives to smaller or less sophisticated participants, including certain

municipalities, in the OTC derivatives market. Naturally, no participant should enter into the OTC derivatives market without understanding both the benefits and risks to the participant from doing so.

In addition, Congress should consider revising the qualification standards for participation in the OTC derivatives markets. The standards for being an "eligible contract participant" ("ECP") are important under Treasury's proposal because only ECPs may trade derivatives over-the-counter. All other market participants must trade on exchanges, which provide better protections for less sophisticated participants. More specifically, Congress should consider raising the qualification standards for a governmental entity or political subdivision – such as a municipal government – to qualify as an ECP. Higher standards may also be appropriate for individuals, corporations and other entities.

J. Protecting Customer and Counterparty Assets

One key issue is how best to protect customer and counterparty assets in the event of insolvency. Regulators should have the authority to address this issue by, for example, requiring swap intermediaries to segregate counterparty funds and securities. The discussion draft includes a number of important account segregation requirements that will do much in this regard.

We also note the importance of legislation providing for an insolvency framework that protects, first and foremost, customers. We believe that a resolution regime should clarify how counterparty assets held by OTC derivatives dealers and other major market participants would be treated in the event of an insolvency, as well indicate the extent to which counterparties would have a prior claim on the other assets of the estate. Without legal certainty, the insolvency of an OTC derivatives dealer or other major OTC derivatives participant could result in further market disruptions and systemic risk.

K. Ensuring that the "Identified Banking Products" Exception is Not Abused

Treasury's proposal contained an exclusion from the regulatory scheme for OTC derivatives for products that fall within a category called "identified banking products." Although this exclusion may make sense for banks that are regulated in the U.S., we believe that this exclusion could allow foreign banks (and their subsidiaries) that are not subject to oversight by any federal banking regulator, to offer OTC derivatives to U.S. persons in the guise of "bank products." We believe this exclusion should be revised to make clear that it is not available to foreign banks or their subsidiaries that are not subject to federal banking oversight.

III. Conclusion

The discussion draft is a significant step toward addressing current problems in the OTC derivatives marketplace. It helps to establish a regulatory framework that addresses risks to the financial system and promotes efficiency and transparency in the markets. We strongly encourage Congress to build off this proposal and enact legislation that will bring even more vital transparency and oversight to this market.

Thank you for the opportunity to address issues of such importance for the strength and stability of the U.S. financial system, and the integrity of the U.S. capital markets. I look forward to answering your questions.

MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

STUART J. KASWELL
EXECUTIVE VICE PRESIDENT AND
MANAGING DIRECTOR, GENERAL COUNSEL

MANAGED FUNDS ASSOCIATION

For the Hearing on
Reform of the Over-the-Counter Derivative Market:
Limiting Risk and Ensuring Fairness

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

OCTOBER 7, 2009

WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

Reform of the Over-the-Counter Derivative Market:
Limiting Risk and Ensuring Fairness
October 7, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Committee on Financial Services' hearing, ""Reform of the Over-the-Counter Derivative Markets: Limiting Risk and Ensuring Fairness" held on October 7, 2009. MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies.

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

MFA is fully supportive of the goals embodied in the Over-the-Counter Derivatives Markets Act of 2009 ("DMA"): (1) reducing systemic risk through the use of central clearing houses, the segregation of customer collateral by central clearing houses and by providing customers with the option of having their collateral for customized swaps segregated; (2) increasing regulatory transparency through trade and position reporting; and (3) providing the government with additional authority to avert and respond to economic or financial turmoil without disrupting the ordinary operation of the markets. MFA believes that smart regulation will improve efficiency and competitiveness in the OTC derivative markets, reduce counterparty and systemic risk, and help regulators identify cases of market manipulation, insider trading or other abuses. We believe the DMA takes a huge step in the right direction and largely addresses the outstanding concerns with respect to the swap markets.

As active participants in the OTC derivative markets, MFA members have a strong interest in promoting the integrity and proper functioning of these markets, and ensuring that there is no repetition of the AIG debacle that required Congress to use taxpayer funds to shore up the stability of that market. Similarly, MFA members are concerned with the possibility of another Lehman Brothers-like failure. As is discussed further in my testimony, a large share of the money that was lost in the failure of Lehman Brothers belong to their customers, including swaps customers, who had posted collateral on their OTC swap transactions with Lehman Brothers that was not segregated. As the Committee may be aware, these assets will likely be tied up in bankruptcy proceedings for many years. Both AIG's near default and the actual Lehman Brothers failure raise significant counterparty and systemic risk concerns for our members. MFA members depend on reliable counterparties and market stability. As such, we have a strong interest in ensuring that new legislation addresses counterparty and systemic risk, and protects customers' collateral by requiring a clearing organization to hold, and a swap dealer to offer to hold, customer funds in segregated accounts, which are protected in the event of bankruptcy. In this regard, we appreciate and support the provisions in the Committee's discussion draft that address segregation of collateral. We provide additional comments further below.

MFA appreciates and commends the Committee on its thoughtful discussion draft. We provide a number of comments, which we believe are consistent with the public policy goals of the DMA and will further enhance the benefits of OTC derivatives regulation. We would like to work with the Committee in addressing these issues and are committed to working with Congress and the Administration with respect to efforts that will restore investor confidence, stabilize our financial markets, and strengthen our nation's economy.

I. THE REGISTRATION OF SWAP DEALERS AND "MAJOR SWAP PARTICIPANTS"[1]

MFA favors the registration and regulation of swap dealers along the lines provided by the DMA, with governmental oversight of swap dealers in a manner consistent with its oversight of securities dealers. We believe that such registration and regulation, such as trade and position reporting, will largely close the regulatory gaps that exist in the OTC derivative markets since most swaps transactions are effected with a swap dealer. In particular, the reporting requirements imposed on swap dealers will do much to assure that all material information is available to the responsible regulators.

With respect to registration of "Major Swap Participants", we recognize that the DMA has a more precise definition of major swap participant than the Obama Administration's proposed OTC derivatives legislation, which we believe will better serve the Committee's objectives of reducing risk to the economy while preserving the availability of OTC derivatives as appropriate risk-management tools. Nevertheless,

[1] Unless the context otherwise requires, we use the term "swaps" to refer both to commodity "swaps" that would be regulated by the Commodity Futures Trading Commission under the DMA and to "security-based swaps" that would be regulated by the Securities and Exchange Commission.

regulated users could potentially include insurance, energy and airline companies, utilities, private funds, pension plans and local governmental entities. Developing and imposing regulations, including capital regulations, on entities engaged in such diverse tasks, and doing so without impairing the new registrants' ability to operate, would be difficult, if not impossible, to implement. Accordingly, we do not believe that the regulators should undertake to require the registration of non-dealer entities as a routine matter. Should there be a situation where the regulators believe it prudent and materially beneficial to require the registration of a non-dealer entity as a major swap participant we believe that the regulators should not be required by the DMA to impose capital restrictions on such major swap participant. We believe that collateral and margin requirements, instead, would achieve the same objective.

In defining a major swap participant, we believe it is important that the DMA direct the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC", together the "Agencies") to publish objective standards for purposes of defining a "substantial net position" in order to provide market participants with a clear understanding of the regulatory boundaries for becoming a major swap participant. For non-dealer participants, the standards demanded of a major swap participant could be highly disruptive and impede a participant's primary business. To lessen the potential disruption and impediment, regulation should alert participants as to the major swap participant registration threshold and allow those participants that cross the threshold to take action, whether it be reducing OTC derivative positions or otherwise, to deregister.

We believe the term "substantial net position" is overly broad and subjective. We recommend the DMA direct the Agencies in defining the term to consider certain factors, such as:

(i) The relative net position of swap dealers (*i.e.,* substantial net position should be measured with respect to the net position of swap dealers);

(ii) The participant's average net position over a relative period of time, such as a year;

(iii) Whether the participant's counterparties have a substantial unsecured credit exposure to such participant from outstanding swaps;

(iv) Whether the participant holds assets belonging to retail customers; and

(v) Whether the participant is an existing registrant with either the CFTC or SEC.

II. TRANSPARENCY AND TRADE REPORTING

MFA believes that price transparency, accomplished by trade reporting through the reports of central clearing organizations or swap repositories, is an essential feature of developed markets. Such transparency both protects end-users who may have more

limited access to trading and price information than dealers, and it serves as a means to ensure that parties mark their positions accurately and do not transfer, or demand the transfer, of either too much or too little margin. As such, MFA supports the establishment of a regulatory reporting regime for swap participants in which both cleared and uncleared swap contracts are recorded and reported to regulators on a confidential basis.

In addition, we believe that trade reporting to regulators will provide regulators with greater information and transparency for purposes of understanding and regulating the markets as a whole, and for compliance and enforcement purposes. We believe such transparency and efforts by regulators will enhance the integrity and competitiveness of our markets. We strongly believe that swap repositories, central clearing organizations and regulators should maintain information on individual OTC derivative contract information on a confidential basis to protect the proprietary trading information or intellectual property of individual market participants. Further, we believe that disclosure of trading information of individual market participants could lead to unintended consequences, and may be misleading to the public and harmful to reference entities. To enhance general transparency of the OTC derivative markets, we support the broad publication of aggregated market information that does not disclose individual proprietary trading information.

Insofar as the mechanics of trade reporting are concerned, we believe that the operations of the swaps markets should be consistent with the operations of the securities markets. We support the DMA's reporting framework, which requires a derivatives clearing organization to report cleared swaps, a swap dealer to report trades with a non-dealer, and for swap participants to contractually agree as to which party shall report when a dealer is not a counterparty.

III. Clearing, Segregation and Portability Requirements

MFA believes that a regulatory framework for OTC derivatives should maximize the ability of market participants to mitigate risk and encourage product innovation. As such, it is critical to provide market participants with the ability to engage in non-standardized or customized products. These products allow market participants to custom manage their firm or company's specific risks in a way unmatched by standardized products. Further, we must recognize that today's standardized products were, at their inception, highly customized innovations.

That said, however, we believe that cleared OTC derivatives play an essential role in reducing the interconnectedness that results from too much credit exposure flowing through a limited number of dealers and as a result significantly reduce systemic risk. Central clearing will also allow participants to net trades and more efficiently reduce their OTC derivative exposures across positions, rather than engage in off-setting contracts with multiple dealers to economically neutralize a position where counterparty risks are still present. In addition, central clearing reduces operational and counterparty risk, as it

does in the equity and futures markets, and offers increased regulatory and market efficiencies with respect to cleared OTC derivative products. Thus, we believe that legislation should strongly promote central clearing of standardized OTC derivative products.

In this respect, we believe the DMA does not go far enough in promoting the use of clearing organizations to clear standardized OTC derivative products. The DMA would only make central clearing mandatory after the appropriate Agency had determined such clearing was appropriate for a particular swap, and even then only as to swaps involving a limited group of participants. We recommend that the DMA broadly encourage central clearing by:

(i) Allowing end-users that post cash collateral to have access to central clearing either through direct participation in a clearing organization or through a swap dealer where there is a clearing house that will take the swap;

(ii) Providing, where it is possible for a swap to be cleared through a clearing house, that the appropriate regulator impose capital requirements on a dealer that would motivate the dealer to trade through the clearing house and not on an uncleared basis; and

(iii) Requiring the Federal Reserve Bank of New York ("NY Fed"), with appropriate standards, to continue its efforts to increase the volume of transactions that are centrally cleared and to report to the Committee on at least an annual basis as to progress in this direction and any impediments to progress.

With regard to clearing organizations, we support the provisions in the DMA that: (i) governance arrangements should be transparent and take account of the views of all market participants; and (ii) membership standards should be fair and open, including with respect to access by non-dealers. In sum, we believe an OTC derivatives regulatory framework should make available to end-users the opportunity to engage in standardized trades eligible for clearing either as direct clearing organization members or through a swap dealer.

At the same time, while we hope that most pre-adoption date or "legacy" standardized swaps would be moved to central clearing organizations, we raise the concern that these trades may have been entered into on the basis of understandings and economic arrangements that reflected then current law. We believe that if Agencies, under the DMA, mandate central clearing for products before addressing these concerns, such a requirement may be very disruptive to the market. For example, the initial margin requirements for a standardized, cleared trade may be linked (or "hedged") to the initial margin requirements for a non-standardized, non-clearable trade. In this instance, if this hedged trade was disrupted by a *post facto* change in law, we think there is the potential for market disruption that would outweigh the advantages of mandatory clearing for this existing business. For these reasons, we suggest that the DMA do the following: (i) exempt from the Agencies' clearing requirement any new swap contracts that hedge legacy swap contracts, but would otherwise be clearable, until the legacy contracts

mature or are unwound; and (ii) expedite the transition of legacy trades into centralized clearing by creating inducements (*e.g.*, substantially better capital treatment for cleared trades), but any such provision should not penalize end-users relative to dealers.

With respect to reducing systemic risk, we believe the most important requirement that must be imposed on a registered clearing organization is the prohibition against a clearing organization or its members having access to the collateral of their customers or commingling their proprietary assets with those of their customers, based upon a legal framework that protects those assets from the insolvency of a clearing member. In this regard, we believe the DMA takes a number of important steps by expressly requiring the segregation of collateral on cleared trades and further by requiring that dealers make segregation optional with respect to trades that are not cleared. As positive as these steps are, MFA is concerned that Congress's intent in protecting end-users from dealer failure will not be realized unless corresponding changes are made to the bankruptcy laws, including those applicable to banks that act as swap dealers, which recognize that the margin segregated for customers is meant to be returned to customers and not appropriated for the general expenses of the swap dealer. These changes to the bankruptcy laws, which protect customer assets, will also make it possible to transfer swaps out of a failing dealer and into a stable dealer, which will hopefully do much to diminish financial contagion caused by rippling failures.

