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BUILDING THE NEW DERIVATIVES REGULATORY FRAMEWORK: OVERSIGHT OF TITLE VII OF THE DODD–FRANK ACT

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

CONTINUING THE OVERSIGHT OF THE IMPLEMENTATION OF TITLE VII OF THE DODD–FRANK ACT

APRIL 12, 2011

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C O N T E N T S

TUESDAY, APRIL 12, 2011

BUILDING THE NEW DERIVATIVES REGULATORY FRAMEWORK: OVERSIGHT OF TITLE VII OF THE DODD–FRANK ACT

TUESDAY, APRIL 12, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:45 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I would like to call this hearing to order. Due to the length of this afternoon's hearing, we will limit opening statements today to myself and Ranking Member Shelby, and I would ask the other Members of the Committee to please submit their opening statements for the record.

Today we will review the implementation of the new regulatory framework for the OTC derivatives market required by the Dodd-Frank Act. This is our Committee's first oversight hearing on this issue since the passage of Dodd-Frank. While I know there are many other issues that Senators may like to raise with the regulators before us today, we should focus our questions on the subject of this hearing.

The Dodd-Frank Act brings needed transparency and accountability to our derivatives market and addresses problems that greatly exacerbated the 2008 financial crisis. I commend all of the regulators here today and their staffs for their extraordinary work and long hours they have dedicated to these important reforms.

Putting in a new framework to regulate the vast $600 trillion swaps market in this age of instantaneous global capital movement is an enormously complicated task that demands close cooperation with international regulators. We must create new rules of the road to ensure that our financial markets remain the envy of the world. Our regulators should follow congressional intent to craft rules that are based on relevant data that reflect the unique structure of the swaps market while avoiding rulemaking for political expediency, and ask Chairman Gensler and Chairman Schapiro and all our regulators to work carefully to do what is necessary to get this right.

This effort will require strong coordination both within and among regulators to review the full set of final rules in a holistic way before they are finalized. The regulators must also integrate meaningful public input into this review. I urge our regulators to work together to craft a streamlined, harmonized set of workable rules that protect the ability to hedge risks in a cost-effective manner and minimize unintended consequences that could send American jobs overseas.

With that, I turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Today the Committee will examine the implementation of the Dodd-Frank Act's new derivatives regulatory scheme. There is particular need for oversight in this area because Dodd-Frank has needlessly, I believe, created widespread uncertainty about the regulation of derivatives and threatens to impose huge costs on Main Street businesses as well as on our overall economy.

The irony is that the proponents of Dodd-Frank told us that the new law would bring certainty to the market and stimulate economic growth. Instead, Dodd-Frank has set in motion a massive regulatory rulemaking process that is on an unrealistic timetable. Predictably, the result has been regulatory confusion and market uncertainty.

Regulators are hastily proposing rules to meet the extremely short deadlines without fully considering either their economic impact or how they interact with the rules proposed by other regulators. Meanwhile, market participants are scrambling to understand how the numerous and complicated rules will impact their businesses. In fact, they have filed thousands of comments on the proposed rules.

The comments reveal the gravity of their concerns as well as their confusion about how the rules will work in practice. This process is a direct result of the poorly conceived regulatory structure created by the Dodd-Frank legislation. Although numerous studies have recommended consolidating our financial regulators, Dodd-Frank actually dispersed authority for derivatives regulation. Unfortunately, the danger of having multiple regulators involved is a process marked by disorder and confusion.

For example, although regulators have proposed numerous new rules for derivatives, the CFTC and the SEC have still not proposed rules that clarify the definition of a swap. This omission alone has had serious ramifications for our markets and the implementation process. After all, if regulators do not know what the definition of a swap is, how can they finalize their own rules governing swap dealers or major swap participants since it is unclear exactly who is covered by these rules? And if market participants do not know if they will be classified as a swap dealer or a major swap participant, how can they be expected to know when to submit comments?

This is just one example of how Dodd-Frank has created a confused derivatives rulemaking process that is not proceeding in a logical order and creates significant uncertainty in our markets.

The regulatory process is further hampered by the fact that the Dodd-Frank Act was so poorly drafted. Here is just one example, a simple example that illustrates my point.

One of the first Dodd-Frank rules promulgated by the CFTC was an interim final rule for "reporting pre-enactment swap transactions." The stated purpose of the rule is to reconcile two conflicted Dodd-Frank provisions: Sections 723 and 729.

The CFTC rule proposal specifically states, and I will quote, "The inconsistencies between these two reporting provisions must be reconciled in order to eliminate uncertainty with respect to the actual reporting requirements for pre-enactment swaps." In other words, our regulators have been forced to undertake additional rulemaking in an effort to correct the inconsistencies and errors in the Dodd-Frank Act. And although I am not sure how rules can alter statutory requirements, it is clear that Dodd-Frank has some fundamental flaws and should be revisited.

Today I look forward to hearing how the regulators plan to improve this broken regulatory process, particularly how they will consider and incorporate comments from the public.

Make no mistake. The unprecedented scale and scope of agency rulemakings mandated by the Dodd-Frank derivatives title make it impossible for regulators to engage in deliberative and rational rulemaking and still meet the unrealistic deadlines imposed by the act.

I am also concerned that the regulators are not fully considering the costs and benefits of the rules and the effect that these rules could have on our markets and job creation in the country.

As the American economy continues to struggle, this may be the most important facet of the current regulatory process. I think it must not be overlooked.

Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to welcome and introduce the witnesses on our first panel:

The Honorable Mary Schapiro is Chairman of the U.S. Securities and Exchange Commission. Previously, she was CEO of FINRA. Ms. Schapiro also served as Commissioner of the SEC from 1988 to 1994 and Chairman of the Commodity Futures Trading Commission from 1994 to 1996.

The Honorable Gary Gensler is Chairman of the Commodity Futures Trading Commission. Mr. Gensler previously served in the Treasury Department as Under Secretary of Domestic Finance and Assistant Secretary of Financial Markets. He also served as senior adviser to Chairman Paul Sarbanes.

Daniel Tarullo is a member of the Federal Reserve Board of Governors. Prior to his appointment to the Board, Mr. Tarullo was a professor at the Georgetown University Law Center. He served as Assistant Secretary of State for Economic and Business Affairs as well as Deputy Assistant to the President for Economic Policy and Assistant to the President for International Economic Policy in the Clinton administration.

Mary Miller is Assistant Secretary for Financial Markets in the Department of the Treasury. In that role she advises the Treasury Secretary on a variety of issues relative to domestic finance, financial markets, and other important policy matters. Previously, Ms. Miller worked as director of the Fixed Income Division for the T. Rowe Price Group and served as a research associate for the Urban Institute.

Chairman Schapiro, you may proceed.

STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Good afternoon, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission regarding the implementation of Title VII and Title VIII of the Dodd-Frank Act regarding a regulatory framework for derivatives. It is a pleasure to appear with my colleagues Chairman Gensler, Governor Tarullo, and Assistant Secretary Miller.

As you know, Title VII and VIII are intended to bring greater oversight and transparency to the derivatives markets and to payment, clearing, and settlement systems and activities and, with that, to increase the stability of our financial markets.

While implementing these provisions is a complex and challenging undertaking, particularly in light of our other regulatory responsibilities, we recognize the importance of this task, and we are very committed to getting it right.

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

Since passage of the legislation, we have been very engaged in an open and transparent implementation process, seeking input on the various rules from interested parties even before issuing formal rule proposals.

Our staff has sought meetings with a broad cross-section of interested parties. We joined with the CFTC to hold public roundtables and hearings, and we have been meeting regularly with other financial regulators to ensure consistent and comparable definitions and requirements across the rulemaking landscape.

To date, the SEC already has proposed a number of security-based swap-related rules. Among them are rules that would address potential conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps; rules that would specify who must report security-based swap transactions, what information must be reported, and where and when it must be reported; rules that would require security-based swap data repositories to register with the SEC; rules that would define security-based swap execution facilities and establish requirements for their registration and ongoing operations; rules that would specify information that clearing agencies would provide to the SEC in order for us to determine if the swaps must be cleared and specify the steps that end users must follow to rely on the exemption from clearing requirements; and rules that establish standards for the operation and governance of clearing agencies. In addition, with the CFTC, we have proposed rules regarding the definitions of several of the key terms within the Dodd-Frank Act.

Our staff also is working closely with the Federal Reserve Board and the CFTC to develop a common framework for supervising financial market utilities, such as clearing agencies, which are designated by the Financial Stability Oversight Council as systemically important. In the coming months, we expect to propose rules to establish registration procedures for security-based swap dealers and major security-based swap participants and rules regarding business conduct, capital, margins, segregation, and record keeping requirements for security-based swap dealers and major security-based swap participants. We will also propose joint rules with the CFTC governing the definitions of swap and security-based swap, as well as the regulation of mixed swaps.

We recognize the magnitude and interconnectedness of the derivatives market, and so we intend to move forward at a deliberate pace, continuing to thoughtfully consider issues before proposing and adopting specific rules and working closely with our domestic counterparts and international regulators.

The Dodd-Frank Act provides the SEC with important tools to better meet the challenges of today's financial marketplace and fulfill our mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As we proceed with implementation, we look forward to continuing to work closely with Congress, all the regulators, and members of the financial community, and the investing public.

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

Chairman JOHNSON. Thank you, Chairman Schapiro.

Chairman Gensler, please proceed.

STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Good afternoon, Chairman Johnson, Ranking Member Shelby, and Members of this Committee. I thank you for inviting me here today. I am pleased to testify on behalf of the Commodity Futures Trading Commission, and I also thank my fellow Commissioners and all of the staff at the CFTC for their hard work and commitment in implementing the Dodd-Frank Act. I am pleased to testify along with my fellow regulators Chairman Schapiro and Governor Tarullo, who I had the honor to be announced with by then President-elect Obama 2½ years ago, so we get to be together, and Assistant Secretary Mary Miller. We have known each other now for about 15 years, so it is great to be here together.

The CFTC is working very closely with the SEC, the Federal Reserve, and other regulators in the U.S. and overseas. We are coordinating and consulting with international regulators to harmonize oversight of the swaps market, and we have received thousands of comments today both before we have made proposals and after we have made proposals. At this point in the process, the CFTC has proposed rules in 29 of the 31 areas that the Dodd-Frank Act required us to do so, including proposing rules this morning on margin, which, of course, as well the Federal Reserve and other prudential regulators took up.

Consistent with what Congress did in exempting nonfinancial end users from clearing, the proposed rule would not require margin to be paid or collected on transactions involving nonfinancial end users hedging or mitigating commercial risk.

Over the next several weeks, it is our goal to largely complete the mosaic of proposed rules by proposing rules relating to capital as well as the joint product definition rule along with the SEC and segregation for cleared swaps. And it is our goal to try to complete that in the next several weeks.

One component that we have asked the public about is phasing of implementation. We have not moved to any final rules yet. The whole mosaic will be out there, but implementation is very important. The SEC and the CFTC actually earlier today jointly announced that we would ask the public more on this. We have asked on every one of our rules, but we want to do it in a coordinated way. So early in May we are going to hold 2 days of public roundtables to hear about effective dates and implementation schedules, which compliance should come later, which may be earlier, how it should be phased, whether by asset class, by market participant, or by other characteristics.