Finally, over the past several years, MFA and its members have worked with swap dealers and regulators, including the NY Fed, to build-out the infrastructure of the OTC derivative markets. We believe the NY Fed's involvement has been instrumental in encouraging the industry to agree on key documentation terms that constitute standardization and developing central clearing. This process has benefited buy-side investors by expediting the process of reducing systemic and counterparty risks, and developing and making available efficient, standardized products. We would like to see regulators build on existing public-private efforts to further promote the development of these markets. We recommend that the DMA formalize the public-private working group as an "OTC Derivative Markets Advisory Committee" to further promote the development of central clearing and the OTC derivative markets infrastructure.

IV. SEGREGATION OF CUSTOMER ASSETS ON NON-CLEARED TRANSACTIONS

MFA supports the DMA provision that requires swap dealers to offer customers the availability of collateral segregation. We believe that the benefit that the financial system will derive from the mandatory clearing of standardized products will be substantially multiplied if consistent protections are at least made available with respect to non-cleared products.

The case in point is the failure of Lehman Brothers. The losses resulting from the failure of Lehman Brothers are astronomic. Even as to the money that may eventually be recovered, the delays will be substantial, into the many years. Further, the process of recovery will undoubtedly generate numerous disputes over valuation and conflicting

rights that seem likely to deplete a good portion of what otherwise might have been available for distribution to the directly injured parties.

A large share of the money that was lost by the failure of Lehman Brothers was not that of Lehman Brothers' shareholders or even of its ordinary creditors who had made an investment decision to lend money to that firm. Rather, the money lost was that of Lehman Brothers customers, including its swaps customers, who had posted collateral with Lehman Brothers that was not segregated.[2] Ironically, such collateral is often posted as a credit mitigant against a customer failure—yet dealer counterparties are currently free to use such collateral as their own property—exposing customers to the risk of loss. MFA believes that the financial markets cannot perform their purpose of capital formation if customers that are seeking safe custodial treatment of their assets are subject to the same risks, or even disproportionate risks, to the shareholders and creditors of a company. Custodial customers ought to be protected from the imposition of investment risk. In this regard, MFA believes that initial margin posted by end-users on swaps is intended as a safeguard against failure; it ought not to be transformed by a swaps dealer into a disguised and forced investment by a customer into the assets of the swaps dealer. The DMA takes an important step in this direction. But again we emphasize the importance of changing the bankruptcy laws to effectuate these changes.

V. EXCHANGE TRADING

MFA supports the goals of market transparency and enhanced liquidity. In this regard, we support the ongoing development of trading markets that respond to the needs of both swaps dealers and end-users, whether this is exchange trading, OTC trading, or, as we think will eventually likely be the case, a hybrid market that accommodates both exchange and OTC trading. Further in this regard, MFA supports the development of exchange-traded products as a complement to OTC products and we believe, that given the recent and significant efforts regarding product standardization and clearing, such products will steadily emerge in the marketplace. We support the DMA's approach to exchange trading in that it requires the Agencies to endeavor to eliminate unnecessary impediments to exchange trading. However, we believe that exchange trading should not be viewed solely as a vehicle for swap dealers and major swap participants. We believe that end-users may also benefit from exchange or electronic market trading. We recommend that to the extent such products or exchange markets do not emerge over a reasonable time period, the Agencies should undertake a study to determine whether there are artificial barriers standing in the way of the development of such products or markets.

[2] We believe that there is in excess of $50,000,000,000 in customer assets still being held in Lehman Brothers International (Europe) ("LBIE"), which belongs to pension funds, endowments, hedge funds, and other large U.S. institutions whose beneficiaries are U.S. citizens. There is no timetable for when the assets will be returned. Congressman Gregory Meeks (D-NY) has offered a Concurrent Resolution seeking action to free the assets trapped at LBIE (See H. Con. Res. 184).

VI. POSITION LIMITS AND REPORTING

We have strong concerns with the DMA provisions providing the Agencies with the authority to impose position limits in the swap and security-based swap markets. We believe the statutory purpose or public policy objective behind position limits is unclear and that the DMA does not provide the Agencies with adequate guidance as to the policy objectives behind position limits. Position limits do not address systemic risk concerns, which as discussed, can be addressed through appropriate capital and margin charges, among other solutions.

As a general matter, MFA believes that position limits should only be imposed for physically-delivered commodities and only where the deliverable supply of the commodity is limited and, thus, subject to control and manipulation. Even then, regulators need to consider the right size for such limits to accommodate a market's unique depth and liquidity needs. On the other hand, where there is a nearly inexhaustible supply of the underlying commodity, concerns related to control and manipulation are largely irrelevant, making position limits an unnecessary and costly interference in markets.

We observe that it has long been recognized that cash-settled commodities do not raise the same market manipulation concerns as do physically-delivered commodities. Cash-settled commodities have deep and liquid markets, are primarily used for hedging and risk mitigation, and have little or no impact on consumers. We believe that the mechanical imposition of limits for cash-settled commodities will have the effect of reducing liquidity and the ability of commercial participants to hedge against future changes in price by limiting the ability of market participants to appropriately diversify and reduce risk. We are also concerned that position limits would distort markets, especially given the global nature of the OTC derivative markets. We respectfully urge the Committee to take into consideration the impact that such regulation would have on U.S. markets when international markets do not impose position limits. To the extent the Committee determines it necessary that the DMA provide the CFTC with authority to impose position limits, we believe the authority to apply position limits should be subject to the international harmonization provision of the DMA.

With respect to securities, we strongly disagree to the DMA providing the SEC with the authority to set position limits on securities, either in the cash market or on securities-based swaps. Under the Securities Exchange Act of 1934 ("Exchange Act"), securities investments and related transactions are regulated through disclosure, not by establishing limits on the size of permitted investments. That is, under the current regulatory regime, to the extent the size of investments is a concern, it is dealt with through Exchange Act Section 13 reporting requirements and, as an anti-trust issue, under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR"). Under the HSR, procedures are in place to monitor positions that may be anti-competitive.[3]

[3] We also note that many specific industries have ownership restrictions in cases where it is viewed as beneficial to restrict ownership in these industries (*e.g.*, banks, airlines, and casinos).

Giving the SEC the authority to set position limits on capital markets investments would be unprecedented. Any such extraordinary action should not be shoehorned into swaps legislation but should only be considered following an open discussion on the merits. Furthermore, it is not clear why, or on what basis, the SEC would impose position limits on investments in corporate issuers or economic exposure to corporate issuers. We are concerned that imposing position limits on corporate ownership or exposure could have very substantial negative impacts on capital formation, the ability of banks and other credit institutions to transfer risk, the ability for corporations to obtain credit, and on corporate control.

We believe that the emphasis on position limits in the draft legislation is unrelated to the stated goals of addressing systemic risk and should not be used as an inadvertent vehicle to open up issues relating to corporate control. In addition, we believe that in this environment where the SEC is focused on improving shareholder rights and boosting investor confidence, providing the SEC authority to limit investors' investments in corporations may be an unwise expansion of government intervention into corporate governance. We believe these issues should be given further consideration in a separate hearing with representatives from the broader investor community.

MFA stands ready to work constructively with Congress and the SEC in providing an investor perspective as to the appropriate degree of public and regulatory position reporting transparency. As with position limits, however, we do not think it is good policy to revise Section 13(d) and related reporting requirements without giving much greater consideration as to how these statutory changes would impact the capital markets. Accordingly, we respectfully request that the Committee consider a separate hearing to address these important investor issues. Moreover, with respect to position reporting, we believe that the swap repositories will provide the SEC with access to all the data it needs to track swap positions and make factual determinations to see if changes in disclosure policy are warranted.

VI. ABUSIVE SWAPS

The DMA provides the Agencies with the authority to ban abusive swaps. We are concerned that such provision is overly broad and vague, and lacks clear statutory and public policy goals. If the Committee is concerned about the use of a swap to manipulate the market of a reference entity, we believe such scenarios may be more appropriately addressed through the current antifraud and anti-manipulation authority of the SEC and CFTC. To the extent the Committee is concerned that a swap provides a negative signal to the market as to the financial health of a reference entity, we are concerned that by banning the swap, the Agencies would not reduce or eliminate the risk of default by the reference entity, but instead would prevent parties from mitigating their exposure to the reference entity. Moreover, the act of banning such a swap is likely to signal to the market the negative financial condition of the reference entity and could exacerbate the decline of the reference entity's stock price and counterparty relationships. Accordingly, we recommend the Committee replace the DMA's abusive swap provision with an anti-

fraud and anti-manipulation provision to protect the integrity of the swap markets and the markets of their underlying reference entities.

VII. CONCLUSION

MFA appreciates the Committee's thoughtful discussion draft on the Over-the-Counter Derivative Markets Act of 2009. MFA believes that regulation of OTC derivatives products should be implemented in a manner that respects the similarities and important differences among asset classes. To the extent practicable, regulation of OTC derivatives by the CFTC and SEC should be streamlined, consistent, and take into consideration the economic fundamentals of the product. We support the DMA's requirement that the Agencies engage in joint rulemaking, adopt uniform rules, where applicable, and share interpretative guidance. In this way, we believe that the Agencies will minimize the likelihood to create regulatory loopholes and arbitrage opportunities. Further, regulation that were to treat products within an asset class differently, such as single security CDS and CDS indices, would add no benefits in protecting against systemic risk, but would greatly increase the complexity and cost of regulation for market participants and limit their ability to use such products to manage credit risk. We believe that smart regulations that parallel market practice will enhance oversight and compliance, support the risk management needs of market participants and further promote innovation and competition.

MFA is committed to working with Members and staff of the Committee and regulators to enhance our regulatory system, to reestablish a sound financial system and restore stable and orderly markets. Thank you for the opportunity to appear before you today. I would be happy to answer any questions that you may have.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

ON

REFORM OF THE OVER-THE-COUNTER DERIVATIVE MARKET: LIMITING RISK AND ENSURING FAIRNESS

October 7, 2009

Statement Made by

Mr. Scott Sleyster, CFA

Chief Investment Officer, Domestic

Prudential Financial

Statement of the American Council of Life Insurers on

Reform of the Over-the-Counter Derivatives Market

Introduction

Mr. Chairman and members of the Committee, my name is Scott Sleyster. I am Chief Investment Officer of Prudential Financial's U.S. Operations and I appear here today as a representative of the American Council of Life Insurers (ACLI).

ACLI is a national trade association with 340 members that account for 93 percent of the industry's total assets, 94 percent of life insurance premiums, and 94 percent of annuity considerations. In addition to life insurance and annuities, ACLI member companies offer pensions, including 401(k)s, long-term care insurance, disability income insurance, and other retirement and financial protection products.

Members of the ACLI use the Over-the-Counter ("OTC") derivatives markets to protect their assets and to hedge risks inherent in the policies and products they issue to customers. Life insurers' use of derivatives is carefully and prudently regulated by state insurance departments pursuant to state laws and regulations. These laws and regulations uniformly prohibit life insurers from using derivatives as a means of speculation or proprietary trading. In short, life insurers are key "end users" of derivatives who will be immediately affected by regulatory changes in these markets mandated by new federal laws and policies.

The composition of life insurers' assets is significantly different from other financial institutions, and reflects the long-term commitments and stability necessary for life insurers' obligations. Life insurers' financial products protect millions of individuals, families and business through guaranteed lifetime income, life insurance, long-term care and disability income insurance. The long-term nature of their products requires insurers to match long-term obligations with assets of a longer duration than other types of financial institutions. Derivatives allow life insurers to prudently manage the credit, interest rate, and market risk in their portfolios, and concomitantly to fulfill their obligations to contract owners. The regulatory status of derivatives, therefore, is critically important to the life insurance industry.

As the largest class of investors in the debt of U.S. corporations[1], life insurers need the ability to prudently manage the risks inherent in these asset categories through the

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[1] Some basic background reflecting 2008 data may provide useful scope and context:

- life insurance industry assets were invested in: corporate bonds (42%); stocks (24%); government bonds (14%); commercial mortgages (7%); other assets (13%);
- life insurers provide the single largest U.S. source of corporate bond financing;
- approximately 56 percent of life insurers' $4.6 Trillion total assets in 2008 were held in bonds, with 42 percent composed of corporate bonds; and,
- over 41 percent of corporate bonds purchased by life insurers have maturities in excess of 20 years (at time of purchase).

derivatives markets. Efficient and cost-effective derivatives markets, therefore, are very important to life insurers as end-users, as well as to our corporate borrowers, their employees and their local business communities.

We have evaluated the Discussion Draft (dated October 2, 2009) to enact the Over-the-Counter Derivatives Markets Act of 2009, as well as the Department of the Treasury's draft legislation and its whitepaper, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*. We offer the following views on these important legislative developments.