We have also put a dedicated comment file up on our Web site today so that people can comment on this very important issue.

We will be considering final rules only after staff can analyze, summarize, and consider comments, after the Commissioners themselves can provide feedback, and after we can consult with other regulators not only here but around the globe.

Before I conclude, I just want to briefly talk about resources. I appreciate any and all that this Committee did now that we are going to move forward and get some breathing room and certainty in 2011 funding. But the CFTC is a good investment, and it has been asked to take on a much more significant role than just overseeing the futures marketplace. The futures marketplace is about $40 trillion in notional size, maybe about $2.50 to $3 in futures for every dollar in the economy. But the swaps marketplace that we have been asked to oversee is $300 trillion in size here in the U.S. Give or take, $20 of swaps for every dollar in the economy. We share that role with the SEC, but clearly it is 7 times the futures marketplace.

We are a good investment, even with what it just looks like Congress will be recommending this week, $202 million. It is dwarfed by the size of the financial industry itself, which is measured in the hundreds of billions of dollars in revenues. So the President has put forward a plan for us at $308 million next year. I look forward to working with this Committee and the appropriators on both sides of the aisle and in both Houses to see how we can assure that we have the resources to fulfill the mission.

Thank you.

Chairman JOHNSON. Thank you, Chairman Gensler.

Governor Tarullo, please proceed.

STATEMENT OF DANIEL K. TARULLO, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Mr. Chairman, Senator Shelby, and other Members of the Committee, thank you for this opportunity to provide the Federal Reserve Board's views on the implementation of Title VII of Dodd-Frank. The Board's responsibilities fall into three broad areas. The first relates to coordination and consultation with other authorities, both domestic and foreign.

As to domestic consultation, Dodd-Frank requires that the CFTC and the SEC consult with the Board on rules to implement Title VII. In providing comments to the two market regulators, we have tried to bring to bear our experience from supervising dealers and market infrastructures and our familiarity with markets and data sources.

There are also very important international coordination activities related to derivatives. Most prominently, the Group of 20, or G-20 leaders, sometime ago established commitments related to reform of the OTC derivatives market that would form a broadly consistent international regulatory approach. In an effort to implement the various portions of that commitment, the Committee on Payment and Settlement Systems is working with the International Organization of Securities Commissions to update international standards for systemically important clearing systems, including central counterparties that clear derivatives instruments, and trade repositories.

Even before the G-20 leaders initiative, the Basel Committee on Banking Supervision had established capital standards for derivatives. More recently, the committee has strengthened those standards and has created leverage and liquidity standards which will be applicable to them.

The goal of all of these efforts should be a level playing field that will promote both financial stability and fair competitive conditions to the fullest extent possible. And I think for all of the agencies represented here today, the pursuit of this end is going to need to remain a priority for some time.

The second task given to the Federal Reserve under Title VII relates to the strengthening of infrastructure. Central counterparties are given an expanded role in the clearing and settlement of swap and security-based swap transactions. If properly designed, managed, and overseen, central counterparties offer an important tool for managing counterparty credit risk, and thus reducing risk to market participants and to the financial system.

Title VII of the act complements the role of central clearing by heightening supervisory oversight of systemically important financial market utilities. This heightened oversight is important because financial market utilities such as central counterparties concentrate risk and thus have the potential to transmit shocks throughout the financial markets.

As part of Title VIII, the Board was given new authority to provide emergency collateralized liquidity in unusual and exigent circumstances to systemically important financial market utilities. We are at present carefully considering how to implement this provision in a manner that protects taxpayers and limits the rise in moral hazard.

The third task committed to the Board by Dodd-Frank is that of supervision. Capital and margin requirements are central to the prudential regulation of financial institutions active in derivatives markets as well as to the internal risk management processes of those firms. The major rulemaking responsibility of the Board and the other prudential regulators is to adopt capital and margin regulations for the noncleared swaps of banks and other prudentially regulated entities that are swap dealers or major swap participants.

The Board and the other U.S. banking agencies played an active role in developing the enhanced capital leverage and liquidity regime that I mentioned before. These requirements will strengthen the prudential framework for OTC derivatives by increasing risk-based capital and leverage requirements and requiring banking firms to hold an additional buffer of high-quality liquid assets to address potential liquidity needs resulting from their derivatives portfolios.

The statute also requires the prudential regulators to adopt rules imposing initial and variation margins on noncleared swaps to which swap dealers or major swap participants that they supervise are a party.

The statute directs that these margin requirements be risk-based. In accordance with the statutory instruction, the Board and other prudential regulators proposed to implement the margin provisions in a way that recognizes the low systemic risk posed by most end users. The proposed rule would not specify a minimum margin requirement. Rather, it would allow a banking organization that is a dealer or major participant to establish a threshold based on a credit exposure limit that is approved and monitored as a part of the normal credit approval process, below which the end user would not have to post margin.

Finally, I would note that the proposed regulation provides that the margin requirement should be applied only to contracts entered into after the new requirement becomes effective.

Thank you for your attention.

Chairman JOHNSON. Thank you, Governor Tarullo.

Assistant Secretary Miller, please proceed.

STATEMENT OF MARY J. MILLER, ASSISTANT SECRETARY FOR FINANCIAL MARKETS, DEPARTMENT OF THE TREASURY

Ms. MILLER. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to testify today about Treasury's role in implementing Dodd-Frank's derivatives provisions.

As you know, the President signed the Dodd-Frank Act into law almost 9 months ago. The act established a framework for the country to build a stronger, safer, and more competitive financial system. It creates safeguards to protect consumers and investors, end taxpayer bailouts, and improve the transparency, efficiency, and liquidity of U.S. markets. The derivatives provisions are a critical part of that framework, and the Administration strongly supports them. Dodd-Frank's derivatives provisions will shed light on a market that previously operated in the shadows. Central clearing, trade execution, and reporting requirements and business conduct standards will provide substantial benefits. The work that the Administration is undertaking in partnership with our colleagues at the CFTC, SEC, and Federal Reserve Board is vital in preventing the harmful buildup of risk that contributed so greatly to the financial crisis in 2008.

As other Treasury officials have previously testified, several broad principles guide our implementation efforts. First, we are moving quickly to meet the statute's deadlines, but we are also moving carefully to make sure that as we implement the act we get it right.

Second, we are bringing transparency to the process so that as many stakeholders as possible have a seat at the table, the American people know who is at that table, and anyone who wants to provide input on requests for comment and proposed rulemakings can do so.

We are creating a more coordinated regulatory process. The Financial Stability Oversight Council is playing a key role by bringing together the financial regulatory agencies to help develop consistent and comparable regulations and supervisory regimes.

Fourth, we are building a level playing field by setting high standards in the United States and working diligently with our international counterparts to follow our lead.

Fifth, we are crafting rules of the road that will provide U.S. investors and institutions the conditions they need to invest capital, develop innovative products, and compete globally.

Finally, we are committed to regularly keeping Congress informed about our progress. The Treasury Secretary has specific statutory responsibilities with respect to derivatives implementation and also has other responsibilities in his capacity as the Chairman of the FSOC.

Starting with the specific, Congress gave the Secretary the authority to determine whether foreign exchange swaps and forwards should be exempt from the definition of swap in the Commodity Exchange Act. The Secretary must consider the statutory factors set forth by the Dodd-Frank Act, including the impact regulating FX swaps and forwards swaps under the CEA would have on systemic risk and financial stability; the existing regulatory regime and supervision of FX swaps and forward participants; and, finally, whether an exemption could lead to evasion of other regulatory requirements.

We published a request for comments to solicit public input on a wide range of issues relating to a potential exemption. We received 30 comments in response, and Treasury staff has also conducted an independent analysis, including extensive discussions with a range of interested parties.

We know that market participants, other stakeholders, and the Committee are closely following this issue. Regardless of the decision the Secretary makes, market participants need to be able to prepare for it. While we intend to move expeditiously, it is also critical that we take enough time to make the right decision for the safety and soundness of the markets.

The Secretary also has derivatives implementation responsibilities in his capacity as FSOC Chairman. The FSOC recently approved the publication of a Notice of Proposed Rulemaking regarding the designation of systemically important financial market utilities. FMUs support and facilitate the transfer, clearing, and settlement of financial transactions, and they form a critical part of the Nation's financial infrastructure. The notice was published on March 28th and will be open for comments for 60 days.

One final area I would like to touch on is the importance of comparable international standards, including derivatives oversight. The United States will set high standards, but today's financial system is highly interconnected, mobile, and global. We must work not only to protect the competitiveness of U.S. financial markets but also to ensure that the reforms we implement here are not undermined by lax standards elsewhere.

We will continue to work at home and abroad to build a regulatory framework for derivatives that will help our financial system become safer and sounder and a platform on which we can build strong financial markets that will fuel our economic growth.

Thank you.

Chairman JOHNSON. Thank you, Assistant Secretary Miller. I will start off the questions. Thanks for your testimony.

I will remind my colleagues that we will keep the record open for statements, questions, and any other material you would like to submit. As we begin questioning the witnesses, I will put 5 minutes on the clock for each Member's questions.

Chairman Schapiro and Chairman Gensler, how do you plan to reconcile the different SEC and CFTC proposed rulemakings governing swap execution facilities, real time reporting, block trades, and other infrastructure consistent with Dodd-Frank's requirement to assure regulatory consistency and comparability and treat functionally or economically similar products or entities in a similar manner?

Ms. SCHAPIRO. Mr. Chairman, I would be happy to start. We are very, very focused, obviously, on the issues surrounding the fact that in a number of areas, and you just articulated several of them, we do have differences in our rule sets between the SEC and the CFTC. Some of those differences may actually be necessitated by the fact that the markets, while they are both derivatives markets, the products may trade differently, have different liquidity characteristics, and for that reason, some differences may actually be appropriate in order to continue to foster the development of these markets. But we have asked for comment on whether our understanding in that regard is correct.

But I would also say that we are continuing to work extremely closely together through the proposing stage, and now that for a number of rules comment periods have closed, we were able to review the comments that have come in on our proposals as well as those that have come in on the CFTC's proposals where they have gone in a slightly different direction and we are very committed to continuing to work through those differences, and if they are not grounded in very good market structure reasons because of the nature of the products, trying to get them as consistent as we possibly can.

Where we have proposed after the CFTC, I would just add, on some rules, we have actually sought explicitly to get comment on their approach to see if that might be a better way to go forward. So in a number of areas where we do have differences, I believe because we are still at the proposing stage and not at the adopting stage, we will be able to work through many of those differences. And then, of course, through implementation, it may be necessary for either or both of us to engage in some interpretation of our rules in order to ease implementation and make them consistent.

Mr. GENSLER. I will keep it brief. I agree with what Chairman Schapiro said. It is a lot of consultation and coordination. It is also in the context of there are some differences between the futures marketplace and the securities marketplace that either have existed in statute or in rules or just in market practice for decades, and so we are trying to be as close as we can between swaps and securities-based swaps while also not creating some regulatory arbitrage and undercut, for instance, in our case, a futures marketplace that has worked with a great deal of transparency and low risk to the American public, and not undercut that marketplace through some differences, as well. And I suspect the same issues on your side.