Comprehensive Federal Regulation of the OTC Derivatives Markets Is Appropriate

ACLI supports comprehensive federal regulation of OTC derivatives markets and products. The proper operation of these markets and the continued availability of OTC products are major concerns to ACLI members as end users of derivatives. Given that the derivatives markets are national and international in scope and inter-related with many other federally-regulated investment and financial markets and institutions, with potential systemic impacts, these markets and products should be regulated at the federal level, rather than by states. This federal pre-emption of market and product regulation should leave intact state and federal functional regulators' jurisdiction over derivatives usage by insurers and other financial institutions.

Continued Availability of Customized OTC Derivatives is Important

ACLI supports continued recognition of different classes of OTC derivatives – standardized and customized. Insurers use a diverse group of financial derivatives, from standardized derivatives, like single name Credit Default Swaps (CDS), to customized derivatives, like structured interest rate and currency swap transactions. Although standardized derivatives are a core hedging tool for life insurers, they do not offer the flexibility and cost efficiency needed to properly manage risks associated with the full range of insurers' assets and liabilities. Consequently, customized derivatives account for a large portion of insurers' OTC derivatives usage and are utilized to provide a closer offset to the market risks of insurance products that are tailored to fit customer needs and to precisely hedge risk in assets held to manage insurance liabilities. For example:

- Many insurance products such as long term care insurance, traditional life insurance, and fixed annuity products are of very long duration, characterized by payments to customers that can range from 15 to 25 to even 50 years. These products require insurers to manage interest rate risk that is much longer in duration than what can be effectively hedged through the exchange-traded futures markets. Customized OTC derivatives are utilized to better manage the cash flow timing and maturities of the policyholder obligations.

- Under certain variable annuity contracts that contain equity guarantees, a policyholder has the ability to withdraw funds at a guaranteed minimum market

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These calculations are based on data from the NAIC and the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S. *See* American Council of Life Insurers, *Life Insurers Fact Book (2009)*.

value, regardless of stock market performance and interest rate movements. These guarantees, tied to market performance, are prudently hedged with a combination of customized swaps and options.

- In order to diversify investment portfolios, insurers at times purchase fixed income securities issued by non-U.S. companies. An investment that is attractive from a credit perspective could be denominated in a foreign currency. If the policies supported by these investments are dollar-denominated liabilities, these foreign currency investments will be "swapped" to dollars to reduce exposure to fluctuations in currency values. Customized currency swaps are utilized to exactly match the rate, payment periods, and maturity of the foreign currency assets to convert the foreign currency amounts into U.S. dollars.

Burdensome restrictions on customized OTC derivatives could create unnecessary, non-economic frictional costs for delivering life insurance, long term care and retirement savings products to millions of Americans. In some instances, insurers' products may be removed from the market altogether if risks cannot be effectively hedged. Ultimately, additional costs to derivatives can lead to an increase in product pricing or the inability to purchase products to manage customers' retirement savings, estate planning, or long-term care coverage.

In sum, therefore, we support the approach taken in the Discussion Draft that does not present a bias in favor of standardized derivatives and acknowledges the continued need for customized derivates in managing end-users' risks.

Increased Costs for Hedge Protection Should be Carefully Evaluated

Insurers' cost of obtaining necessary hedge protection could be increased through aspect of the different legislative proposals. An increase in hedging costs could produce higher prices to consumers for insurance products or might frustrate prudent hedging that becomes too expensive. If insurers cannot adequately hedge market risks due to the cost of obtaining hedges, they may need to reduce the product guarantees or even stop offering the product altogether. Increased hedging costs could arise in a number of different ways. A regulatory bias driving customized derivatives onto clearinghouses or exchanges could substantially increase the cost to end users of obtaining hedge protection. Further, regulatory measures which reduce liquidity in markets (such as bans on naked CDS) will increase the cost of buying credit protection. Finally, the costs of transaction fees or taxes, fees charged to dealers for transacting in customized derivatives or punitive capital charges for these transactions, will not actually be borne by the dealers, but will be passed on by the dealers to end-users in their transaction pricing. It is critically important, therefore, to carefully balance burdens against the benefits of revised derivatives regulation.

Centralized Clearing for Standardized OTC Derivatives Appropriate, but not for Customized OTC Derivatives

ACLI supports centralized clearing of standardized OTC derivatives. Plain vanilla OTC derivatives such as single-name and index credit default swaps fall into this category. Clearinghouses and particularly exchanges operate on the basis of numerous, precisely off-setting, transactions that net down the clearinghouse risk to an amount that is effectively margined by deposits from members and customers. Margin levels are set

based on risk modeling, which is fairly straightforward in the case of highly standardized products such as exchange-traded futures, or certain types of OTC credit derivatives.

By their unique nature, however, customized OTC derivatives are not capable of being off-set on this basis, and the risk modeling of these contracts at a clearinghouse would be extremely complex and challenging. Accordingly, market users of customized OTC derivatives would face the risk of prohibitively expensive collateral and margin levels if these contracts are forced into a central clearinghouse. For example, a clearinghouse might for its own protection require both parties of a trade to post super-sized-margins based upon the full potential value (risk) of their transaction.

Life insurers that are active in OTC derivatives markets currently execute their customized derivatives through prudent collateral agreements with their counterparties under which exposures are netted and collateral must be posted between the parties. In this manner, insurers and their counterparties are able to effectively reduce and control the counterparty credit risk arising from customized OTC derivatives.

An impetus toward creation of clearinghouses in the OTC derivatives market is not desirable for several reasons:

- The creation of multiple single product clearinghouses could increase, rather than decrease risks in these markets. Under insurers' current netting and collateral agreements with their counterparties, multiple diverse and offsetting risks (e.g., interest rate, credit, equity, and currency risks) can be netted off and these risks reduced bilaterally. Likewise, in an ideal efficient clearing system, the clearinghouse will recognize and credit the offsetting risk of multiple derivative classes, which will have the benefit of reducing margin flows and capital requirements. But this positive feature of clearing would be lost if the number of clearinghouses proliferate, especially for individual products, so that offsetting risks are not recognized. Also, the insolvency risk may be higher for small specialist clearinghouses.

- Clearinghouses could decrease collateral flexibility for end users, increasing frictional costs at minimal benefit to the stability of the financial system. At the present time, insurers' collateral arrangements with their direct OTC counterparties normally allow for the posting as collateral of a range of investment securities typically held by insurers, such as corporate bonds (subject to an appropriate "haircut" to reflect the counterparty's evaluation of the collateral credit risk). This flexibility is not available in exchanges and clearinghouse systems, where cash and U.S. Treasury securities are normally required to be posted. A clearinghouse system which does not have the current OTC market's flexibility and requires the posting of cash and Treasuries exclusively, or imposes onerous haircuts on other collateral classes would greatly increase the hedging costs of our members and could force them to abandon hedge strategies that are too costly or alternatively increase insurance product pricing or reduce the benefits to policyholders.

ACLI supports exploration by market participants and regulators about additional clearing solutions to reduce systemic risk, and believes that any bias toward compulsory clearing for the current well-understood and risk-constrained contractual approach should be avoided. Regulatory bias toward clearing of OTC derivatives without regard to the cost involved in the case of complex, difficult-to-price transactions could result in an inefficient use of capital, high transactional costs and the potential loss to our industry

and other end users of critically important risk management tools. We support the approach of the Discussion Draft that does not mandate compulsory clearing.

OTC Derivatives Trade Reporting Appropriate

ACLI endorses greater market transparency and prevention of market manipulation, fraud, and other market abuses. To this end, we support recommendations that will require OTC derivatives transactions to be reported to a central trade information repository and to financial regulators, provided that that timing of required reporting is reasonable and takes into consideration the hedging needs of market participants. Like other hedgers, insurers frequently execute integrated hedging strategies involving a series of individual trades which may require one or two days to complete. Premature public reporting of individual trades in these circumstances would likely make the strategy's accomplishment more expensive and might jeopardize its completion. For this reason, we would oppose a requirement of public (rather than confidential regulatory) reporting of individual trades prior to the completion of a hedging program.

Safe-harbor for Intra-Group Derivatives Transactions Needed

Complex insurance organizations operate through various insurance company affiliates. It would be counterproductive to require OTC derivatives trades among companies within the same holding company system to clear through a central clearinghouse. Such a requirement would have the burdensome consequence of requiring affiliates to post collateral/margin at a clearinghouse for their related-party risk, even though this risk is presumably well-managed within the existing holding company system under applicable insurance regulation. We note that the American Clean Energy and Security ("ACES") bill recently passed by the U.S. House of Representatives could be read to require standardized transactions among affiliated companies to be cleared through a central clearinghouse. State insurance laws and the Administration's proposed systemic risk measures are adequate to control any risks associated with this intra-group activity. The Discussion Draft should be amended to allow intra-group transactions without clearing through a central clearinghouse.

Prohibition of "Naked" Derivatives Transactions Is Inappropriate

There have been some proposals to ban or limit the entry into "naked" derivatives positions, most recently in the ACES bill, which would prohibit entry into a credit default swap transaction by a party that does not hold the underlying investment. U.S. life insurers generally enter into non-hedging CDS transactions only for "replication" purposes, an unleveraged and fully-funded conservative derivatives strategy permitted under insurance law for creating synthetic asset positions. While we are concerned that a prohibition of "naked" derivatives could affect this strategy, ACLI has broader concerns with this prohibition.

These proposals reflect a potentially harmful misunderstanding of the dynamics of financial markets, particularly derivatives markets. A healthy, robust market is a two-sided market, where both positive and negative views of a particular risk or investment may be taken. A buyer and a seller are required for every trade. The existing futures and options markets are a good example of markets in which "naked" derivatives positions are utilized to express investment views. In order for insurers and other hedgers to obtain the necessary protection or for OTC derivatives dealers to manage the

risk of protection they sell, additional market participants are needed to take the other side of the market.

Prohibition of "naked" derivatives transactions could cripple the OTC derivatives marketplace by eliminating a necessary market segment. The counterparty risk of "naked" derivatives is properly controlled through appropriate margining and collateralization at the contractual or clearinghouse level and systemic risk regulation, not through wholesale prohibition of the activity. Credit default swaps are critical to life insurers in managing the credit risk of our investment portfolios. The Discussion Draft prudently avoids bans on naked derivatives transactions.

Summary

I greatly appreciate the opportunity to present ACLI's views in today's hearing before the Committee. Life insurance products help Americans manage their financial risk and plan for their financial future. Life insurers can offer these products given their ability to manage large pools of assets and manage risk. Customized derivatives play a vital role in both asset and liability risk management. Therefore, it is very important to the life industry that derivatives oversight and regulation are reasonable and cost-effective.

Testimony of René M. Stulz[1]

To the

House Committee on Financial Services

Over-the-Counter Derivatives Markets Act of 2009

October 7, 2009

[1] René M. Stulz is the Everett D. Reese Chair of Banking and Monetary Economics at the Fisher College of Business of the Ohio State University, a Research Associate of the National Bureau of Economic Research, a trustee of the Global Association of Risk Professionals, and a member of the Squam Lake group of academics studying financial reform. The opinions expressed are his own, but he is grateful for useful comments from many colleagues and thanks especially Rich Apostolik, Darrel Duffie, Donna Howe, and Jack Stulz for helpful discussions.

Mr. Chairman, Ranking Member Bachus, and members of the Committee, I thank you for providing me this opportunity to discuss with you draft legislation concerning the over-the-counter derivatives markets. My name is René M. Stulz. I am the Reese Chair of Banking and Monetary Economics at the Ohio State University. I am testifying in my individual capacity as an academic expert in risk management and derivatives.

My testimony is divided into five parts. First, I want to briefly review how derivatives are used by non-financial and financial firms throughout the world and make the point that the legislation you are contemplating should not make it harder for firms to use derivatives to manage risk. Second, I would like to address the role of the over-the-counter market and why it is important for legislation to make that market work better rather than reduce its role. Third, I will then turn to clearing and how the draft legislation addresses clearing. Fourth, I would like to discuss the capital requirements contemplated in the draft legislation. Fifth, I want to address the reporting, disclosure, and business conduct provisions of the draft legislation.

1. The use of derivatives.

Derivatives are used in many different ways. Many uses of derivatives lead to greater economic growth and to job creation. In contemplating legislation regulating derivatives, it is important to avoid decreasing the uses of derivatives that are good for the economy.

Let me give you a simple example of how the use of derivatives can create jobs. Consider a small exporter in Ohio that exports machinery and considers bidding on a contract to export to Italy where it will be paid in Euros. The moment the exporter makes a bid in Euros, it takes on

currency risk. The Euro could depreciate between the time the bid is made and a decision is rendered. During that time, the Euro could fall in such a way that all the profits of the exporter are lost. The exporter may decide that the currency risk is too large and decide not to bid. With currency options, the exporter could hedge against the possible depreciation of the Euro. Hence, through the use of derivatives, the exporter could decide that it can bid on the contract, in which case jobs will be created if the contract is awarded. In my example, the exporter would have to use the over-the-counter market to obtain the best hedge. The reason is straightforward: the contract would have to be tailored to the size of the bid and reference the date that the decision is made in order to be cost effective.