Ms. SCHAPIRO. If I could just add, it is critically important to us, as well, that because securities-based swaps can be economic equivalents to equity positions, that we want to make sure that we do not create, while we are trying to be more and more synched up with the swaps markets, between the security-based swaps and swaps markets, that we are not creating great distance between the security-based swap markets and the equity markets, as well.

Chairman JOHNSON. Assistant Secretary Miller and Governor Tarullo, how are Treasury and the Fed working to harmonize international derivatives regulations through the G-20 and the Financial Stability Board, especially given the different international time frames for moving ahead on new rules? How are your efforts in this area being coordinated with the CFTC and the SEC to be sure that requirements for capital and other rules are both appropriate and consistent?

Ms. MILLER. Well, we are following this very closely, because as I said, we are very interested in having good harmonization globally on these rules. So in many settings, Treasury staff are engaging with their counterparts in different international groups. There are a number of working groups on derivatives that are occurring through the Financial Stability Board in Europe. We are also interested in things that are going on in Asia. So we are following both the rulemaking process in the U.S. and we are engaging regularly with our counterparts in other countries.

Mr. TARULLO. Mr. Chairman, let me add a couple of thoughts there. As you can tell from the testimony today, the other rulemakings that the SEC and the CFTC have ongoing, dealing with the international equivalents of Title VII and Title VIII, are going to implicate a number of different regulatory authorities in other jurisdictions.

So I think what was looked for by the G-20 was a framework of agreement or commitment on a set of goals that would then be pursued in the various appropriate international bodies. What we have got now, I think, is a good bit of very productive work on efforts to get agreement on central counterparties, on electronic trading, on transparency for those counterparties, on risk management standards. That is being done, I think, through a lot of cooperation among agencies, but in particular, the Fed and the SEC, because, in fact, we have got a Reserve Bank President and a Commissioner of the SEC who are chairing the key international committees on this point—President Dudley of the New York Fed and Commissioner Casey of the SEC.

On capital, as I said in my prepared remarks, the Basel Committee on Banking Supervision has a set of capital requirements for derivatives in a part of its overall internationally recognized capital standards. They have been updated to take account of what was learned during the crisis, but they are already agreed among all the Basel Committee members, which constitutes not just the G-20 but some additional countries beyond the G-20.

I think the one area where we probably need some more work now is on margins for noncleared derivatives and noncleared swaps. I think the fact that we, the prudential regulators and the market regulators are now moving toward a proposal for the U.S. is going to enable us to have a clear, coherent, and unified position internationally to try to move along some other countries which are actively, or in some cases not so actively, considering putting these requirements in place.

With respect to coordination, I think it has been very good. As you can tell from just my recitation of the different committees, we need to have everybody involved because there are different expertises here, and from all accounts that I get from our staff and directly from talking to principals at other agencies, I think this is one area where the convergence of views and the cooperation among U.S. agencies has been quite good.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Assistant Secretary Miller, on our second panel today, we will hear from the Treasurer of FMC, a large manufacturing company here in the U.S., who has grave concerns, according to his testimony, about the excessive regulations mandated by Dodd-Frank. His testimony indicates that these regulations will increase operating costs, making it more difficult for his company to both create jobs and to manage risk. Do you believe that FMC Manufacturing Company, the end user, is the type of company that should be regulated under Dodd-Frank, and does Treasury have any concerns about the potential consequences of Dodd-Frank derivatives regulation on job creation? Have you done any work in this area?

Ms. MILLER. OK. Thank you for the question. We have heard a great deal from end users, nonfinancial and financial in the markets, and I think that there is sufficient flexibility in the Dodd-Frank legislation to work with a company like FMC in terms of providing flexibility under derivatives regulation.

Senator SHELBY. In other words, a company that is an end user that is managing risk but not in the pure financial speculation, is that right?

Ms. MILLER. Yes. We have not done any specific work on the economic impact on job creation of this particular title.

Senator SHELBY. Will you do some research, have Treasury do some research into that area?

Ms. MILLER. Well, we have worked——

Senator SHELBY. Because this could have ramifications for creating jobs, could it not, if it is——

Ms. MILLER. There were many studies mandated by Dodd-Frank and we have been diligently delivering the work that has been delivered under the statute. So we have put out quite a bit on the financial market ramifications.

Senator SHELBY. Foreign exchange swaps and another area. Treasury is charged with determining whether foreign exchange swaps and forwards should be subject to extensive Government regulation. In your testimony today, you stated that, quote—I will quote you—"we want to move expeditiously with respect to making the determination that the treatment of foreign exchange—about the treatment of foreign exchange and swaps." When will Treasury make its determination, in your judgment?

Ms. MILLER. So I regret that I do not have that decision to give you today for the hearing. I think we are very close. We have been working on that——

Senator SHELBY. Would you furnish that for the record and the other Committee Members when you get it?

Ms. MILLER. We absolutely will, and we would be delighted to come up and brief you on our decision either way.

Senator SHELBY. Are you at Treasury aware of any market failure in the foreign exchange market that would justify further regulation?

Ms. MILLER. There are many parts of the foreign exchange market. The FX swaps and forwards part that you just mentioned is one part of the foreign exchange market——

Senator SHELBY. Are you aware of any failures in that area that would justify further regulation?

Ms. MILLER. I think there are many parts of that market that were under severe stress during the financial crisis and some parts of it will be subject to Dodd-Frank regulation.

Senator SHELBY. To your knowledge, were any of the areas in derivatives where you are managing risk and you are an end user under extreme stress? I do not know of any.

Ms. MILLER. I would be happy to reply to that question with further research if you want specific examples——

Senator SHELBY. Will you do that for the record?

Ms. MILLER. Sure.

Senator SHELBY. OK. Governor Tarullo, central clearinghouses is an area which is very important. Last week, Chairman Bernanke of the Federal Reserve gave a speech about the importance of properly regulating clearinghouses. He noted that one of the reasons that clearinghouses have not had trouble to date is, quote, "good luck." We cannot always count on good luck, as you know. Beyond relying on luck, what steps can we take, or can you take, to ensure that taxpayers are never called upon to bail out clearinghouses because that was a concern of a lot of us when we were debating the Dodd-Frank legislation, as you will recall.

Mr. TARULLO. Right. I do recall your questions on that topic, Senator, a year or two ago. So with respect to the central clearing parties that are designated as systemically important, there will be oversight by the appropriate market regulator, but the Federal Reserve has a role to play there as well. We have a consultative role. We hope to be involved in the exams, bringing to bear, if I can put it this way, a supervisory or prudential supervisory perspective on these institutions. So we would hope that they will all be subject to strong prudential requirements for credit risk, strong liquidity buffers——

Senator SHELBY. What does "hope" mean? Now, you said you would hope——

Mr. TARULLO. The mechanism here is one—the primary regulators are the market regulators.

Senator SHELBY. I know. We know.

Mr. TARULLO. We have a consultative role——

Senator SHELBY. Oversight role.

Mr. TARULLO. We have an oversight role, that is correct, and in that capacity, I think we will hope to contribute to the perspective on the supervision of these organizations. I suspect that there will be convergence among the agencies on the kind of standards that are important, and, as I said, I think we are going to draw on our experience not just with market entities, which we do have, but also supervising from a prudential point of view, looking to safety and soundness and not simply market operations.

Senator SHELBY. In the same type area, the United Kingdom's Financial Services Authority wrote a comment letter in response to a rule proposed by the CFTC on risk management requirements for clearinghouses. The FSA, the United Kingdom's Financial Services Authority, warned the CFTC that lax eligibility requirements for firms to be members of clearinghouses could create new risk to the financial system. Do you agree with FSA's comments, or are you concerned about that, too?

Mr. TARULLO. Senator, I have not seen the FSA comment on the proposed CFTC rule. I would say that an effective member qualification and default set of standards is very important to the integrity of any central clearing party.

Senator SHELBY. Should not you or we, we altogether, should not we do everything we possibly can do to ensure that there is no bailout of a clearinghouse?

Mr. TARULLO. Absolutely, Senator. I think that is why we all, everybody up there, everybody at the table here, share an interest in having rigorous and effectively enforced standards for the central clearing parties.

Senator SHELBY. Can I get Chairman Gensler's comments on that, because that is in his area.

Mr. GENSLER. It is a big yes. I think that central clearinghouses need robust oversight. I view it as a partnership with the Federal Reserve, even we might be the front line and, of course, the SEC has their clearinghouses, as well. I think they should not have central bank liquidity, though Dodd-Frank did allow for it in emergency exigent circumstances when the Secretary and the Board of Governors decide that. But I think that should be an absolute rare occurrence. It should not happen.

Clearinghouses have not failed in this country. We have survived two World Wars and we have survived great crises. I think the clearinghouses have to have collection of margin. They have to have it on a daily basis. They have to be able to have proper default management and so forth——

Senator SHELBY. They have to make sure everything clears, do they not?

Mr. GENSLER. They absolutely have to make sure everything clears, and that which clears has available pricing, available liquidity. And I think also with regard to the comment letter that you referred from the——

Senator SHELBY. From the U.K.——

Mr. GENSLER. ——from the U.K., it is very important that these clearinghouses have open membership, that the access to the clearinghouse is not just so narrow—clearinghouses have greater risk if it is only narrow membership. But if it is broadened out, markets work best when they are open and competitive.

Senator SHELBY. Since there are international implications to derivatives and derivatives trading and everything, should we not listen to our counterparts in Europe, like the United Kingdom and FSA and others who have similar concerns that we should have?

Mr. GENSLER. Absolutely, and we are listening. We are consulting with sharing all our drafts, our term sheets, our memos with not just the FSA, but ESMA and the European Commission and the like. So their comment is very helpful, but we also believe that membership should be opened up, but the smaller members can only scale into that membership and not be like the large members. Right now, the clearinghouse they are thinking about has sort of an exclusive club deal and I think Congress spoke to that in the statute, saying there is supposed to be open access.

Senator SHELBY. Yes. Exclusive clubs are dangerous things sometimes.

Mr. GENSLER. Yes, and that is what occurs in swaps clearing today, not in futures clearing. Futures clearing is much more open. Securities clearing is much more open. Swaps clearing today has been more exclusive, but Dodd-Frank actually said it had to be more open and competitive.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Let me begin by associating myself with the comments Senator Shelby made about the utility of clearing platforms to dissipate the risk *vis-a-vis* bilateral transaction, but the inherent danger of not-well-regulated trades create, and I know everyone at this table is acutely focused on that and I urge you, as Senator Shelby did, to keep your focus on that issue.

But Secretary Miller, following up on another line of questioning of Senator Shelby about forex contracts, were these contracts part of the Lehman bankruptcy, *i.e.,* were there losses incurred when Lehman failed because they could not fulfill forex contracts, and would those losses have been avoided if the contracts were traded or cleared?

Ms. MILLER. There were open contracts with Lehman Brothers when they failed. Those contracts were settled, so they were able to be settled.