Firms throughout the U.S. and the world use derivatives in a similar way on a daily basis. They use derivatives to eliminate risks that they do not want. As they eliminate these risks, they can take advantage of business opportunities that otherwise would have to be turned down. Academic research generally provides quantitative studies on the benefits from the use of derivatives. For instance, a recent study that examines the use of derivatives by non-financial firms investigates 6,888 firms from 47 countries during 2000 and 2001.[2] These firms constitute 99% of the world market capitalization. It finds that 60.5% of these firms use derivatives. The sample includes 2,076 U.S. firms and 65.1% of these firms use derivatives. The study concludes that using derivatives makes firms less risky and worth more. In 2009, ISDA conducted a survey of derivatives usage by the world's largest corporations, those corporations in the Fortune Global 500. The survey finds that 94% of the world's largest corporations use derivatives.[3]

Derivatives also make financial markets work better. Derivatives markets are often more liquid and better at price discovery than the markets for the underlying securities. For instance,

[2] See "The effects of derivatives on firm risk and value," by Söhnke M. Bartram, Gregory W. Brown, and Jennifer Conrad, working paper, University of North Carolina, Chapel Hill, NC, March 2009.
[3] http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes2.pdf.

they make markets like the market for Treasuries function better by enabling investors to hedge risks associated with Treasuries quickly and cheaply when the bonds they hold lack liquidity. With better functioning Treasury markets, interest rates are lower and less volatile.

2. The role of the over-the-counter markets.

The over-the-counter markets are central to the trading of derivatives. This critical importance of over-the-counter markets is not unique to derivatives. Over-the-counter markets play a central role in the trading of many securities. Treasury bills and bonds trade over-the-counter. Foreign exchange trades over-the-counter. Most observers would agree that the Treasury and foreign exchange markets are among the deepest and most liquid markets in the world. Corporate bonds trade mostly over-the-counter as well. Even large trades of common stocks take place over-the-counter.

The notional amount of derivatives originated on the over-the-counter markets dwarfs the amount originated on exchanges. The most recent statistics available globally from the Bank for International Settlements show that the notional amount of over-the-counter derivatives outstanding at the end of 2008 was $591 trillion. In contrast, the amount outstanding on exchanges was roughly one-tenth of that amount. Much of the difference in size between the over-the-counter markets and the exchange–traded markets is accounted for by the fact that these two types of markets work very differently.

The over-the-counter markets are intermediation markets. In an intermediation market, an end-user – for instance, a manufacturing firm – will contact a dealer wanting a derivatives product. The dealer will sell the product to the end-user, but typically it does not want to take the

risk associated with that product and has to find somebody who wants to bear that risk. Consequently, there are many intermediaries between end-users in such a market because, when a dealer enters a contract with an end-user, the most likely outcome is that the dealer will enter an offsetting contract with some other dealer. As an example, if a manufacturing firm executes a $25 million interest rate swap (pay the fixed rate, receive the floating rate) to reduce its interest rate risk, then the dealer will execute the offsetting trade with another dealer – $25 million receive the fixed rate, pay the floating rate – who might then offset that position with another dealer, and so on, until an end-user has a demand for this offsetting trade. So the outstanding size of the market is a multiple of the end-user positions in derivatives. However, measuring size this way does not measure the value of the derivatives positions or their risk. For instance, in the latest report by the Comptroller of the Currency, the notional value of derivatives held by U.S. commercial banks was $203.5 trillion, but the fair value of these derivatives after taking into account netting at the dealer level, which is a measure of the credit exposure of dealers, was a quarter of a percent of that amount – $555 billion.[4] In contrast, with exchanges, end-users come to the exchanges to find other end-users, so that intermediaries are not needed. Exchanges work well for products where end-users come to the market continuously. They cannot work for products that are customized or have low liquidity.

Recent history shows that it is imperative to be concerned about potential systemic risks of the over-the-counter derivatives market. However, during most of the credit crisis, the over-the-counter market for derivatives worked remarkably well in many ways: derivatives were traded, payouts were made, collateral was exchanged. There is considerable focus on the problems that AIG experienced and justly so. Any legislation that addresses the regulation of

[4] OCC's Quarterly Report on Bank Trading and Derivatives Activities Second Quarter 2009.

derivatives markets should make it much harder for problems similar to AIG to surface again. Nevertheless, it is important to point out that the core of the problems of AIG was its levered exposure to subprime mortgages, which experienced large unexpected losses because of a collapse in housing prices.

The regulation of derivatives markets should allow the over-the-counter markets to thrive, but it should put in place safeguards that reduce the probability that these markets could impose excessive risks on the financial system. Almost all the innovations in derivatives started from the over-the-counter market. Further, the over-the-counter market is the most efficient vehicle to address specific needs of corporations through the provision of customized derivatives. Though corporations can frequently address their hedging needs through the use of standard products with standard maturities, often they cannot. Sometimes, a derivatives contract that has never been written before and may never be written again is the solution to a hedging problem that makes it possible for a firm to expand greatly and create many jobs. No standardized exchange product could help such a firm as effectively. Further, imposing large costs on financial firms for writing derivatives that are not plain vanilla would have just the opposite effect this legislation is meant to achieve, since it would make it unprofitable for financial firms to develop and sell such derivatives and would reduce the ability of firms and investors to manage their risks.

In principle, there is no reason why financial firms cannot manage the risks of derivatives trading effectively through good risk management and good corporate governance. JP Morgan Chase has had the largest share of the market for derivatives since it came into existence and has managed its derivatives activities with hardly a hiccup. Many more firms have managed the risks

of their derivatives books well than have made large unexpected losses. Good risk management and good corporate governance should be strongly encouraged.

Though derivatives specifically tailored to the needs of a specific firm can often be the most useful derivatives in allowing firms to manage risk, standardized derivatives are more liquid and are easier to value. Though the draft mentions standardized derivatives, it does not define them. Such a definition would be helpful. With such derivatives, disclosure and reporting are more meaningful because their terms are easily understood and compared.

3. The role of clearing.

For the typical derivatives position in the over-the-counter market, at least one counterparty is a financial institution. Consequently, the financial institution promises to make payments if called upon to do so through the derivatives contract. The largest financial institutions have a large number of such promises on their books, so that they may be called upon to make large payments on their derivatives. Typically, their books are well-balanced because they make their money out of intermediating transactions by taking a bid-ask spread. Consequently, if they are called to make such payments, most likely they will also receive such payments.

After the fall of Lehman, it was quite clear that there was a great deal of uncertainty about the financial condition of some banks. Most of this uncertainty had little to do with derivatives positions. The public filings of some banks provide an incredible wealth of information about their derivatives positions, but not all banks have filings that are equally transparent. Greater transparency of derivatives activities and exposures should be encouraged.

Further, the filings are typically not instructive about the exposure of banks through derivatives to individual counterparties. There are good reasons why exposures to individual counterparties should not be disclosed in public filings. However, it is imperative that regulators have a good understanding of such exposures and of how they change through time.

The over-the-counter derivatives industry has managed to reduce counterparty risks through a variety of mechanisms. The most important mechanisms so far have been netting and collateral arrangements. In addition, however, the industry has also moved towards using clearing for standardized products. A clearinghouse launched in July to clear CDS trades has already cleared 24,000 transactions for a notional amount of $2.2 trillion.[5] All these efforts should be encouraged and one should be wary of regulatory efforts that inadvertently slow down or revert the industry's progress in managing counterparty risk without substituting better mechanisms.

Clearinghouses assume counter-party risk. If dealer A and dealer B enter a derivatives contract, they have counter-party risk with each other. If dealer B defaults, dealer A makes a loss if the replacement cost of the derivatives contract is positive for dealer A – this would necessarily be the case if on net dealer B was expected to make payments – and dealer A has insufficient protection against a default by dealer B. A systemic concern with such losses is that, as a result of losses from the default of dealer A, dealer B could default as well – and so could subsequently a dealer who is a counterparty to dealer B. If dealers A and B clear the trade through a clearinghouse, the counterparty to dealer A becomes the clearinghouse and the counterparty to dealer B becomes the clearinghouse. As long as the clearinghouse is well-capitalized and manages its risks well, there is no material counterparty risk with clearinghouses.

[5] http://ir.theice.com/releasedetail.cfm?ReleaseID=406881.

This fact explains the widely-held belief that requiring clearing for over-the-counter derivatives will significantly reduce systemic risk. It is important, however, to understand that we have much experience with exchange clearinghouses and little experience with over-the-counter clearinghouses. Over-the-counter clearinghouses have not been tested in a financial crisis.

If a financial firm fails when derivatives are cleared, in principle there are no follow-on effects from the failure if the losses are absorbed by the guarantee fund of the clearinghouse rather than by counterparties. With clearing, the positions of a financial firm with the clearinghouse are netted, so that if the financial firm fails it might owe the clearinghouse much less than it might owe some financial firms without clearing.[6] Further, the collateral deposited with a clearinghouse for margin requirements is not at risk in the way that it would be if deposited with a dealer, so that default of a dealer would not endanger collateral for other dealers. Consequently, the failure of a financial firm could have much less of an impact on the financial system with properly conceived clearing. However, clearing is not a panacea. It is perfectly possible that clearing could actually increase systemic risk and therefore it is of great importance to manage clearing requirements in a way that insures that systemic risk will be reduced. In the remainder of this section, I discuss how clearing could increase systemic risk and what should be done to avoid this outcome.

Counterparties can fail, but so can clearinghouses. Failure of a clearinghouse could have a much more dramatic impact on the financial system than failure of a derivatives dealer if that clearinghouse clears a significant amount of over-the-counter derivatives trades. Even if a clearinghouse does not fail, large losses can force it to make a capital call on its members during

[6] For instance, firm A could have $100 billion notional long and $100 billion notional short positions with the clearinghouse, for a net of zero. However, this net amount of zero could be $100 billion notional long with firm B and $100 billion notional short with firm C.

a financial crisis, which could lead members to default and worsen the crisis. It is therefore important that clearinghouses be properly capitalized and that margins be sufficient to insure a low probability of loss in the event of a default. The proposed legislation requires margins that cover risks in the ordinary course of business and requires the clearinghouse to hold capital that would cover the losses resulting from the failure of its largest participant. Neither requirement seems sufficient. The span margining system, which I understand to be industry best practice, is set up so that margins cover stress losses. It seems to me that this requirement should apply to the clearinghouses generally. Further, the capital requirement should be such that not only should a clearinghouse have the ability to absorb the default of its largest counterparty exposure, but it should still be able to operate properly if such a default occurs. The capital requirement for clearinghouses in the proposed draft does not appear sufficient for that purpose.

Academic research has shown that clearing could increase systemic risk rather than decrease it if there are too many clearinghouses.[7] With a clearinghouse, a counterparty is only responsible for its net exposure arising from contracts cleared by the clearinghouse. This netting benefit can be considerable. When a financial institution enters derivatives contracts without clearing, it also benefits from netting. In that case, netting takes place among all contracts under the same ISDA master agreement with a counterparty. If all derivatives contracts were cleared by the same clearinghouse, the benefit of clearing through the clearinghouse would dominate the benefit of netting arising from exposure under master agreements. However, the benefit from netting might be less through clearing if there are many clearinghouses. It is therefore important that legislation does not lead to a plethora of clearinghouses. Further, clearinghouses should be

[7] See the discussion in "Credit Default Swaps, Clearinghouses, and Exchanges," Squam Lake Working Group on Financial Regulation, July 2009, and "When does a central clearing counterparty reduce counterparty risk?" by Darrell Duffie and Haoxian Zhu, working paper, Graduate School of Business, Stanford University, February 2009.

allowed to clear different types of over-the-counter derivatives – for instance, interest rate swaps and credit default swaps, options on currencies and options on commodities. Another problem that arises with multiple clearinghouses is that dealers can select the clearinghouse through which they clear a trade opportunistically. Dealers will select the clearinghouse that has the lowest margin requirements for a trade, but that clearinghouse may have a low margin requirement because it underestimates the risk of the trade. With such a situation, clearinghouses could end up with derivatives whose risk they misjudge.

With many inadequately capitalized clearinghouses, systemic risk could be worse than under the current system. However, with few clearinghouses, the collapse of any clearinghouse would have a worse impact on the financial system and the lack of competition among clearinghouses means that clearing may quickly become inefficient. With few clearing houses, the risk management capabilities of each clearing house become critical to the stability of the financial system if these clearing houses clear a significant fraction of over-the-counter trades. Both operational risk and counterparty risk management of the clearinghouses have to be carefully monitored and clear minimum standards have to be established. Further, if there are few clearinghouses, these clearinghouses will have some monopoly power and could abuse this power through their pricing and margining policies and possibly in other ways. It seems to me that it would be beneficial for the legislation to address explicitly the situation where a clearinghouse becomes a monopolist in clearing trades of a given type of derivative and to specify how such a clearinghouse would have to be regulated.

A fundamental problem with clearing is that the clearinghouse has to be able to model the risks of the derivatives it clears and calculate daily gains and losses on positions. Such modeling is expensive. It does not pay for a clearinghouse to model the risks of derivatives that it will have

to clear infrequently or for which there is little market data. Had AIG wanted to clear the default swaps it sold, a clearinghouse would have been unlikely to want to clear these swaps because the modeling effort would have been too expensive and there would have been no market prices to use to set margins and evaluate gains and losses. This means that clearinghouses can only be used effectively for fairly standard products that trade frequently so that the clearinghouse observes market prices. Yet, often, the most useful derivatives to end-users are precisely customized derivatives that may be hard to model and do not trade at all. It is therefore important that banks be allowed to sell derivatives that cannot be cleared. On efficiency grounds alone, it would make little sense to require clearing for customized derivatives. The bank that sells the derivative has done the modeling. It should understand this derivative better than anyone else. It should therefore be in a better position than anyone else to manage the counterparty risk associated with such a derivative. If a financial institution understands and manages the risks of derivatives poorly, that is a problem that can have systemic implications. Clearing does not fix that problem because risks are left with the financial institution that writes the derivatives.