Senator REED. And they were settled how?

Ms. MILLER. A large number of them moved through a payment versus payment settlement system. I cannot give you the precise percentage that were settled that way, but it is my understanding that all of the open contracts through Lehman Brothers were settled.

Senator REED. Governor Tarullo, did the Federal Reserve in any way support the forex market during the months, the late months of 2008?

Mr. TARULLO. Well, it was not support for the foreign exchange market as such, Senator. There was liquidity provided in the form of dollar liquidity, both through the discount window directly to institutions operating in the United States and to central banks of some other countries. But this was not in pursuit of settling foreign exchange swaps. This was as a byproduct of the general liquidity squeeze that——

Senator REED. But part of their exposure was the foreign exchange contracts?

Mr. TARULLO. I do not think it was—I think it was much more a funding problem, a dollar funding problem. It was not a matter of failing on a contract but not having access to wholesale funding in dollars when you had obligations in dollars.

Senator REED. But there is a possibility, if these contracts are exempt, that there could be another situation where—a liquidity freeze where it is not a question of settlement, they just cannot get the money to settle, and the Fed is prepared or will enter into supporting this sector?

Mr. TARULLO. Well, Senator, under Dodd-Frank, we are not permitted to offer institutions specific assistance except obviously for the discount window or through the FMU provisions here. I think—and Secretary Miller alluded to this—I think most people who have studied this issue think that the problems in the foreign exchange market have largely concentrated on settlement. There is a quite short duration of most forex forwards. As you may know, all the international work on foreign exchange transactions began after the 1974 failure of Herstatt Bank, which produced these kinds of settlement problems.

So I think that is where most of the attention has been focused, and today, there are, I would not say perfect or all comprehensive mechanisms for making sure that foreign exchange transactions settle, but there has been a substantial amount of improvement over the last 36 years.

Senator REED. I have approximately a minute and a half, so Governor Tarullo, you can explain to me the interaction between the capital requirements of the Volcker Rule for companies that have derivative activities and Basel III and the general prudential guidelines for capital that you are developing for financial security, and the clock is ticking.

[Laughter.]

Mr. TARULLO. So, I am sorry, what are the three areas again?

Senator REED. Under Dodd-Frank, the Volcker Rule has some specialized language with respect to companies, financial companies trading derivatives. There is also the Basel III requirements that talk about derivatives. And then there is just the general prudential safeguards for capital that the Fed can insist on a case-by-case basis——

Mr. TARULLO. Oh, sure.

Senator REED. ——a general basis. So in your mind, are these separate categories, or does this blend into one sort of gut feeling about how much capital a company should have?

Mr. TARULLO. Well, now it is not going to be a gut feeling. There will be an analytic backdrop for it, and I think there already is. We devoted a lot of attention even before the Basel III process to improving the market risk part of the general capital standards and derivatives were one of the focuses for attention, including important upgrades to counterparty risk, evaluation and capital set-asides, and also to making sure that you stressed the potential exposures as opposed to just a random test through a normal market environment.

I think with respect to any capital authority that we have, our aim will be to have a set of rules, backstopped by specific supervisory oversight, which ensure that those activities are not creating risk to the institution that does not have an adequate set-aside. That is what existed in the precrisis period. There were opportunities for arbitrage that were readily taken by firms. I think there was inattention to counterparty risk, both at the firm level and among regulators. Those are the kind of changes that need to be put in place, and those are the kind of changes that are in the rules that we are promulgating under Basel III but with an eye to the specifics of a firm, not just to sort of a gut feeling about that firm.

Senator REED. Thank you, Mr. Chairman. Thank you, Governor. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank all of you for being here, as usual.

I think the notion of a clearinghouse was something that—or focusing on clearing trades was something that was very bipartisan in nature. Obviously, you move into details and there ends up being some differences, especially on the end user piece. But for what it is worth, among market participants, and we, obviously, like you, are talking to many among those on the buy side and the sell side, and those who strongly supported Dodd-Frank and those who obviously oppose it, I think there is a concern about the rapidity that these rules are being put in place and even more so on their prescriptive nature, OK, and just being overly prescriptive.

So with that, Mr. Gensler, I am going to focus on a few things with you. I noticed that people have to have five quotes now, for instance. Even a large institutional trader that might have a relationship with one institution has to have five quotes, and I am wondering, who is it you are trying to help or save, or what is the point behind that?

Mr. GENSLER. Senator, I think you are referring to the swap execution facility——

Senator CORKER. That is right. That is right.

Mr. GENSLER. ——in the proposed rule, and in that regard, Congress said that those transactions that are cleared and made available for trading would be brought to swap execution facilities. That is a mandate and it is transparency. Congress in the statute said that it would be to promote pretrade transparency.

These are trades that are not large blocks. The blocks are excepted. So it might be a $5 or $10 million trade, not a $500 million trade, and it is one that is cleared so it is anonymous. There is no credit risk.

On those trades, what Congress suggested we do and what we think we are doing in the rule is promoting transparency where multiple participants have an ability to execute against other multiple participants. In the futures marketplace, when a request for quote goes out, it goes out to the whole marketplace. It does not even go just to five. It goes out to a broader group in the marketplace, and the quotes that come back in are seen by the marketplace. So there is far more liquidity. What we are proposing is actually less transparency than the futures marketplace.

Senator CORKER. So on the large block trades, they are excluded——

Mr. GENSLER. They are excluded.

Senator CORKER. ——and do you think this was something wise that we asked you to do, just briefly, yes or no?

Mr. GENSLER. Yes.

Senator CORKER. OK.

Mr. GENSLER. Yes.

Senator CORKER. The real-time reporting, I noticed you have come up with a 15-minute time frame. I am just curious about what was magic about that. I know numbers of people think that is not long enough, especially in larger transactions.

Mr. GENSLER. Well, I am glad you asked. Congress said that real-time reporting after the trade should be as soon as technologically practicable on the smaller trades, and then on the blocks, we could have a delay. So we looked at what delay do we have in the futures marketplace. It is about 5 minutes now. We proposed 15 minutes if it is on a swap execution facility. If it is bilateral, we asked a lot of questions and sought comment. In the securities world, Chairman Schapiro could speak better, but I think their delay is 90 seconds now. So we looked at this and said it is three times the futures world, about ten times the securities world. We are going to get comments. The proposal will change once we get to a final rule, but that was the thinking.

Senator CORKER. So on the larger trades, it may be much longer. It may be end of day. It may be something——

Mr. GENSLER. Well, I——

Senator CORKER. ——the block——

Mr. GENSLER. The larger trades that are on a swap execution facility, we proposed 15 minutes.

Senator CORKER. Right.

Mr. GENSLER. If it is a bilateral, we did not propose a specific time. We just asked a lot of questions.

Senator CORKER. And is it your vision—a lot of people think that it is, so I will give you that editorial comment, but do you think the derivatives market and equity markets should be very similar when you finish all of these activities?

Mr. GENSLER. I think that markets work best when they are transparent, open, and competitive, and those three core factors, whether it be futures or securities, or derivatives, ultimately help end users, investors, and I think it helps the economy grow. It does shift some of the information advantage to the tens of thousands of users away from the most sophisticated——

Senator CORKER. So that is a yes?

Mr. GENSLER. I think it is a yes——

Senator CORKER. I think there are a lot of concerns because people view the two instruments as being very different and I think there is some concern out there that that is your vision and it is not taking into account the differences between the instruments.

Mr. GENSLER. Senator, I think you asked about equities and derivatives and we regulate futures. I think markets work best, whether they are futures, equities, or swaps, when they are transparent. When they are competitive, people get the benefit of that competition in contrast to a closed or dark market.

Senator CORKER. If derivatives are moving out to electronic platforms, is there any concern about a growth of high-frequency trading taking place in that area?

Mr. GENSLER. It is something that captivates our commission every day in the futures marketplace, when 85 to 90 percent of the marketplace is now electronic. It is something that we think is very much on our mind as we think about regulation in the swaps marketplace.

Senator CORKER. And we look forward to having you in our office, and I am sorry we have not.

If I could ask one more question to Mr. Tarullo or Ms. Miller, either one, you know, we had a lot of discussions, I remember, in the hearing room when Mr. Volcker came in and started talking about the Volcker Rule, sort of a flower in the middle of regulation. It ended up being a part of Dodd-Frank. And I am out, as I know all of you are, and certainly my colleagues. We talk with banks throughout our country, small community banks and others, about the Examiner in Charge, and the Examiner in Charge that comes into their institution, basically, their attitude, their understanding of whatever regulator it is they are working with changes pretty dramatically how their bank's status is interpreted, OK. The Examiner in Charge is basically king.

As you look at the Volcker Rule, again, Mr. Volcker, who I respect greatly and I think everybody up here does, could not really describe to us what propped trading was. You just know it when you see it. How are you all going to sort of institutionalize the whole Volcker issue when, again, you have these examiners, EICs, that are out amongst these various institutions that have judgment? I do not see how you do that properly and I would love to have any help with understanding that.

Mr. TARULLO. Senator, I think there are a couple of things. First, when you are talking about 7,000 financial institutions as you are with some of the very basic prudential standards, the balance is always as between allowing for the local knowledge of the examiner-in-charge, because he or she is going to understand the institution they are in better than anybody, on the one hand, and on the other hand, assuring a consistency in treatment across everybody in the United States because people deserve that.

When it comes to something like the Volcker Rule or a number of the other provisions that we are talking about, you are almost surely dealing with a much smaller subset of institutions, and I think there, the kind of horizontal approach to regulation and supervision that we have been taking with respect to larger institutions is going to be particularly important.

So once we, the prudential regulators, come up with the regulations to implement the Volcker Rule, we are going to have to have a coordinated and coherent and unified approach to implementing and overseeing the implementation of that rule, and I would expect that as we have already done with some of our activities over the last couple of years, beginning with the stress tests in early 2009, we will have a process internally to make sure that these things are being implemented consistently, that the CPC teams, the leads of the teams that are in place in the large institutions, have a common framework of knowledge and training, and that we are making sure that the regulatees have an opportunity to come to us, that is to the Board, and to say, we are uncertain about what is going on here or we are not sure we are being treated the same way.

So I think will it be a task? Yes. Will it be more difficult, I think, than a lot of the other supervisory tasks that we have now? I do not think so. That is not to understate the attention it is going to require. But once we get those rules in place, I think we do have a mechanism for making sure they are applied in a consistent fashion—that people have recourse to come to the Board to ask about the interpretation of a rule.

Senator CORKER. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman, and thank you, all four of you, for your work on Dodd-Frank and getting the legislation passed. Passing this bill last July in so many ways was only the beginning of the effort to impose transparency and accountability and unregulated in the opaque and unregulated derivatives markets. It is pretty clear in newspaper reports that the opponents of transparency and the opponents of oversight lost the first fight, but they are working on budget issues to try to restrict a lot of the things that you are trying to do and trying to handcuff your efforts.

Just listening to your testimony today and looking at the magnitude of the regulatory effort that you are undertaking I think really illustrates the importance of that, so thank you.