A final issue with clearing has to do with the decision of when it is appropriate for a regulator to require clearing for a type of derivative. Clearing requires data to model risk and to assess gains and losses in normal times, so that only liquid derivatives are likely to be acceptable for clearing. However, for clearing to reduce problems in a financial crisis, it must also be the case that the cleared derivatives remain liquid in a crisis. If clearing is required for derivatives that stop trading in a crisis, clearing might break down since the clearinghouse would not have accepted prices to determine daily gains and losses. This problem suggests that clearing should be limited to derivatives that have a high likelihood of remaining liquid in a crisis.

There are both costs and benefits in requiring clearing. Historically, when a type of derivative trades both on exchanges, where it is cleared, and over-the-counter, where it typically has not been, the cleared derivatives market does not necessarily dominate the over-the-counter market. For instance, for the last thirty years, it has been possible to buy or sell foreign currency for future delivery both on exchanges and over-the-counter. Both exchanges and the over-the-counter markets have done well. Similarly, currency options are traded both over-the-counter and on exchanges. It seems to me to be very difficult to argue that over-the-counter trading of foreign exchange products has created meaningful systemic risk. Given that exchange-traded versions of derivatives have not won over the over-the-counter versions of derivatives, it should be that the decision to require clearing be made based on clear, quantified, evidence that clearing must be required for the public good. Viewed from this perspective, the criteria in the proposed legislation appear to be too subjective; they could lead to arbitrary decisions and unwarranted expenses.

One way to address this important issue is that the CFTC and the SEC be required to define how systemic risk is measured. It would then be possible for these agencies to quantify how the clearing requirement for a type of derivative would reduce systemic risk. These agencies could then report to Congress how the clearing requirement they imposed reduced systemic risk. Absent a mechanism of this type, participants in the derivatives markets would find it difficult to anticipate when clearing is or is not going to be required. As a result, these participants might find it unprofitable to invest in systems that reduce counterparty risk and operational risk with derivatives when these mechanisms would become obsolete with clearing.

When the agencies require that a type of derivative must be cleared, they should also have to explain what the costs of clearing will be. It cannot be that anything that decreases

systemic risk is good by definition irrespective of cost. Collateral is scarce for dealers. It is therefore essential that any reform lead to a situation where collateral is used efficiently. Properly implemented, clearing could reduce use of collateral, which would be valuable and could lead to greater economic growth. Improperly implemented, however, clearing could have the opposite effect. By consuming excessive amounts of collateral, it could shrink the size of derivatives markets and make products valuable to end-users more expensive or even more difficult to obtain.

4. Capital requirements.

To the extent that derivatives that are not cleared pose systemic risks, it is important to make sure that institutions that do not clear derivatives have to bear the full cost to the economy of the risks posed by these derivatives. Consequently, the draft proposal to have higher capital requirements for derivatives that are not cleared is exactly what is required. However, it is important that the differential in capital requirements only be applied in instances where it is clear that there is a difference in systemic risks posed by derivatives depending on whether they are cleared or not.

The difficulties of AIG show, however, that it is not enough to have capital requirements. Financial institutions have to manage their liquidity so that they can make the payments that they are required to make for their derivatives contracts. From this perspective, greater attention should be paid to the liquidity of financial institutions and not just to the capital they hold.

5. Disclosure, reporting, and business conduct requirements.

An investor who wants to take a bearish position in a stock can do so in many ways. The investor can short the stock, buy a put on the stock, enter a total return swap, and so on. Currently, different approaches to achieve the same economic outcome are regulated differently. Such differences lead to regulatory arbitrage, which lessens the efficacy of regulation and can destabilize the financial system. In this context, it is important for derivatives trades that could influence prices of publicly traded securities to be recorded and for these records to be accessible to regulators. However, recording and disclosure requirements as well as business conduct rules that reflect concerns about conflicts of interest are of limited use for many types of derivatives where manipulation and insider trading concerns are not present. In fact, such requirements and rules could decrease the ability of derivatives markets to help end-users by making derivatives more expensive and by reducing the flexibility of dealers.

Reporting and disclosure requirements could make it much more expensive to introduce new derivatives products. Typically, new derivatives products have little or no volume. This low volume may be due to the fact that these products are not yet widely known and understood or could be because they were designed to serve very specialized needs from end-users. There is a huge diversity of derivatives products. Some products have been sold only once. Others have a huge market. If reporting, disclosure, and business conduct requirements are too onerous for new products, innovation will slow in derivatives markets. Yet, the most widely used derivatives of today, interest rate swaps, started in the 1970s as products that took weeks if not months to negotiate and with no trading volume at all. Care should be taken to make it possible for new products to emerge that may turn out to be as widely used as interest rate swaps in twenty or thirty years.

The draft legislation requires regulators to specify margins for derivatives. Having regulators specify margin requirements for each type of new derivative would cripple innovation in the over-the-counter market because it would effectively create an approval process for derivatives. It would seem worthwhile to consider a materiality threshold for reporting and margin requirements. In any case, it is not clear how this would work in practice. Margin requirements should be dependent on market conditions and should be determined at the portfolio level for positions with a counterparty. For instance, it could well be that an option bought by dealer A from dealer B has high risk, which would justify a high margin. However, at the same time, dealer B might have bought an option from dealer A that offsets most of the risk, so that the portfolio of exposures has little risk and justifies a low margin. It is not feasible for regulators to contemplate margin rules for all possible portfolios of exposures a dealer might face, but not taking into account diversification and hedging benefits at the portfolio level would lead to an inefficient increase in the cost of holding derivatives positions. Such a situation could actually increase systemic risk because dealers would not receive credit for hedges.

The current description of what a dealer would have to reveal to a potential purchaser of derivatives seems to be too broad and it ignores the realities of derivatives dealings. Derivatives dealers should not have an implied fiduciary duty to their customers if they are not acting as advisors. The proposed legislation asks that a dealer reveal all sources of income from a derivatives trade to an end-user. Such a requirement seems impractical. Often, derivatives transactions take place quickly. An end-user might ask for bids from five dealers. These dealers are taking an economic risk by making these bids and do not want them to be outstanding for a long period of time. Further, a dealer might obtain a hedging benefit from the transaction. Absent the transaction, the dealer might have to buy a derivative. It would seem unreasonable to require

the dealer firm to reveal information about its books in such a situation. Further, the derivatives salesperson might not even be aware of that hedging benefit.

6. Conclusion and summary.

Derivatives have a critical role to play in the management of risks. This role is critical for non-financial companies as well as for financial firms. Used well, derivatives reduce systemic risk. Managed poorly, derivatives can increase systemic risk. Many aspects of the draft legislation can help in reducing the systemic risk of the over-the-counter derivatives markets. In summary, my main conclusions are:

1) Often, customized or infrequently traded derivatives are the most useful derivatives to resolve specific risk management problems for non-financial firms. By solving such problems, these derivatives can enable such firms to grow more and to create more jobs. Such derivatives can only be sold on the over-the-counter market and clearing of such derivatives, if feasible at all, is uneconomical. It is important that the proposed legislation does not make it more difficult and expensive for end-users to obtain such derivatives by imposing reporting, margin, disclosure, and business conduct requirements on customized and infrequently traded derivatives that make it unprofitable for financial institutions to sell such derivatives.
2) Properly implemented clearing can reduce systemic risk. However, clearing is not a panacea. If there are too many clearinghouses with too little capital, clearing requirements could increase systemic risk compared to the current situation. For clearing to reduce systemic risk, there have to be few well-capitalized clearinghouses.

The capital and margin standards for clearinghouses set out in the draft proposal seem insufficient. The draft proposal should also explicitly address the issue of how clearinghouses that have a monopoly in the clearing of a specific type of derivatives would be regulated. Finally, there has to be clarity for market participants as to when regulators are going to be able to require that a type of derivative be cleared. To make such a requirement, regulators should be asked to show conclusively that requiring clearing for a type of derivatives would reduce systemic risk in a quantifiable way.

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Testimony before the
Committee on Financial Services
Hearing on
"Improvements to Regulation of Over-the-Counter Derivatives Markets"

Chairman Frank, Ranking Member Bacchus and Members of the Committee, my name is Larry E. Thompson, General Counsel for The Depository Trust & Clearing Corporation (DTCC) and I'd like to thank you and the members of the Committee for the opportunity to share with you today our views as you consider legislation concerning the regulation of over-the-counter derivatives markets in light of the lessons learned during the past year's financial crisis.

We applaud the work of the Administration and this Committee under your leadership to advance the cause of providing sensible and effective regulation for the over-the -counter (OTC) derivatives markets. We share your desire to ensure more transparent markets for regulators, who must oversee market stability and mitigate systemic risk, and the public, who require more precise information while ensuring that innovation and risk mitigation that are trademarks of the OTC business continue to exist. Our testimony will focus principally on one aspect that we strongly believe undermines the goals of re-regulation and represents a step backward by reducing the level of transparency that now exists. As you will note, we believe strongly that regulators and the public need a consolidated source of market information. However, the various proposals under consideration will result in fragmentation of that information. We present a specific proposal to remedy that situation.

What is DTCC?

DTCC has been the primary infrastructure organization serving the capital markets in the U.S. We have a 36 year history of bringing safety, soundness, risk mitigation and transparency to our financial markets. Indeed, as global financial markets went through crisis last year, DTCC's systems for record-keeping, transparency and risk mitigation helped federal regulators identify the true exposure of major market participants, and helped make possible informed decisions about to how to work through that exposure and how to protect the public.

As an example, following the Lehman bankruptcy last year, DTCC clearance and settlement systems played a significant role in unwinding over $500 billion in open trading positions in equities, mortgage-backed and U.S. government securities, without any loss to the industry—and avoiding any burden on taxpayers.

Bringing Automation and Efficiency to OTC Derivatives

By 2003, the market for OTC credit derivatives had taken off, but only 15% of the trades were being captured electronically. The trading process was manual and error-prone. Both the global dealers and regulators felt the market for these instruments faced growing risks, if a solution was not found. DTCC was asked to develop and we delivered an automated matching and confirmation system, called Deriv/SERV, within nine months. Today, over 95% of all OTC credit derivatives are captured in this automated environment and matched by MarkitSERV, an average of 41,000 transactions per day.

With major dealers making ambitious commitments about improving their operational practices to global regulators, DTCC's collaboration with the industry is continuing to bring a wider universe of the OTC derivatives market on to its electronic matching and confirmation platform, which is helping to significantly reduce the level of unconfirmed trades that remains in the market. These services, I might add, are provided at-cost to global dealers or sell-side firms and at no charge to buy-side customers.

However, after entering the OTC derivatives space, it was clear to DTCC and market participants that the downstream process for credit default swaps was another major area of concern. Once credit default swap trades were completed, these contracts could be resold or reassigned multiple times over their five-year lifecycle, but the process for recordkeeping and reconciling these transactions was largely manual.

DTCC launched the Trade Information Warehouse in November 2006, to provide an automated central repository to house and service all CDS contracts. During 2007, working with the industry, DTCC updated the Warehouse with information on over 2.2 million outstanding CDS contracts, and our Deriv/SERV matching engine is now supplying the Warehouse with more than 41,000 transactions daily. Today, our Trade Information Warehouse is the only comprehensive data base or repository of OTC derivative activity in the world.

I'd submit to you, Mr. Chairman, and Members of the Subcommittee, that had DTCC and the industry not had the foresight to create this Trade Information Warehouse and load

the Warehouse with all these records of CDS trades in 2007, we might still be sitting here today in 2009 trying to sort out the total exposure of trading obligations following the Lehman bankruptcy, i.e., who traded with whom, at what point in time and at what price? Instead, we have found ourselves at the center of financial storms – and are able to help rapidly to resolve them.

Need for Integrated Data on Derivatives Through Unified Repository

This experience leads me to emphasize one fundamental policy point. Fragmentation of data in the financial industry can impede the ability of regulators to protect investors and the integrity of the financial services system as a whole. These core policy goals are advanced when information on trades is held on a centralized basis.

We believe maintaining an integrated trade repository for OTC derivatives contracts is an essential element of safety and soundness for two primary reasons. First, it helps assist regulators in assessing systemic risks, thereby protecting consumer and financial markets. Second, as a practical matter, it provides the ability, from a central vantage point, to identify the obligations of trading parties, which can speed the resolution of these positions in the event of a firm failure, as we found last year in the case of Lehman Brothers.

Fragmentation of Information the Result of Initial Committee Draft

While we greatly appreciate that the intent of all parties involved in this debate to increase regulatory and market transparency, some of the proposals represent a step backwards from existing practice – a move that we believe could jeopardize the one comprehensive repository that currently exists for the credit default swap market. Unfortunately, by **not** requiring all swap documentation and trade information to be reported to a single, comprehensive repository, the proposals would have the effect of denying regulators the opportunity to see systemic risk from a central vantage point, because it would fragment the existing information on CDS contracts stored in the Trade Information Warehouse. In other words, it would be significantly more difficult to create a comprehensive source of information for regulators and the public for all other classes of OTC derivatives.