Chairman Gensler, my questions are directed at you. I sent a letter to you back in January about gas price speculation and the importance of the CFTC's position limits rules in curbing excessive speculation. I am concerned that excessive speculation can once again perhaps seriously hurt our economy. Every time there is a pipeline outage or a refinery fire or trouble in the Middle East, it seems that one reaction of that is speculators and oil companies move in to spike prices up, using that as a typical excuse for that happening.

The Commodity Markets Oversight Coalition, a group of commercial end users, pointed to 57 studies conducted in the last 5 years showing the role of speculation in driving up asset and commodity prices. In the 1990s, speculative interest in commodities was about 15 to 30 percent typically. Today it is closer to one-half to two-thirds of the market. Financial companies account for over 51 percent of crude oil futures, an increase of 5 percent just in the last month.

We know what this means to our economy potentially. We know what it means to individual motorists, to small businesses operating on small margins to truckers, to so many others. And we have seen what speculation can do, similar price increases in other commodity markets.

Last week, the CEO of Starbucks said financial speculators have come into the commodity markets and drove those prices up to historic levels, and as a result of that, the consumer is suffering.

Chairman Gensler, talk to us about financial speculation, its effect on prices, and then answer this question, if you would. What authority under Dodd-Frank do you have now to combat speculation? What do you need from us in terms of additional tools to carry that out?

Mr. GENSLER. Hedgers meet speculators in marketplaces. From the earliest days in the derivatives marketplace, a farmer planting corn or wheat or soy wanted to hedge a price and lock in that price at harvest time, and it was generally a speculator who was on the other side to assure that price.

When our agency's predecessors were formed, it was to make sure that markets were transparent; a hundred percent of the market had to come to a marketplace. Transparency is so important, and it is important that we have the tools, legal and other tools, to combat fraud and manipulation. Position limits were part of that toolkit that we were given in the 1930s.

In Dodd-Frank, that was expanded. It was expanded not just to be futures but also for economically equivalent swaps.

We are not a price-setting agency, but our agency is to ensure that markets have a certain basic integrity, you can have confidence in them, and they are not so concentrated. You are accurate that speculators, if you might say, somebody who is not in the physical marketing channel, somebody who is not producing or using the oil or natural gas or the corn or wheat, are a large part of the marketplace. They are well over half of the marketplace usually in different parts of the market statistics will show. We put these statistics out every Friday. They are public.

So what we need to do, I believe, is complete a rule on position limits. Position limits have been in place in the agricultural products for decades and were in the energy products in the 1980s and 1990s. We have a rule out and that the comment period just closed. We actually got—and I misstated it in my written testimony. We got 11,000 comments on this position limit rule, on the energy and agricultural limits. So we are going to need to sort through that. We are going to take a number of months. That is a lot of comments to sort through. Many of them are repetitive.

To your question, we also need to promote transparency in this marketplace. I think the more transparent, the more market participants can see the aggregates as well as the pricing, that is a very important thing. And I think we need resources, if I might say. This small agency I think is a good investment to ensure the integrity of these markets.

Senator BROWN. Thank you.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and thank you very much to all of you for testifying.

I just cannot help but make one brief observation, which is—gosh, it is just amazing to me. I have here in my hand the CFTC rule on position limits for derivatives. It looks like it is about a 4-point font. It is 25 pages long. And according to CRS, Dodd-Frank calls for 330 rules.

It is not a criticism of this particular rule, but it strikes me as an incredible cost to the financial institutions that have to understand these, digest these, hire the manpower to then comply with these. And it strikes me as something that could approach a miracle if they are all perfectly consistent and compatible and operate exactly as intended with no unintended consequences. This is really a very, very difficult undertaking, it seems to me, an enormous cost to the financial institutions to comply with. I suppose the very large ones will be able to afford it. Smaller ones, I am not so sure.

I would like to follow up with a question on the position limits, Mr. Chairman, if I could.

One is my understanding of Dodd-Frank, which passed before I got here, but my understanding is that the bill does provide some flexibility in terms of how you go about imposing position limits. And my further understanding is that thus far the European regulators have not promulgated any rules whatsoever regarding position limits.

Is there a danger that if we go ahead and impose position limits and they do not, we simply have a migration of business to other venues? Are you concerned about that at all?

Mr. GENSLER. We are working closely with the European and Asian regulators. I think capital and risk do not know any geographic boundary, so whether it be position limits or other rules, Senator, that is something that we are very conscious of.

On position limits, I think after numerous hearings, starting probably in 2007 and 2008 in the House and the Senate, our authorities were not only broadened to include economically equivalent swaps, but also something very important, the exclusion from those position limits, called *bona fide* hedging, was narrowed a bit. So we take congressional direction on this as well.

Senator TOOMEY. I understand that, but are you concerned that in the absence of comparable European regulation that we have the opportunity for regulatory arbitrage across borders?

Mr. GENSLER. I would have to say yes, but not just with regard to position limits. That is why we have been so active in Europe and elsewhere to try to harmonize where we can. But in terms of position limits, what we are looking at in the proposal is about futures and options on futures, where we have set them for decades in agriculture. We did in energy in the 1980s and 1990s along with the exchanges, and the exchanges took the lead. And it is looking to reimpose those, and we are benefited because, as I said, we have 11,000 public comments in the file right now. So this is one that the public is very engaged in.

Senator TOOMEY. Well, I am concerned about this apparent developing disparity between the regulatory regimes.

Another quickly question, if I could, on the real-time reporting. We had a little discussion earlier about speculators and the fact that speculators—and I completely agree with your observation. Speculators provide a great deal of liquidity. It is often the case that speculators also need to have a certain amount of anonymity, and while transparency has many virtues and can be very important, sometimes anonymity is important, too.

My understanding is—and maybe you could correct me if I am mistaken—that the CFTC's 15-minute disclosure requirement is different than the SEC, which has a longer period of time before a comparable transaction has to be disclosed. So is there a difference between the two?

Ms. SCHAPIRO. There is, Senator, a difference with respect to block transactions, the larger transactions, which are the ones that would give rise to the concern about whether too much information was being revealed that might allow somebody to run ahead of the hedge, for example, on the block.

Senator TOOMEY. Right.

Ms. SCHAPIRO. We have not actually proposed yet standards for how we will define a block transaction. We have asked for comment on that, and then we will propose some specific standards. But we have said that while we would recommend disseminating the price of the transaction in real time, the size of the transaction would not be disseminated for as long as 8 to 26 hours after the transaction.

Senator TOOMEY. OK. And, Mr. Gensler, would your goal be to have a harmonization with respect to the SEC's approach?

Mr. GENSLER. We are working very closely together, not just on real-time reporting, but to try to bring them together as much as we can. Of course, there are differences in the underlying markets. There are differences between futures and securities, and the interest rate market, which is a vast and large market, is different than the credit default swap market, which is largely over at the SEC. So there will still be some differences, but whether it be on the block role, the real-time reporting role, the swap execution role, we are looking to try to get as close as we can, but also respect that there are some gaps between the underlying futures and securities markets.

Senator TOOMEY. Well, thank you very much. I see my time has expired.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much.

Chairman Gensler, I would like to discuss the core principles issue with you. First of all, I would say just generally the complaint I get from the futures industry is that the CFTC is working at such a furious pace. Difficult to keep up with your rulemaking. I think there are 60 rulemaking procedures ongoing. Difficult to conduct business and continue to comment on the things that are happening at the CFTC. But more troublesome to me is the implementation of a provision in Dodd-Frank that seems unnecessary to me, and that is that the CFTC has operated under a core principles regime, and I think most observers would say survived the disaster of several years ago in a very solid way, in a sound way. And yet as I recall, you asked the House Agriculture Committee in my days there that you have the authority to abandon the core principles and move to a more SEC-type regulatory environment for the futures industry. And I would just question you as to why you believe that the core principles method of regulating the futures industry, which at least in my view or the view of observers that I read and hear, worked well and were moving in an entirely different direction. And I recall this conversation in the House Agriculture Committee with Chairman Peterson in which we were assured that this is a backstop, if it becomes necessary, the CFTC does not intend to go down this path of changing the nature of its regulatory environment in the futures industry. But that is certainly not the way it has turned out to be.

Where would you characterize my understanding as wrong?

Mr. GENSLER. I would never like to do that with a Senator, but——

Senator MORAN. I appreciate that attitude, but I know you would be thinking it if you did not say it.

[Laughter.]

Mr. GENSLER. No, I just want to give a little clarification. The CFTC, as part of the Commodity Futures Modernization Act, got core principles for two areas, but it was not in all the areas. It was for clearing and for trading platforms. We do not have today nor have we had it on oversight of what is called intermediaries, the futures commission merchants and the like. There are many rules there.

You are absolutely correct, Dodd-Frank gave us a little bit greater ability on the clearing and the trading, and particularly on clearing because now there is a mandate to move what may be $200 to $300 trillion of derivatives into the clearinghouses, that it was thought and I still believe it is thought that this is a place that needs robust risk management, and that we cannot as Americans just rely solely on the good risk management standards of the clearinghouses themselves, but that regulators and the whole Financial Stability Oversight Council have a role and the Federal Reserve has an important role to play advising us and joining in those examinations. So I think in clearing very much so.

I could say, Senator, though Congress also set a 1-year time limit to put out the rules, we have proposed rules—it is actually 47 as of this morning. We have proposed rules, but we have not finalized any. We are going to get the rest of the proposals out hopefully in the next handful of weeks. The whole mosaic will be out there. Though some comment files have closed, we have discretion to continue to take comments, and using that discretion we do continue to take comments. And we are only going to move forward on final rules when we can sufficiently summarize comments, get Commissioner feedback, get regulatory feedback. We are not going to make the July deadline. I know many people in the markets are probably pleased to hear that. We are only going to do this according to when we are ready to move over the spring, summer, and well into the fall on the timing issue.

Senator MORAN. Chairman, I have two responses to your comments. One, do you have examples of where the regulatory environment that the CFTC operated failed in regard to the circumstances that we found our economy in that cause you to have that sense. And then, second, just generally, your comment about the mosaic, would it be your plan for the industry and for Congress to be able to see the whole mosaic before any of the rules are individually approved and implemented?

Mr. GENSLER. I think to your second question, yes. As the mosaic, we are hopeful to complete, as I said, in the next 3 to 5 weeks working with the SEC on one very important joint rule and the capital rules and so forth.

Senator MORAN. So we can see the big picture before we get any ruling taking——

Mr. GENSLER. That is right, and we are also doing some joint meetings that we announced today with the SEC on implementation phasing that we are going to be doing in early May. We have an open comment file that we have put up on that phasing as well.

I think in terms of your other question, I think that we did not regulate—as a Nation, we did not regulate the swaps marketplace, and it contributed to the crisis that we had in 2008. It was not the only reason, but all we need to do is think about credit default swaps and AIG and the interconnectedness of the financial system. So part of the cost—and Senator Toomey referred to the cost the financial industry is taking on, part of that cost is so that the taxpayers do not have to bear as great a risk to bail out financial institutions in the future.

Senator MORAN. Thank you, Mr. Chairman.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you all of our witnesses on our first panel.

I would ask those on our second panel to take your place at the witness table. While you get seated, I would like to welcome and introduce the witnesses on our second panel.