First, the various proposals would authorize two different mechanisms for the collection of information on OTC derivative contracts – either a derivatives clearing organization, or a trade repository. The latter would only be required for derivative contracts that were not accepted for clearing by a derivatives clearing organization. While it may be contemplated here that the proposal would encourage multiple trade repositories, the real effect is to create multiple sources of different information for OTC derivatives, making it more difficult for regulators and the public to see a comprehensive view of market activity.

The result of this approach to repositories would mean that information on derivatives contracts could be split up among a number of different clearing organizations, as well as

one or more trade repositories. For public policy reasons, this is very undesirable. The fragmentation of information would create grave inefficiencies and delays at times of crisis, impairing the kind of view that DTCC was able to give regulators in the minutes and hours after the Lehman Brothers collapse.

Another major concern with having multiple repositories is the confusion that would likely arise over where a trade should be housed. Take, for example, a situation where a U.S. firm executes a CDS contract with a European firm on an underlying asset in Asia. Where should that contract be stored?

If you go by parties to the trade, the contract would need to be placed in both the U.S. and European repositories. However, under that scenario, the contract would be duplicated, and therefore double counted in reporting to the public and regulators. Because there's no common identification system for derivatives, regulators, the public and the industry would not necessarily know that the U.S. repository listing and European listing of the trade are, in fact, the same. And if the US firm at some point decided to assign the trade to a European firm, it would simply drop out of the US repository – and there would be no audit trail on the contract.

Likewise, if the storage of trades in a repository is based on the underlying asset, then the above trade would be held only in the Asian repository. As a result, neither U.S. nor European regulators would have regulatory authority over the data even though the risk of the contract is assumed by parties under their jurisdiction. The systemic risk regulators in each region would have only a partial and incomplete view of the market.

A Better Alternative – Unified Reporting in a Trade Repository

DTCC urges this Committee to consider revising the bill to require all derivatives traded by U.S. financial institutions be reported to a single trade repository for each asset class, which would serve regulators as a comprehensive source of information. The derivatives central counterparties (CCPs), which are organized as derivatives clearing organizations, would continue to retain the data from the trades that they clear – and this would allow them to capture whatever commercial value they desire from that market data. However, from a public policy perspective and in the interests of ensuring the stability and transparency of financial markets, there must be a consolidated, comprehensive single entity that collects and maintains the underlying position data and makes it available to regulators in the most efficient, timely and usable manner.

Indeed, based on our long experience managing the risk flowing from the failure of a single market participant, we have found that knowing the underlying position data of multiple transactions across asset classes in a timely manner is significant in providing transparency to regulators—and in protecting confidence in the market itself. Given this, we ask the Committee to reinforce the role of a central repository as a matter of public policy, instead of moving forward with an approach which would fragment that responsibility and create the risk of inadequate oversight of derivatives markets at times of crisis.

DTCC also suggests that revisions to the draft include a few basic principles guiding how a trade repository should function so that it meets public policy needs, as follows.

1. Any trade repository should function as a utility that would serve the market in a non-discriminatory manner.
2. Any trade repository should be neutral and independent and therefore be prohibited from being owned by any single market participant or small group of market participants to protect its independence.
3. The data collected by the repository would be fully available to regulators, with aggregate data released publicly.
4. Sufficient experience in these activities should be required to ensure that a swap repository is able to carry forth its role successfully and protect the integrity of over the counter markets.

Background on DTCC and its History

The general public may not have heard of DTCC before. That's probably not an accident. We have traditionally kept a low profile, given the critical nature of the essential infrastructure role we play in U.S. financial markets. Last year DTCC settled $1.88 quadrillion in securities transactions across multiple asset classes. We essentially turnover the equivalent of the U.S. GDP every three days—and we provide the post-trade processing efficiency and low cost that attracts investment capital that helps fuel the U.S. economy.

DTCC, through its subsidiaries, provides clearing, settlement and information services for virtually all equities, corporate and municipal bonds, U.S. government securities, mortgage-backed securities, commercial paper and other money market instruments, and over-the-counter derivatives. In addition, DTCC has supported the enormous growth and consumer choice in the purchase of mutual funds and annuity transactions, by linking funds and carriers with the firms who market these products. Lastly, DTCC's depository is the largest securities depository in the world, providing custody and asset servicing for 3.5 million securities issues from the United States and 110 other countries and territories valued at $30 trillion.

Equally important, we are a market-neutral, member-owned and governed organization. We are regulated by the SEC, the Federal Reserve Board of Governors and the New York State Banking Department for many of our activities.

DTCC, throughout its history, has played a central role in helping our financial markets during a period of crisis. Our subsidiaries, The Depository Trust Company (DTC) and National Securities Clearing Corporation (NSCC), were created in the 1970s to help address the famous paperwork crisis on Wall Street, when thousands of messengers carried bags of stock certificates and checks to settle trades and recordkeeping strains forced the New York Stock Exchange to shut down on Wednesdays to process the backlog of trade records. During this period the NYSE traded an average of 15 million

shares daily. Today, DTCC supports more than 50+ equity markets, including the NYSE, Nasdaq, ECNs and ATSs, and we can process 19.3 billion shares traded in a single day. In the mid-1980s, we implemented similar protections for the U.S. Treasury markets, providing automation and processing safeguards to protect the certainty and attractiveness of trading in U.S. Government securities. In the late 1980s, we removed the barriers preventing the growth in sales of mutual funds—and providing U.S. investors with unprecedented choice and low cost.

At its core, DTCC is a huge data processing and risk management business, involving the safe transfer of securities ownership and settlement of trillions of dollars in trade obligations, under tight deadlines every day. At the same time, DTCC's primary mission is to protect and mitigate risk for its members and to safeguard the integrity of the U.S. financial system. Mitigating risk means we not only have the capacity to handle unpredictable spikes in trading volume, but that we have the business continuity and resiliency to withstand both the "unthinkable" –and even the "unknowable."

Operating During Crises

For example, one major challenge to our resiliency was after the September 11 attacks. Our headquarters was just 10 blocks from the World Trade Center. While the stock exchanges did not open, DTCC still had a job to do and never missed a beat. Despite the chaos that Tuesday morning, nearly 400 employees remained at DTCC 's headquarters, even though lower Manhattan was sealed off by the government, to complete that day's settlement of more than $280 billion in outstanding trades from the prior Friday and Monday. And throughout that week, working from backup facilities, DTCC completed settlement of nearly $1.8 trillion in trades that were in the "pipeline", which was a critical step to allowing our capital markets to open the following Monday.

The crisis following the Lehman bankruptcy was equally challenging. Because of our ability to manage risk and see exposure from a central vantage point across asset classes, DTCC was able to help market participants and regulators ensure that market risk – and systemic risk – was controlled. DTCC successfully closed out over a half trillion dollars in exposure from Lehman's trading in equities, mortgage-backed and U.S. government securities. Most would agree this was the largest and most complex wind-down in history, but with nearly 36 years of experience in managing risk events, we were able to complete this wind down in a matter of a weeks with no impact to our own company's balance sheets, loss to our market participants' clearing fund deposits—or additional exposure to taxpayers. These are just two examples of the comprehensive and critical roles DTCC plays in maintaining stability for our capital markets.

Managing Multiple Credit Events from a Central Vantage Point

Our Warehouse for OTC credit derivatives likewise does more than simply maintain comprehensive records on CDS transactions. The Warehouse also handles the calculation, netting, and central settlement of payment obligations between

counterparties, and it has automated the processing of "credit events" – situations where the protection against default provided by a credit default swap is activated.

Over the past year, DTCC has seamlessly processed or is processing, through the Warehouse, more than 40 credit events, including the Lehman Brothers and Washington Mutual bankruptcies as well as the conservatorships for Freddie Mac and Fannie Mae. No one could have foreseen the storm of credit events that shook the market last year and this year, but thanks to the central infrastructure we built for the CDS market and our ability to see and manage these credit events from a central vantage point, we were able to ensure a more seamless and safe final disposition of hundreds of billions of dollars in CDS payouts triggered by these bankruptcies and government takeovers.

If I may cite the March 9, 2009 report, prepared by the Senior Supervisors Group, which comprises the senior financial regulatory supervisors from seven major countries, including Germany, France, UK, Swiss, Japan and the U.S.:

"DTCC's credit event processing service enabled firms to manage the large number of affected CDS trades during the recent events. All surveyed participants indicated that without the DTCC service and the [Trade Information Warehouse], the process would have been manual and burdensome and they could not have completed timely processing."

Having all CDS trade information in one centralized infrastructure was highlighted in the report as making it easier for market participants to identify affected trades and facilitate handling of various lifecycle events, such as settlement and credit event processing. In the midst of the crisis, the process of having to glean and coordinate the necessary information from more than one repository would have been a frightening prospect.

Enhancing Transparency

As the only source of key data on the CDS market, DTCC recognizes and supports the public policy goals articulated in U.S. Treasury Secretary Geithner's May 13 Letter to the House and Senate Leadership on the need to promote transparency in the OTC markets.

DTCC has been working closely with market participants and regulators to achieve that vision. Since November 2008, DTCC has been publishing weekly on its website, key statistics and data from the Warehouse on the size and turnover of the CDS market.

Increased public disclosure on CDS data has been instrumental in bringing better clarity to the market's true risk exposures to credit events, which first surfaced following the Lehman Brothers bankruptcy filing in September 2008. At the time of the Lehman crisis, rampant speculation valued the market's CDS risk exposure from the bankruptcy to be as high at $400 billion, causing unease and a sense of panic in some quarters. Since we held the vast portion of information on CDS positions in our Warehouse, we took the unprecedented step to issue a press release on a Saturday in mid-October to clarify that based on our Warehouse records, the exposure to Lehman was closer to a net notional

value of about $6 billion. Ultimately, at the close of this credit event, the actual value was $5.2 billion, changed hands between counterparties.

Over the summer, we issued a similar press release following the GM bankruptcy, reportedly to be the largest for an industrial company in U.S. history, surpassed only in dollar value by the Lehman bankruptcy CDS numbers.

In the June 8 *New York Times'* Breaking Views column, the Warehouse was praised for bringing greater transparency on CDS exposure following the GM bankruptcy:

"The vague guesses of four years ago have been replaced by hard data. The Depository Trust & Clearing Corporation, which now collects trading information, was able to say last week that the $35.3 billion in outstanding swaps trades on GM netted down to possible payments between market participants of an unremarkable $2.2 billion."

Today, when credit events such as GM occur, having this data more readily accessible to the public through our weekly postings has helped demystify CDS instruments somewhat and help avoid the market anxiety that was so pervasive during the Lehman crisis.

Working with Global Regulators

The marketplace for OTC derivatives is truly global in nature, but we would express caution about the proliferation of trade repositories. When we originally designed the Warehouse with market participants, we spent a long time making sure there would be no duplication of data and that the transfer of information happens when it is supposed to. None of those control mechanisms would work very well in a context where there is more than one Warehouse. Additionally, every regulator in the world, if it was seeking to ensure the soundness of firms under its purview, would need access to *all* global central repositories in order to effectively supervise the risks firms were taking. The risks associated with the market for OTC derivatives will not be easily managed, if you can not see the positions globally.

To this end, we regularly provide information to regulators worldwide in support of their own regulatory missions, including the European Central Bank and the Financial Services Authority in the U.K.

Here at home, we also recently filed an application with both the Federal Reserve and the NY State Banking Department to create a new subsidiary to operate the Warehouse, as a regulated member of the Federal Reserve System, aligning ourselves with the direction that our regulators have set and formalizing the interaction that we are already having with regulators in the U.S. and abroad. Regardless of our current regulatory status, DTCC is prepared to come under the regulatory purview of any regulator that you deem relevant to overseeing our activities.

International regulators demonstrated their own commitment to increasing cooperation on a global basis with the announcement this week that they have established the OTC

Derivatives Regulators' Forum, a group comprised of central banks, market regulators, government bodies and others that have jurisdiction over OTC derivatives market infrastructure providers or OTC derivatives market participants. The Forum will be charged with developing a global framework for regulatory cooperation and to share ideas and information on CCPs and trade repositories serving the OTC derivatives market. DTCC supports this effort because we recognize that in the OTC derivatives market, there needs to be a global solution with a regional approach versus a regional approach that doesn't provide a global perspective. In other words, a global marketplace demands a coherent set of regulations that apply on a global basis.

DTCC to Support All CCPs in OTC Derivatives Market

While DTCC supports the role of central counterparties (CCPs) in OTC derivative trading to provide trade guarantees, the CCPs do not obviate the need to retain the full details on the underlying trading positions in a central trade repository to support regulatory oversight and transparency in this market. As an organization that provides CCP services in other markets, like equities and government securities, we support and recognize the value a CCP can bring to the derivatives markets. In fact, we've stated publicly that our Trade Warehouse will support all efforts to create CCP services planned in the U.S. and overseas, on a non-discriminatory basis.

At the same time, we are concerned that some in the OTC derivatives market may assume once a trade guarantee is provided through a CCP, there may be less need for a central registry to track the underlying position data. We reject this view, based on our long experience managing the risk flowing from the failure of a single member firm. At the critical juncture of a firm failure, knowing the underlying position data of multiple transactions in a timely manner will be significant in providing transparency to regulators—and in protecting confidence in the market itself.

And so, as I wrap up my remarks, I would like to reiterate the importance DTCC places on the progress made to-date with market participants and regulators to foster a sound, safe and transparent OTC derivatives market. As the operator of the only global trade repository, we have a unique perspective on its value in helping regulators mitigate systemic risk during a crisis.