Thomas Deas is vice president and treasurer of the FMC Corporation, a Philadelphia-based company focused on ag, industrial, and specialty markets. Mr. Deas has served in this position since 2001 overseeing financing pension investments, insurance, risk management, and other company functions.

Lee Olesky is chief executive officer of Tradeweb Markets, a provider of online trading services for derivatives. Prior to working for Tradeweb, Mr. Olesky was the CEO and founder of BrokerTec, an electronic brokerage platform, and also worked at Credit Suisse First Boston in a variety of positions.

Terry Duffy is executive chairman of the CME Group, which operates several major futures and derivatives exchanges and online trading platforms. Mr. Duffy has served in his current position since 2006 and has been a member of CME's board since 1985.

Ian Axe is chief executive of LCH.Clearnet Group, which is an independent clearinghouse group serving exchanges, platforms, and OTC markets. Mr. Axe previously served as global head of operations for Barclay's Capital.

Jennifer Paquette is chief investment officer of the Public Employees' Retirement Association of Colorado. Ms. Paquette has held this position since 2003. She oversees the investment process for a public pension fund that provides benefits to employees of the Colorado State government, Colorado municipalities, public schools, universities, and colleges, and other public entities.

Before we begin the testimony, I will recognize Senator Toomey for some brief remarks.

Senator TOOMEY. Thank you very much, Mr. Chairman, for giving me the opportunity in particular to welcome Mr. Thomas Deas.

Mr. Deas is the vice president and treasurer of FMC Corporation, which is headquartered in Philadelphia. FMC is one of the world's foremost diversified chemical companies with leading positions in agriculture and industrial and consumer markets. Mr. Deas has served as vice president and treasurer of FMC since 2001. He has responsibilities for the worldwide treasury function, including finance treasury operations, pension investments and funding, and insurance and risk management. He brings over 20 years of experience in this field, and I have had the pleasure of having a number of discussions with Mr. Deas, especially about the end user issue as it applies to derivative use.

And I just wanted to welcome you today and thank you very much for coming to testify.

Mr. DEAS. Thank you, Senator.

Chairman JOHNSON. Mr. Deas, you may proceed.

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

Mr. DEAS. Thank you, Mr. Chairman. Good afternoon to you and to Ranking Member Shelby and the Members of the Committee.

In addition to my role in FMC Corporation, I am also president of the National Association of Corporate Treasurers. FMC and NACT are together members of the Coalition for Derivatives End Users, representing thousands of companies across the country that employ derivatives to manage day-to-day business risk. I would like to express my gratitude to you, Mr. Chairman, and to Ranking Member Shelby, for your bipartisan efforts on behalf of derivative end users, and particularly to Chairman Johnson for your work last week with the other Committee Chairmen in support of end user margin exemption. We also appreciate Senator Johanns' effort to extend the statutory effective date for the proposed regulations, and I thank you, Senator Toomey, and Ranking Member Shelby for your kind words about FMC Corporation and your care and interest for manufacturing companies of which we are a proud one.

In fact, FMC Corporation was founded almost 130 years ago to provide spray equipment to farmers. Today, in addition making agricultural chemicals that farmers apply to protect their crops, our 5,000 employees have worked hard to make FMC a leading manufacturer and marketer of a whole range of agricultural, specialty, and industrial chemicals. We have achieved this longevity by continually responding to our customers' needs with the right chemistry delivered at the right price. This year marks our 80th anniversary of listing on the New York Stock Exchange. I had the valuable experience on a newer financial market, one that we have been discussing today. I had the opportunity to negotiate and execute some of the very first derivatives—currency swaps—going back to 1984. I have seen the derivatives market grow from its inception in the mid-1980s to its current size by adapting and responding to market participants' needs.

We support this Committee's efforts to redress the problems with derivatives experienced during the financial crisis in 2008, but I want to assure you that FMC and other end users were not and are not engaging in risky speculative derivatives transactions. We use over-the-counter derivatives to hedge risks in our business activity. We are offsetting risks, not creating new ones.

FMC is the world's largest producer of natural soda ash, the principal input in glass manufacturing, and we are one of the largest employers in the State of Wyoming. We can mine and refine soda ash products in southwestern Wyoming, ship them to South Asia, and deliver them at a lower cost and with higher quality than competing Chinese producers. We have achieved this export success in part because of the derivatives we enter into to hedge natural gas prices. These derivatives are done with several banks, all of which are also supporting FMC through their provision of almost $1 billion of committed credit. Our banks do not require FMC to post cash margin, but they take this risk into account as they price the transaction with us. This structure gives us certainty so that we never have to post cash margin while the derivative is outstanding.

But the current system, where end users and their counterparties decide collaboratively whether and how margins should apply is changing. Today the FDIC proposed a rule that could in the future subject end users to margin requirements. While we are still reviewing the details, it appears regulators, not market participants, will now determine how margin will be set. Regulators will have the final say over how much cash an end user will have to divert to a margin account where it will sit unavailable for productive uses.

In our world of finite limits and financial constraints, posting cash margin would be a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, conduct research and development activities, and ultimately sustain and grow jobs.

In fact, a coalition survey of derivative end users extrapolated the effects of margin requirements across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs, depending on these proposed thresholds. The effect on the many thousands of end users beyond the S&P 500 would be proportionately greater.

Although I have focused here on margin, end users are also concerned about the more than 100 new rules that will determine whether we can continue to manage business risk through derivatives. We have heard also about capital requirements that our counterparties would be required to hold, and we have heard through the publication of rules today that uncleared over-the-counter derivatives, the kind that we employ to hedge our business risk, are singled out as high-risk transactions, which will attract additional capital we are concerned could be almost punitive and could end that ability of end users like FMC to hedge their business risk with them.

Thank you very much for your attention. I would be happy to answer your questions.

Chairman JOHNSON. Thank you, Mr. Deas.

Mr. Olesky, please proceed.

STATEMENT OF LEE OLESKY, CHIEF EXECUTIVE OFFICER, TRADEWEB MARKETS LLC

Mr. OLESKY. Mr. Chairman and Ranking Member Shelby and Members of the Committee, good afternoon and thank you very much for inviting me to participate in this hearing.

My name is Lee Olesky. I am the chief executive officer and a founder of Tradeweb, and I appreciate the opportunity to testify today about the regulatory framework for implementation of Title VII of Dodd-Frank.

For the last 15 years, Tradeweb has been at the forefront of building regulated electronic markets for the trading of OTC fixed income securities and derivatives. Tradeweb's core competency centers around leveraging technology to create more transparent and efficient electronic markets that provide a valuable service to the institutional buy-side and banks that are our clients.

Before electronic markets like Tradeweb were established in fixed income, institutional clients picked up the phone and spoke to different dealers to obtain prices and trade U.S. Government bonds. This phone-based trading model is how the OTC derivatives market largely functions today.

In the late 1990s, due to technological advances and the acceptance of the Internet, we saw an opportunity to provide buy-side clients with greater pretrade price transparency and execution efficiency in the U.S. Government bond market. In 1997, we established Tradeweb and created the first multibank electronic Request for Quote marketplace for U.S. Treasury securities. Our RFQ model gave clients the ability to run an electronic auction among banks to get the best price and automate a manual trading process.

Tradeweb's RFQ marketplace for U.S. Government bonds helped transform a phone-based and largely opaque Government bond market into a more transparent and competitive and efficient market, with the added benefit of reducing operational risk. As a result of this evolution, institutional clients such as asset managers and pension funds now have access to regulated trading systems that provide greater price transparency and more efficient execution. Today on Tradeweb's global platform for Government bonds, we trade on average approximately $40 billion each day with 1,000 institutional clients located in every financial center around the world. Among all of our platforms and products, the daily volume on Tradeweb is in excess of $300 billion per day.

Tradeweb supports the goals of Dodd-Frank, which we believe to be enhanced transparency and reduction of systemic risk. However, it is vitally important to understand and give due consideration to the needs of market participants in promulgating rules for implementing Title VII. The aim must be to achieve the goals of the act without materially disrupting the market and the liquidity it provides to end users.

Market participants need confidence to participate in these markets, and if careful consideration is not given to what the rules say, we fear that this confidence could be materially shaken.

The key for achieving the policy objectives for SEFs is to provide for flexibility in the way market participants can interact and trade swaps. Creating arbitrary or artificially prescriptive limitations on the manner in which market participants interact and trade could result in liquidity drying up, increased costs to trade swaps, and market participants seeking other, less efficient ways to manage their risk.

Finally, there has been a great deal of discussion recently about how best to implement the proposed rules. There is no doubt that an overly hasty timetable for implementation could directly impact the health of the derivatives market, given the complexity of the system. Implementing these regulations in one big bang is unrealistic, so phasing in the rules is a very sensible approach.

However, market participants need clear guidance on when the rules will be effective. This is particularly true for firms such as Tradeweb that commit capital to build technology to support these markets. We believe it is very important for the SEC and CFTC to set clear time frames for when rules will be effective as soon as practical, and we commend Chairman Gensler for taking the initiative to discuss this in an open forum in early May and take public comment on the time frames.

Furthermore, any difference in rules between the SEC and CFTC should be largely eliminated. If there are material differences between the two regulators' rules, the costs for compliance and building technology will go up considerably. By ensuring that the SEC and the CFTC rules retain sufficient flexibility for market participants, clients can trade in a manner that suits their trading strategies and risk profiles. Some institutions may want to transact on live prices. Others may want to use a disclosed RFQ model. And still others may want to trade anonymously in an order book. Regulators should not mandate that clients or platforms pick one model or offer all models. Flexibility that allows for innovation among technology providers is critical to attract the capital necessary to fund the investments in these technologies.

In conclusion, we support the goals to reform the derivatives market, and indeed we provide the very solutions the regulation seeks to achieve. But we are concerned that the Commissions may be overly prescriptive and, in doing so, create unintended consequences for market participants and the marketplace as a whole. We hope our experience in the electronic markets can be helpful and instructive as Congress and the regulators take on the great challenge of implementing Title VII of Dodd-Frank.

Thank you.

Chairman JOHNSON. Thank you, Mr. Olesky.

Mr. Duffy, please proceed.

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

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

In 2000, Congress adopted the Commodity Futures Modernization Act. This leveled the playing field with our foreign competitors and permitted us to recapture our position as the world's most innovative and successful regulated exchange and clearinghouse. As a result, we remain an engine of economic growth in Chicago, New York, and the Nation.

In 2008, the financial crisis focused attention on over-leveraged, under-regulated banks and financial firms. In contrast, regulated futures markets and futures clearinghouses operated flawlessly before, during, and after the crisis. Congress responded to the financial crisis by reining in the OTC market, to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. We support these goals.

But we are concerned that the CFTC has launched an initiative to undo modern regulation of futures exchanges and clearinghouses. We are not alone. Most careful observers and some Commissioners have concluded that many of the proposed regulations roll back principle-based regulation and unnecessarily expand the Commission's mandate. The CFTC is attempting to change its role. It is an oversight agency whose purpose has been to assure compliance with sound principles. Now, it appears as if it is trying to become a frontline decision maker, empowered to impose its business judgments on every operational aspect of derivatives trading and clearing.

This role reversal is inconsistent with Dodd-Frank. It will require doubling of the Commission's staff and budget. It will impose astronomical costs on the industry and the end users of derivatives. My written testimony includes numerous examples of rulemaking that will have costly adverse consequences on customers, intermediaries, exchanges, and the economy. Obviously, the increased cost will have an indirect impact on business and employment in the United States. Of equal concern, the creation of international regulatory disparities will drive business overseas. We recognize that the CFTC has been working to induce international regulators to be equally prescriptive. However, that effort seems to be failing, as other jurisdictions capture U.S. business that the CFTC is driving offshore.

The threat of prescriptive position limits and restrictions on hedging in the United States are already driving business overseas and into unregulated markets. The threat that margin control will be used to influence prices of commodities will even be more disastrous. Broad, undefined prohibitions on so-called disruptive trading practices and strategies will not only drive liquidity providers from the U.S. markets, but also impair hedging and price discovery.

We are strong proponents of an adequate budget for our regulator and support sufficient funding to modernize this technology. However, we strongly object to the expansion of Commission staff to enforce regulations that are uncalled for by Dodd-Frank or that duplicate the duties now being performed by SROs, which are self-regulatory organizations. This comes at no cost to the Government.

Chairman Gensler cited earlier about the size of the market. The Commission justifies its budget demands by pointing to the growth of the notional value of the contracts it oversees on regulated futures markets and the notional value of the swaps market that it will be responsible for under Dodd-Frank. But there is no valid relationship between the notional value and the regulatory burden. The swaps market that the CFTC will regulate involves only 4,000 to 5,000 transactions per day and the parties are all sophisticated investors. The futures market has grown to millions of transactions a day, but has become a highly sophisticated electronic marketplace with a perfect audit trail and high tech enforcement rules.

The CFTC's budget should reflect the positive impact of technology and the necessary regulatory obligations imposed by Dodd-Frank. Congress should encourage a full and fair cost and benefit analysis for every proposal.

It also should extend Dodd-Frank's effective date to permit a realistic opportunity to comment. Otherwise, we believe that the well-regulated futures industry will be burdened by overly prescriptive regulations. This is inconsistent with the sound practices. Furthermore, it will make it more difficult to reach Dodd-Frank's goal of increasing transparency and limiting risk.

I thank you for your time and look forward to your questions.

Chairman JOHNSON. Thank you, Mr. Duffy.

Mr. Axe, please proceed.

STATEMENT OF IAN AXE, CHIEF EXECUTIVE, LCH.CLEARNET GROUP LIMITED

Mr. AXE. Thank you, Mr. Chairman. Chairman Johnson, Ranking Member Shelby, Members of the Committee, my name is Ian Axe and I am Chief Executive of LCH.Clearnet Group Limited. On behalf of the Group, I would like to thank the Committee for asking me here today.

If I may, let me briefly introduce our company. We operate two of Europe's leading clearinghouses and a fast-expanding office in New York. We are 83 percent owned by members and 17 percent owned by exchanges, such as NYSE Euronext. We clear interest rate, credit default, and energy swaps, bonds and repos, equities, metals, and listed derivatives. We have been clearing commodities for 120 years and pioneered the development of swap clearing in 1999 with our SwapClear service. This operates under a DCO license and has been subject to CFTC regulation since 2001.

SwapClear clears over 50 percent of the global interest rate swap market, with over $276 trillion in notional outstanding, and last year it cleared over 120,000 swaps trades, for U.S. counterparties with a notional value of $64 trillion. We recently extended our SwapClear service to include a client clearing service for U.S. end customers. Twelve members have since joined up to provide this service, and U.S. end users have cleared swaps through them.

We have U.S. members on our sell and buy side committees which meet monthly to discuss the development of our swap service. Our buy side working group includes major U.S. asset managers and hedge fund investors.

Our group played a critical role following the Lehman Brothers collapse, successfully managing the world's largest ever clearing member default. On its default, the firm had a $12 trillion portfolio of risk at LCH.Clearnet, including a $9 trillion swap book. This was liquidated without loss or impact on surviving members. On completion, we returned $850 million of margin to U.S. bankruptcy administrators.

We are strong supporters of the Dodd-Frank Act goals and believe that the legislation will improve stability in the marketplace and greatly reduce systemic risk. In particular, we welcome strong risk management and heightened financial service standards for clearinghouses, a greater level of supervision for clearinghouses, and mandatory clearing obligations.

We have followed the CFTC and SEC rulemaking process closely and applaud the thoughtfulness of the agencies in this task. We have participated in roundtables, attended open meetings, responded to the proposed rulemakings, and met with the Commissioners.

It is key that the legislation and rules emerging from the U.S. and Europe are as closely aligned as possible. This will reduce regulatory arbitrage, ensure consistent risk standards internationally, and make certain that the G-20 commitments are met. A lack of harmonization may impact the economy, jobs, and the recovery.

I will set out three of the greatest areas of concern as regards the difference between the U.S. and Europe in our international oversight.

First, ownership and governance. We believe that Congress correctly rejected aggregate ownership and voting caps for clearinghouses during passage, and are concerned to see the agencies might reintroduce such caps. Aggregate restrictions on clearinghouse ownership or governance may limit innovation, reduce competition, and increase costs.

Second, risk management and access rules for clearinghouses. The CFTC risk management provisions at present are aligned to the futures clearing business. Swaps need to be reviewed as having different risk management techniques and processes. We expect futures and swaps to converge over time, but it is inappropriate now to impose futures clearing criteria on swaps. We also believe access criteria for swap clearing members must be proportionate to the risk introduced and contingent on default management and risk underwriting participation, such that the clearinghouse, its non-defaulting members, and their clients are fully protected.

And third, customer protection. Security is key. Customers clearing swaps, many of them pension funds and other long-term saving institutions, must be protected from fellow customer risk. The introduction of customer safeguards that deliver such security would ensure that U.S. clients have the same protection as clients in Europe.

In conclusion, we believe that the agencies' final rules should afford individual customers the option of legal segregation. Further, any final rules on clearinghouse ownership or governance should be applied at an individual level. Finally, access requirements should do nothing to compromise the integrity of clearinghouses. We look forward to extending our safeguards deeper into the U.S. marketplace and to further growing our U.S. staff and operations in support of the Act.

Thank you for inviting me here today. I am happy to take any questions.

Chairman JOHNSON. Thank you, Mr. Axe.

Ms. Paquette, please proceed.

STATEMENT OF JENNIFER PAQUETTE, CHIEF INVESTMENT OFFICER, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION

Ms. PAQUETTE. Thank you, Chairman Johnson and Ranking Member Shelby, for holding this important hearing. I am Jennifer Paquette, Chief Investment Officer of Colorado PERA.

I would like to share with you a school teacher's interest in derivatives and share some concerns on proposed rulemaking. A Colorado teacher told me years ago about a problem she had in her classroom with a first grade boy. She required all the students to read aloud in front of the class and this little boy was very shy and could not do it. She allowed the student to sit in the chair with his back to the class and whisper to the blackboard instead, and over the course of the year, she took the chair and moved it inch by inch, so that at the end of the year, it faced the class. The chair was empty at the end of the year and instead, the boy was standing in front of the class reading aloud with great pride.

And when she told me the story, it struck me how much I had in common with her. The care that she took with every student in her class is the same care that we give to every single investment that we oversee for her retirement plan. She would not know how to invest a $39 billion institutional portfolio, but I and my investment colleagues in Denver, we know how to do that on her behalf. She would not know how to execute a total return swap to mitigate risk, but we know how to do that. We know how to employ futures to mitigate risk when we are doing portfolio transitions.

The investment vehicles that we use matter to all of our members. It is why I have come here for the honor of just a few minutes before you.

Derivatives are tools we use for mitigating risk. While derivatives are only a modest portion of our total market value, they are very useful. You will find in my written testimony we have concerns about how public plans may be affected by CFTC proposed rules. CFTC's proposed rules include public pension plans as a special entity. In order for us to enter into a swap, the swap dealer would need to have a reasonable basis to believe we have a representative that meets certain requirements. We are concerned that there is a conflict of interest for one party in a transaction to also be responsible for determining who is qualified to represent the other side of the transaction. We are also uncomfortable with how this could potentially impair negotiations with a dealer. We fear higher costs for executing transactions and are concerned that strong counterparties may not want to do business with us for reasons including potential liability.

Colorado PERA and a number of public pension funds whose assets total over $700 billion have suggested a voluntary alternative approach be created. I have included a letter in my written testimony signed by these pension funds which describes the approach. It would allow us to voluntarily undergo a certification process to meet the independent representative requirement. This would include passing a proficiency exam. I think it supports the intent of protecting investors while avoiding some potential conflicts and unintended consequences.

I have the utmost respect for the time and care you and others are expending on these matters. We would like to continue to access the swaps markets for the same portfolio reasons we have used them effectively for years.

On behalf of almost half-a-million current and former employees, public employees of Colorado PERA, I ask that you and all those involved in this process consider our concerns. I owe it to all of our Colorado PERA members and to that particular teacher I told you about to advocate on this issue. That little boy who was afraid to speak, who is not so little anymore, I see every day, and he is my reminder to speak on issues that matter to the investors that are our members.

Thank you for your time.

Chairman JOHNSON. Thank you, Ms. Paquette. I will start off with a few questions. Thank you for your testimony.

I will remind my colleagues that we will keep the record open for statements, questions, and any other material you would like to submit. As we begin questioning the witnesses, I will put 5 minutes on the clock for each Member's questions.

Mr. Olesky, how would the proposed CFTC rule on swap execution facilities requiring five requests for quotes impact market liquidity and potential earning? What would be the impact on your company if the SEC and CFTC proposed rules for SEFs are not reconciled?

Mr. OLESKY. Thank you. Currently, Tradeweb trades interest rate swaps in the U.S. and Europe and we have processed and had about 75,000 interest rate swap transactions over the last several years, and one of our concerns is that as the rules have been proposed by the CFTC in this RFQ process, which is an auction that customers, such as the clients that are at this table, would run in order to get the best prices, that clients would be forced to send out an inquiry to at least five different dealers.

That is not the way the market operates today. In fact, that is not the way the U.S. Government bond market operates today. In our U.S. Government bond franchise, the average inquiry goes out to just three banks and there are some very good reasons for this. Clients need to assess how they are going to get the best possible price in the marketplace, and at times, that means going to just one or two dealers, not five. So that is an example of a rule that has been proposed that is not mindful of the way the market operates today and would require a change. I am not sure what that change entirely would be, but we, as a company that provides services to our clients, are advocates for our clients, which are the large buy-side firms, public pension funds, institutions that want to be able to access liquidity in a way that makes the most sense to them.

Chairman JOHNSON. Mr. Duffy and Mr. Axe, how would applying the Title VII clearing requirements to transactions with foreign counterparties impact the competitiveness of U.S. markets?