Our Trade Warehouse or central repository connects and services over 1,400 global dealers, asset managers, and other market participants, providing a central operational infrastructure covering approximately 95% of all current credit derivatives traded worldwide. This trade repository was designed to combat the risk of fragmentation of information in the financial markets. Unfortunately, the approach adopted in the different proposals under consideration would put at risk this comprehensive source of information that is now in place and ably serving regulators and the public. We, therefore, strongly recommend that the Discussion Draft be revised to ensure that all swap trades, regardless of whether they are cleared or not, be reported to a single swap repository, which exists to provide regulators and the public with the consolidated information they need during normal times, and, especially, at times of crisis.

DTCC remains ready to work with Members of Congress, the Administration, global regulators and market participants to help accomplish our shared vision of greater transparency, risk mitigation and resiliency in this dynamic market. Thank you.

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Statement of John Hollyer
Principal and Head of Risk Management and Strategy Analysis
Vanguard

Submitted to the House Committee on Financial Services
United States House of Representatives

Hearing on Reform of the Over-the-Counter Derivative Market:
Limiting Risk and Ensuring Fairness

October 7, 2009

Thank you for the opportunity to allow Vanguard to submit testimony on the regulation of over-the-counter ("OTC") derivatives. My name is John Hollyer, and I am the Head of Risk Management and Strategy Analysis at Vanguard, a mutual fund company based in Valley Forge, Pennsylvania. Vanguard is one of the world's largest investment management companies, managing over $1 trillion for more than 24 million investor accounts. I oversee risk management functions in the investment management units at Vanguard, including the use of derivatives by funds managed by Vanguard.

OTC derivatives are well-established as a tool for modern portfolio management. They are specialized instruments that require investment techniques and risk analyses that are different from those associated with stocks, bonds, and other traditional investments. At Vanguard, we use derivatives in ways that provide a number of benefits to our shareholders. In many cases, we are able to invest our shareholders' assets with lower transaction costs and with better execution through the use of derivatives. We have developed comprehensive policies and risk controls to ensure that our implementation of derivatives investments captures these benefits for our shareholders while mitigating risk.

As stewards of our shareholders' assets in the capital markets, we seek market structures that are systemically resilient, efficient, and transparent. With regard to OTC derivatives, we are particularly interested in reducing counterparty risk – the risk that one of our derivatives trading counterparties cannot meet its financial commitments to us. To that end, Vanguard strongly supports certain proposals contained in the Over-the-Counter Derivatives Markets Act of 2009, proposed by the Treasury Department this past summer. We believe that appropriate legislation needs to be adopted soon.

Central Clearing and Exchange Trading of Derivatives

Vanguard supports the requirement that standardized derivatives be cleared by a central clearinghouse. We believe that the overwhelming majority of derivatives users should be subject to the clearing requirement, including corporate end users. In a clearinghouse arrangement, both parties to OTC derivatives trades would be required to deposit cash or liquid assets (margin) in an amount sufficient to assure the clearinghouse that the parties can meet their commitments, and even if a party to the trade defaults, the clearinghouse

would insure that the trade is completed. These margin deposits function in much the same way as required insurance does for drivers - to demonstrate that the parties can meet the financial obligations they incur. Futures markets, which require margin deposits, have functioned well in various types of financial crises for decades. Notably, the futures markets survived the crash of 1987, perhaps the single largest one-day event in the financial markets. A highly capitalized central clearinghouse with comprehensive risk controls, including margin requirements, would help to ensure that the demise of one or more derivatives counterparties would not cause a systemic problem and would greatly reduce counterparty risk in our markets.

There are additional benefits that would result from central clearing. The use of a central clearinghouse will increase transparency in derivatives pricing, while exposing potential systemic risk before it becomes unmanageable. It will boost efficiency in the market by eliminating the need for market participants to negotiate complicated bilateral agreements with many trading partners. These contracts are highly negotiated, lack uniformity, and can be extremely-time consuming to complete. A central clearing system would allow market participants to negotiate one set of legal documents to gain access to the clearinghouse, and enable them to expand the number of counterparties with whom they deal. A central clearinghouse will improve price execution, reduce transaction costs, and increase liquidity. Vanguard is pleased that the major derivatives dealers have committed to clear significant percentages of certain types of swaps through a central clearinghouse. Despite these commitments, we favor mandatory clearing of standardized derivatives, rather than voluntary clearing, as the best means of reducing systemic risk.

Vanguard appreciates the fact that certain derivatives are highly customized to the business needs of their end-users and are not therefore amenable to central clearing. Trading in these types of derivatives should be permitted, provided that the parties to these derivatives should be required to post appropriate levels of margin. We also support the proposal that requires transactions in customized derivatives to be reported to a central repository because reporting will further transparency and help reduce systemic risk.

We feel that the lion's share of the benefit of the proposed legislation comes from the use of a central clearinghouse, rather than through exchange trading and electronic execution of derivatives. We encourage exchange trading and electronic execution of derivatives but are not convinced that these practices should be required by law.

Margin and Capital Requirements

Currently, in the absence of the ability to clear derivatives, OTC derivatives are transacted among market participants through bilateral agreements. Vanguard and many other derivatives users incorporate provisions into these agreements that require the exchange of margin collateral on a daily basis to offset counterparty risk. Some derivatives users elect not to require margin collateral at all. This could be because of the cost required to operate an effective collateral management program, as well as the cost and time required to negotiate the necessary legal documentation. The demise of

counterparties to derivative trades could expose their trading partners to significant losses if margin has not been posted.

Vanguard endorses the requirement that counterparties to customized derivative trades post sufficient margin when entering into these transactions and we believe these margin requirements should be greater than those for standardized derivatives cleared through a central clearinghouse. We are not in favor of capital requirements for parties that enter into derivative transactions so long as the applicable margin requirements are adequate. Requiring margin to back derivatives trades will reduce leverage associated with derivatives and increase the resilience of markets in times of extreme market stress or disruption. We think that margin requirements for standardized derivatives should be set by a central clearinghouse rather than by regulators. A clearinghouse has the knowledge and expertise to set margin requirements at levels necessary to reduce risk. Margin requirements for custom derivatives should be set by regulators.

Much concern has been expressed that corporate end users of derivatives would be required to keep large sums of cash on hand and that they would incur substantial costs if they were required to post margin. Regulation needs to strike a balance between limiting systemic risk and not unduly limiting or restricting corporate end users from the tools that they need to manage their business risks. For these reasons, we support the idea that highly liquid assets (*e.g.,* Treasury securities), in place of cash, be accepted as margin. End users of derivatives with substantial illiquid assets should be able to arrange for a reasonably priced lending facility that can be used to post margin. The cost of posting margin is not the amount of the margin posted, but is the cost to borrow cash to post the margin. We believe that these costs, in most cases, should not result in such a financial hardship that end users would no longer be able to use derivatives in managing their business risks. Further, comments from end users that they would be required to post large sums as margin is an indication of the significant amount of risk being taken, and reinforces the systemic risk reduction benefits of both a central clearinghouse and margin requirements.

Currently, some end users of derivatives enter into transactions with dealers that do not require margin, and they may not have access to a full range of derivatives counterparties. These end users also may be paying very high derivatives execution costs that may not be visible to them. The use of a clearinghouse that requires margin could enable these end users to engage a larger number of dealers that, through competition and increased price transparency, could lower their overall derivatives costs in the long run.

Naked Credit Default Swaps

Some have called for an outright ban on "naked" credit default swaps in which the buyer of protection does not actually own the bonds of the referenced issuer, in part, because they believe that such swaps can have a negative effect on the company underlying the swap, or at best, have no benefit to the company at all. We oppose such a ban and believe that these swaps indirectly benefit the underlying company and are a legitimate portfolio management tool for those who have credit exposure other than through bond

holdings, or who wish to reduce their overall credit exposure. Naked credit default swaps enhance market liquidity, help price discovery, and promote efficiency through lower costs. We believe that the use of a central clearinghouse along with the reporting of non-cleared swap positions to a central repository will further transparency, as well as to help prevent fraud and manipulation in the use of these instruments.

Instruments Not Covered by Legislation

For a number of reasons, Vanguard is concerned that the Treasury Department proposals do not cover foreign-exchange swaps and foreign-exchange forwards. First, it is possible that regulation of currency and interest-rate swaps could be undermined by counterparties that design swap transactions that use exempt foreign-exchange swaps and forwards. Second, foreign-exchange swaps and forwards present many of the same risks as other types of derivatives. One risk is particularly problematic – counterparty risk. For instance, foreign-exchange forwards can settle months after they are entered into and changes in exchange rates prior to settlement can greatly affect the value of these instruments. Currently, this risk can only be managed through complicated bilateral agreements among the parties that require the posting of margin.

A better alternative to excluding foreign-exchange swaps and foreign-exchange forwards from regulation is to require that they be subject to the same set of requirements imposed on other derivatives, including central clearing for standardized transactions whenever possible.

Position Limits

Vanguard is opposed to the granting of authority to the SEC to establish position limits on securities listed on a national securities exchange, and any security on which a security-based swap is based. Vanguard funds, which include many index funds, hold substantial positions in thousands of issuers. If position limits were imposed, our funds might not be able to tightly track their indexes, which would have a negative impact on them and their shareholders. Current rules require that an entity that owns more than a certain percentage of an issuer's equity securities make a public filing that discloses such holding. Current rules also require large institutional investment managers like Vanguard to make quarterly filings that disclose all of their equity holdings. We believe that the current rules are sufficient to further the stated goal of preventing fraud and manipulation.

Informational Barriers

We believe that the proposal that would mandate the establishment of informational barriers between stock and commodity research analysts and those persons responsible for a firm's trading should be narrowed significantly. This investment-banking type of separation and safeguard is unnecessary for firms that do not publish, sell, or otherwise make their research available to the public.

Segregation and Bankruptcy

We share the views previously articulated by CFTC Chairman Gary Gensler and SEC Chairman Mary Shapiro regarding the need for legislation to provide the public and marketplace with certainty when a derivatives dealer files for bankruptcy. We believe that legislation should protect customers and counterparties in the event of a bankruptcy of a derivatives dealer. The legislation should provide a derivatives dealer's counterparties with the same types of safety provisions as customers of a futures commission merchant presently have in a bankruptcy situation. To that end, margin collateral received by a derivatives dealer should be required to be segregated from its proprietary assets, thereby rendering it unavailable to its creditors.

Legislation should also provide that customer assets held with an insolvent derivatives dealer may be transferred to another dealer without triggering a violation of the bankruptcy automatic stay or liability for an avoidable transfer. Furthermore, customers should be granted special priority with respect to customer property (including segregated funds) and placed ahead of all unsecured claims of an insolvent derivatives dealer.

Again, I would like to thank the Committee for considering Vanguard's views.

International Swaps and Derivatives Association
Statement for the Record
House Financial Services Committee
Hearing on Derivatives Legislation
October 7, 2009

Like the recent proposal on OTC derivatives from the U.S. Treasury (on which we commented in hearings before the Committee on Agriculture of the U.S. House of Representatives on September 17, 2009), the House Bill reflects many elements of a consensus with respect to regulatory reform in which ISDA and the privately negotiated derivatives markets join. In particular, continued emphasis on clearing and other aspects of counterparty risk management, improved transparency, and regulation of market participants and infrastructure providers, all as appropriate to the vitality of the markets, is encouraging to ISDA and is consistent with many of the efforts undertaken by the over-the-counter markets themselves. The extensive commitments made by major participants in the OTC derivatives business will proceed no matter whether or when legislation is passed.

We note, however, that significant issues remain embedded in the House Bill that would decrease market efficiency and increase costs in ways inimical to the interest of the economy and the end-user community, which is so well-represented in the Committee's hearings today. Most prominent among these issues are:

- overlapping regulatory jurisdictions and the resulting potential for market gridlock
- lack of standards of size and scope to be applied in determining which entities would be subject to various aspects of the regulatory structure
- overbroad authority to "ban" transactions
- weakened legal certainty provisions
- a one-size fits all approach to markets of varied characteristics and a bar to the exercise of exemptive discretion by regulators
- potentially redundant or onerous capital and margin requirements

Many of those testifying before the Committee will make clear the continued strong need for customized, over the counter derivative products in our economy. Others will make clear how important it is that this sector of our economy remain internationally competitive and accessible. With these matters in mind, we tender the following comments with respect to this legislative effort.

1. Overlapping Regulatory Jurisdictions and the Potential for Market Gridlock

The House Bill grants the CFTC primacy with respect to "swaps" and the SEC primacy with respect to "security-based swaps". Yet each is to engage in joint rulemaking with the other, subject under certain circumstances to intervention by the Treasury or contributive efforts by a variety of "prudential regulators". We applaud this approach as a noble experiment in cooperation and harmonization, but we must observe that this is an experiment, and the fate of substantial and useful markets is at stake. Congress should seriously consider this as it proceeds with this legislation.

2. Lack of Standards of Size and Scope in Determining Entities Subject to Regulation

As in the Treasury proposal, a "swap dealer" is defined as including any person who is engaged in the business of buying and selling swaps for such person's own account, through a broker or otherwise. We can imagine very small and unimportant operations being treated on a par with businesses of true systemic importance. This would constitute a waste of regulatory resources and needlessly inhibit the activities of

those who might in the aggregate be useful facilitators of liquidity (and who individually might become important in their markets), but who would be unable at the outset to bear the burdens of dealer regulation.

The term "major swap participant" has received welcome refinement from its Treasury proposal version. The "hedging adjustment" is now coupled with a "risk management purposes" alternative that introduces needed practicality. The key sizing concept of maintaining a "substantial net position" however is left to regulatory definition. The apparent overlap of "swap participant" with the definition of "swap dealer" still remains unresolved. We submit that these latter ambiguities are too significant to be left to be resolved by the regulatory agencies. Greater specificity should be mustered now, through the legislative process, with leave to the agencies to adjust standards where consistent with the public interest.

3. Overboard Authority to "Ban"

Within section 132, the House Bill provides the agencies with a "blank check" to ban abusive swaps ... detrimental to the stability of a financial market or of participants in a financial market." This section, devoid of definitions, is overboard, vague and unnecessary given the breadth of agency powers elsewhere in the bill.

4. Legal Certainty and Pre-emption of State Laws

An issue afflicting the early growth of the derivatives markets has been the question of whether bilateral contracts between over the counter market participants might be voided as a result of the uneasy fit between the markets and potentially relevant statutes, at both the federal and state level. The CEA presently includes meaningful protection of contract enforceability. The House Bill proposes a novel and complex regulatory scheme, but reduces this protection. The legislation also should do more to protect the markets it would regulate from assertions of jurisdiction under state laws, such as those governing insurance.

5. One Size Fits All Approach and Lack of Agency Exemptive Discretion

The over-the-counter derivatives markets are quite varied, more varied than the House Bill's distinction between "swaps" and "security-based swaps" would indicate. Regulation rationally adjusted to the nature and cost structure of different markets is vital to the overall success of the proposed regulatory effort. The bar to exemptive relief contained, for example, in section 112(d) of the House Bill is inconsistent with the adjacent subsection (c)(4) admonition to honor differences in products. The agencies should be vested with broad exemptive powers in order to give effect to this admonition.

6. Potentially Redundant and Onerous Capital and Margin Requirements

The agencies are charged with imposition of capital and margin requirements at nearly every level of market participation. No mechanism exists to filter redundancy and overlaps that should be eliminated in the interests of rationalizing costs. In addition, collateral standards are directed to allow for non-cash collateral, adding cost and logistical difficulty to the margin process. Finally, segregation requirements are imposed that are highly expensive to support in their own right. ISDA believes strongly in initiatives to improve counterparty credit integrity. These initiatives, however, must be crafted with sensitivity to both cost and ultimate value to the end-user, the paying customer - who, at the end of the day, has a legitimate business need to fulfill in a cost efficient manner.

Conclusion

ISDA is grateful for the opportunity to comment on the House Bill. ISDA remains committed to broad-based regulatory reform and looks forward to continuing discussions to produce appropriate legislation.

Statement on Proposed Reform of Over-The-Counter Derivatives Markets

The associations noted[1] represent the electric power and natural gas industries serving every energy consumer in the United States. We use over-the-counter (OTC) derivatives extensively to manage commodity price risk for electric power, natural gas and other fuels, as well as to contain risk related costs when financing energy infrastructure. OTC contracts help to insulate our customers from excessive price volatility and help keep electric rates paid by consumers stable and affordable. It is also important to note that these transactions are not the source of systemic risk to the broader economy.

We appreciate the opportunity to submit this statement on the reforms being considered by the House Financial Services Committee to the OTC derivatives markets. These associations support the goals of the Administration and the Congress to increase regulation as well as improve transparency and stability in OTC derivatives markets. When discussing any increased regulation of exchange and OTC markets, we believe there should be an appropriate balance between establishing market oversight rules that allow for a broad use of market-based risk management tools while providing regulators with the ability to establish a high level of transparency and the tools needed to protect consumers against market manipulation and systemic risk.

We believe that reform to the OTC derivatives markets should increase transparency and oversight to provide confidence to market participants and consumers in the fairness of these markets. In our view, effective OTC derivatives reform should:

- Promote greater regulatory oversight and transparency of OTC derivatives through increased financial reporting and authority to the Commodity Futures Trading Commission (CFTC) to prevent manipulation of the derivatives markets.

- Promote clearing of standardized derivatives or large financial dealers, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency through information regarding pricing, volume and risk.

- Promote the harmonization and clear delineation of regulatory authorities and functions among the Securities and Exchange Commission (SEC), the CFTC, the Federal Energy Regulatory Commission (FERC) and other Federal agencies to

[1] America's Natural Gas Alliance, American Exploration and Production Council, American Gas Association, American Public Gas Association, American Public Power Association, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America, Interstate Natural Gas Supply Association, Large Public Power Council, National Rural Electric Cooperative Association, Natural Gas Supply Association, and U.S. Oil & Gas Association.

These joint associations, however, are concerned with certain aspects of proposals to address oversight of OTC energy markets. Most notably, we oppose mandates that all derivatives transactions be centrally cleared or executed on exchanges. Such a requirement would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks because clearinghouses and exchanges require a high level of margin and collateral for the derivatives and commodities products traded. Such customization is necessary for everything from specific delivery points in electricity contracts to quantities of natural gas. Without the ability to use these customized transactions energy suppliers would be severely constrained in types of products and the costs of those products that could be offered to consumers.

While centrally cleared exchanges strictly require cash collateral, individually-negotiated OTC contracts allow hedging entities to use alternative collateral structures such as asset liens, credit lines or no collateral below agreed upon thresholds. In some cases, because of the very high credit worthiness of a hedging entity there will be a reasonable threshold that must be reached before collateral would have to be posted. Providing such flexibility frees up scarce capital for investments in new energy infrastructure. Conversely, not allowing such collateral structures and forcing all OTC transactions to clear through exchanges would unnecessarily divert substantial capital from productive investments and drive up the price of energy commodities.

In addition, for centrally cleared products to be effective, standardization and a critical mass of market participants to facilitate a robust market are key. For example, in the case of electricity, since its unique physical nature precludes significant storage and requires that it be consumed when generated in hundreds of physical markets, the prerequisites for standardized and centralized clearing are missing. So, electricity price risk cannot be managed through a selection of exchange-traded contracts. Rather, such derivatives often require customization in order to be effective.

Limiting access to these risk management tools by mandating the clearing of OTC transactions would jeopardize the ability of energy providers to manage risks, increase consumers costs and increase excessive consumer exposure to market volatility. The OTC markets' very purpose is to provide customized solutions that meet the individual needs of customers with flexible products as well as diversified margin and collateral requirements.

Provisions requiring clearing of transactions will only increase costs and limit market participants' ability to manage risks without creating any offsetting benefits. As a primary example, utilities purchase firm supplies in the physical delivery

market at prevailing market prices, and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations and stabilize rates.

Similarly, electricity suppliers use OTC forward contracts to plan for and commit to future electric power needs when they do not own sufficient generation assets to meet the total electric demand in their distribution service territories. These suppliers employ various tools to shield customers from potential price volatility in wholesale electric markets, and the availability of OTC contracts allows them to (1) avoid higher costs from the cash margin requirements of a clearinghouse or exchange and (2) secure true hedges of the prices of wholesale purchased power at hundreds of delivery points. [2]

Simply put, electricity and gas providers have a legitimate need to engage in bona fide risk management in the OTC markets. The overly broad imposition of mandatory clearing requirements would impose large and untenable cost increases on businesses and consumers, and severely limit the product and service offerings companies can provide to energy consumers. In addition, we are concerned that excessively restricting what entities could participate in the OTC markets could have the unintended consequence of eliminating the very counterparties used by commodity suppliers.

Additionally, while competitive financial markets provide the best risk management tools, should speculative position limits nevertheless be mandated, we encourage Congress to allow the CFTC to set such limits in a reasonable manner that would ensure the necessary liquidity in a robust marketplace for bona fide risk management transactions. Any aggregate speculative positions should not impair bona fide risk management transactions such as those our members rely on.

This group of energy associations would also like to acknowledge the constructive and thoughtful discussion draft put forward by Chairman Frank, which reflects a number of the concerns that we have raised to date. We particularly appreciate the draft bill's recognition of the importance of maintaining the OTC markets for risk management purposes. We stand ready to work with you to craft reforms that enhance transparency and improve overall market functions without creating unintended adverse consequences for us and the consumers we serve.

Thank you for your consideration of our views on this important topic.

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[2] Additionally, in many jurisdictions with restructured retail electricity markets, regulated utilities have provider of last resort obligations, requiring them to be prepared to provide service to retail customers that have chosen an alternate supplier if those customers suddenly find themselves without service from their alternate supplier (for example, an alternate retail supplier might cease operations and return its customers to the incumbent utility). Regulated utilities will similarly use OTC products to hedge against the possibility that it will need to provide service to many of these customers, and ensure that these customers continue to be served reliably at reasonable rates.

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Statement of Shawn A. Dorsch
Founder
Blackbird Holdings, Inc.
before the
Committee on Financial Services
U.S. House of Representatives

October 7, 2009

Mr. Chairman and Members of the Committee:

Thank you very much for accepting this testimony from Blackbird Holdings, Inc. at this hearing on "Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness." We appreciate the opportunity to submit our views to the Committee as it seeks to address the derivatives business in a manner that retains the benefits of these transactions while enhancing the safety and soundness of the financial system.

About Blackbird

Blackbird Holdings, Inc. is a privately held corporation headquartered in Charlotte, North Carolina. It was founded by swap traders from JP Morgan & Co. who developed the first electronic trading platform for the negotiation and execution of interest rate and currency swaps. Our innovative and patented technology seeks to bring the same benefits to the derivatives business as electronic trading has already achieved in the execution of most types of traded financial transactions, including foreign currency, equities, U.S. Treasury bonds and corporate bonds, and futures contracts.

When swap contracts are executed electronically in greater numbers, swaps will have greater transparency and accurate electronic records which will be created at the moment the trade is executed so that error-free straight through processing, including accurate record-keeping, will be a hallmark of the business. Blackbird is still a small company, but we are international in scope, and we help swap counterparties find each other and execute swaps either across our electronic platform, or through our people in London and New York.

I helped to found Blackbird, in 1996, and our company has been actively involved since then in the public policy debate about regulation and legislation for derivatives, and particularly for electronic swap trading platforms,. We respectfully suggest that legislation to be enacted in this area would be incomplete without fostering presale price transparency for standardized swap transactions.

The Blackbird system provides financial institutions with a computerized system that brings greater speed, precision, safety, and security and lower costs to the interest rate and currency risk management business activities that are now taking place every day in numerous U.S. financial institutions. It is surprising to many in this era of advanced computer technology that most, if not all, of what the Blackbird system can do is still done currently by human beings using telephones and squawk boxes just as stock trades were once done on Wall Street and commodities were traded in the in the Chicago pits.

In fact, Blackbird fulfills the same functions, but with far greater efficiency and benefit to the financial system. Blackbird is not an exchange, nor is it a clearinghouse. Blackbird does not

enter into transactions, it does not provide credit support or take or add credit risk. Blackbird does not change the individualized customized nature of swaps. Blackbird does not introduce preference or bias into the negotiations.

Blackbird simply offers an improved electronic basis for a dealer to identify other dealers who, subject to the resolution of credit and many other terms, may be willing to enter into a transaction having particular economic terms desired by the first dealer. The use of Blackbird promotes competition, improves transparency, recordkeeping and risk control, and reduces costs. Blackbird brings substantial private and public benefit, without changing any meaningful feature of swaps activities as they currently operate.

Electronic Trading

The Administration's plan for improving derivatives regulation requires that standardized swaps be entered into on a board of trade or an alternative swap execution facility. This exchange or electronic trading provision:

1. creates an instant, accurate record for straight-through-processing by the parties to the trade, and for any clearinghouse or other post-trade processing or record keeping facility;
2. generates a high resolution audit trail available to management, auditors, and regulators; and,
3. provides pre-trade price transparency for swaps.

Blackbird supports the view that exchange or electronic execution of swaps is the only way to achieve these goals. Electronic trading platforms, by gathering, displaying, and recording information about amounts and rates at which swap participants would trade, generate useful information for swap participants and their regulators.

Greater pre-trade price transparency also accomplishes these important goals:

1. provides regulators an open window on the derivatives business, in real time;
2. accords swap participants an opportunity to transact at the best price; and,
3. ensures that swap clearinghouses, as proposed in the Discussion Draft will have accurate, timely information with which to value and measure the risk of the swap contracts they take on.

The New York Times editorial board calls this the most important part of the bill, saying: "Exchange trading allows the market as whole— investors, economists, researchers — to see how derivatives are structured, priced and traded. Such knowledge is the best defense against speculative excesses." (June 7, 2009) The pre-trade price transparency provisions for swaps in the Administration bill are supported by the U.S. Treasury, the Federal Reserve Board, the Commodities Futures Trading Commission, and the Securities and Exchange Commission.

As mentioned earlier, most other financial markets have already gone electronic. And in those markets the concept of "best execution" is now well established. Greater transparency in the swaps business can ensure that swap participants have the opportunity to choose the best available deal, and that swap clearinghouses will have accurate swap execution price data with which to value and measure the risk of the swaps contracts they take on.

Conclusion

In addition to the Administration, pre-trade price transparency provisions for swaps have the support of the Federal Reserve Board, the Commodities Futures Trading Commission, and the Securities and Exchange Commission. Pre-trade price transparency requirements should be preserved in the House Financial Services Committee bill by restoring the Administration's requirement for exchange or electronic trading.