Mr. DUFFY. I would be happy to start things. One of the ways, Mr. Chairman, that that would impact us is if the CME had a client that was in Europe and they wanted to do a counterparty transaction with a party in the U.S., we would have to make sure that the CME clearinghouse was registered in the U.K. or in any other jurisdiction that that client—the trade was coming from. This is a very long, burdensome process throughout the U.K. In the U.S., it takes about 6 months to get approved to become a clearing member. So this is absolutely a very difficult thing for us to do going forward. So that is one of the big competitive issues that we have.

I will let Ian make a comment, then——

Mr. AXE. Thank you, Mr. Chairman. We currently clear trades both in the U.S. and in Europe, and to refer to my oral testimony, I think the fear we have in terms of regulatory arbitrage is if we don't ensure that we do have consistent standards. We appreciate the ability to achieve licensed status is one thing, but actually having different systems and different regulatory systems across the different geographies would create inconsistencies and would not be advisable in the ideology of harmonization.

Chairman JOHNSON. Mr. Deas, from your perspective, how would the proposed definition of swap dealers impact end users?

Mr. DEAS. Chairman Johnson, the definition for swap dealers, if it is not done properly, could pick up larger companies who are still engaged in hedging underlying business activities, and there is a fundamental difference between a financial institution acting as a swap dealer and a large U.S.-based company that is doing that.

End users are always hedging underlying business activity. The derivative when valued together with that underlying business exposure creates a neutral position. Swap dealers are maintaining an open position. They are market makers. We believe it is appropriate for them to centrally clear and margin their trades, but because end users are always balanced, if you impose margin on them because you have defined them through this definition to be a swap dealer, then you take a balanced pair of transactions that create a neutral position and you actually impose a new and unwelcome risk, at least for treasurers, that risk of having to fund periodic margin payments with all the attendant uncertainty of that.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Deas, in your testimony today, you warned that regulators could impose costs on companies that would inhibit their ability to produce goods and hire workers in the United States. Chairman Gensler has begrudgingly, I would say, agreed to make some accommodations for companies that use derivatives to hedge their business risk, like yourself. But he also argues that doing so, and I will quote, "only benefits Wall Street and does not benefit Main Street or the corporation that provides service to America." Do you agree with Chairman Gensler's assessment here?

Mr. DEAS. No, sir, I do not. As I have indicated in my testimony, we are manufacturing the goods that are consumed in the U.S. and we have been able to export them successfully overseas, and we do that——

Senator SHELBY. It helps you compete, does it not?

Mr. DEAS. Yes, sir, it does, and it helps us offset risks that we cannot otherwise control.

Senator SHELBY. And the consequences—I think you alluded to it earlier. What would be the consequences of imposing unnecessary regulatory burdens on companies like yourselves ability to hedge your unique business risks? A lot of these risks are tailored, are they not?

Mr. DEAS. Yes, sir. One of the problems is, for instance, I talked about our ability to export. If, as was questioned of the Assistant Secretary of the Treasury, if the Secretary of the Treasury declares that foreign exchange transactions are swept up in this new mechanism, then it could force exporting companies like FMC to incur higher costs, and one unfortunate way to lower those costs would be for U.S.-based exporters to move their manufacturing facilities offshore to the countries where their customers are to achieve in that way a better match between their costs and the currencies in which their customers are paying them. I would hate to see that happen to U.S.-based manufacturers, Senator.

Senator SHELBY. Would requiring companies to use standardized cleared products or forcing them to post margin, as we have talked about here, increase risk in the financial system or decrease it? Would it not increase risk for you because it costs more?

Mr. DEAS. Senator, it would increase risk in two ways. First of all, as I have described, the over-the-counter derivatives market became as—grew to the size it is today because of its ability to respond and to provide customization. The fact that these hedges are effective——

Senator SHELBY. You are talking about tailoring your risk, are you not?

Mr. DEAS. Yes, sir, and the fact that we are able to achieve that customization means that we have exactly offset the business risk. Failure to make it match up exactly if we were forced to use a standardized derivative would mean there would be residual risk we would retain that could come home to manifest itself in higher costs for us.

Senator SHELBY. Mr. Duffy, Governor Tarullo—you were here—explained that central clearinghouses concentrate risk and thus have the potential to transmit shocks throughout the financial markets. What would happen, for example, if CME—we hope it never would—or another clearinghouse failed, and what type of contingency plans has the CME prepared to make sure that if it were to fail, that one of more of its members does not threaten the entire financial system?

Mr. DUFFY. Senator, that is a great question, and one of the things we can go off of to start with is our record. In the 156 years, the CME has never had a customer——

Senator SHELBY. I know.

Mr. DUFFY. ——lose anything due to a clearing member default. So that is the first thing.

The second thing is the way we do clearing at the CME Group. We settle twice a day mark-to-market. So if the customer does not have the funds up and the market runs away from them, we either take them out of the market if the money is not coming forward. So that is one of the things. We have the ability to do that on an hourly basis. We hold over $100 billion of our customers' capital to make sure that these transactions are protected. And so we have many, many safeguards. Risk management is something that we spend a lot of our time on at the CME Group and I think it is what has made us what we are today.

Senator SHELBY. That is good. I want to pronounce your name right. Is it “Paquette”? How do you say it?

Ms. PAQUETTE. “Paquette.”

Senator SHELBY. Paquette. Ms. Paquette, the letter that you and a number of other pension funds submitted to the Commodities Futures Trading Commission noted that however well-intentioned the goal of, quote, “protecting vulnerable or gullible parties in the swap market might be,” the CFTC’s proposed business conduct standards may be so onerous that pension plans are, quote, “left to deal with less desirable counterparties, if they could find any at all.” If the CFTC’s proposal were adopted in its current form, would it make it harder to manage the nearly $40 billion of retirement money for which you are responsible to manage?

Ms. PAQUETTE. Thank you, Ranking Member Shelby. If the proposed rules were put in——

Senator SHELBY. Were adopted in its current form——

Ms. PAQUETTE. ——adopted in their current form, we think it would be more challenging for us to manage our $40 billion——

Senator SHELBY. And by “challenging,” it would be harder. It would be more difficult, would it not?

Ms. PAQUETTE. It would be more difficult in certain areas of our portfolio, yes.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Mr. Chairman, thank you.

Mr. Duffy, earlier, I asked Chairman Gensler questions about why he felt it was necessary to impose prescriptive rules that override core principle regime that we have had at CFTC previously, or currently, and the Chairman said it was because the instruments like swaps, and that is why DCOs needed prescriptive rules. However, to my knowledge, there were no swap DCOs. The only clearing organizations pre- Dodd-Frank were regulated exchanges. Clearing organizations seem to have performed well in 2008. And furthermore, it seemed that the prescriptive regulations have gone beyond DCOs and are actually imparting the exchange—I mean, affecting—excuse me, impacting exchanges, as well.

Can you characterize more specifically how the CFTC is dismantling the core principle regime and how it would negatively—let me be more unbiased—how it would impact CME’s exchanges and clearing organizations, and also, did any of the DCOs fail in 2008 that would warrant Chairman Gensler’s concerns that have led him to override core principles for DCOs?

Mr. DUFFY. No, sir. None of them did fail. Prior to 2008 and 2007, CME cleared $1.2 quadrillion of notional value of trade without one hiccup. So that is just for starters. And the way Chairman Gensler is trying to roll back some of the Modernization Act of 2000, for example, would be on product. If we want to launch a new product, we have the ability to self-certify that product. We innovate it. We should have the ability to self-certify it so we can be first to market. Some of these new rules would call for the CFTC to have days, weeks, months to put this out for public comment again and give everybody an opportunity to look at what CME is trying to innovate. Well, there would be no incentive to innovate new products. So that is one example.

Another example of that would be products we now currently may trade in a block trade or an OTC fashion because there are very few participants in the transaction, so we list it on a facility just for a handful of participants and we still essentially clear it. He is saying that within—if you do not have 85 percent of that trade done, the volume done, you have to delist the product or put it on a central limit order book. So that would kill the product.

Euro-dollar contract is the largest contract in the world today, and the short-term interest rates, and long-term interest rates. When we listed that, if we went by the prescriptive rules back then that they have in place today, we would not have a Euro-dollar contract for folks to manage their interest rate risk like they do today to protect their pensions, mortgages, and other things. So these are just a couple examples why I think the Chairman is wrong on this.

Senator MORAN. The CME is a significant financial institution. You also may have heard my raising the concern that I have heard about the difficulties that the futures industry is having in keeping up with the ongoing proposed regulations, running their business and responding. My guess is that it may be easier for the CME to meet that challenge than it is the smaller exchanges. Am I missing something there? I do not want you to—I do not expect you to say it is easy for you, but I would worry also about, in my case, Kansas City, for example, the ability just to keep up with the volume of activity at the CFTC right now, to actually make intelligent decisions about responses to proposed rules.

Mr. DUFFY. We have a very large outside law firm. We have a very large inside law firm. We cannot keep up with the comment periods that are coming forward with all the new rules and do it in a very thoughtful way. I have talked to the CEO of the Kansas City Board of Trade, Jeff Borchardt. I know they are having similar issues and they are a much smaller institution. We do do business with them, so obviously we have an interest in what their thoughts are on this, also. It is almost impossible to keep up. So when the CFTC is proposing these rules, trying to do them in a very short period of time, and for us to digest and see what the consequences are with major outside law firms and a large inside law firm, as a very large institution and we cannot keep up with it, I am concerned how others can.

Senator MORAN. Your response to my question about innovation, new product, would that then create a disadvantage to being an American, a United States company? Will other countries' exchanges be better capable of innovating than the United States in bringing new products to market?

Mr. DUFFY. Absolutely. If they can self-certify product throughout the world and we do not get a first look at it like they would get a first look at our product, you would put the United States of America innovation in financial services right down the drain.

Senator MORAN. Mr. Duffy, thank you very much.

Chairman Johnson, thank you.

Chairman JOHNSON. Thank you.

As the rulemaking process moves forward, this Committee will continue to provide robust oversight of the reforms to the OTC derivatives market. Striking the right balance for how best to regulate derivatives should not be a partisan issue and I urge Senators on both sides of the aisle to continue working with our regulators to build a stronger foundation for our financial markets.

We did not reach a quorum today to vote on pending nominations as was scheduled. We are going to look for a time within the next 2 days to hold this vote off the Senate floor after a roll call vote. My staff will send a notice when we find an appropriate time.

Thank you again to all my colleagues and our panelists for being here today.

This hearing is adjourned.

[Whereupon, at 4:58 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF MARY L. SCHAPIRO

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

APRIL 12, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee:

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

Background

OTC Derivative Marketplace

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

Dodd-Frank Act

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

Title VIII of the Act provides for increased oversight of financial market utilities designated as systemically important and financial institutions that engage in payment, clearing, and settlement activities designated as systemically important by the Financial Stability Oversight Council. The purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability.

Implementation Generally

The implementation of these titles is a substantial undertaking and raises a number of challenges. Accordingly, we have been engaging in an open and transparent implementation process, seeking input on the various rulemakings from interested parties even before issuing formal rule proposals. We will continue to seek input on each proposal with the goal of producing effective and workable regulation of derivatives activities and oversight of financial market utilities designated as systemically important and financial institutions that engage in payment, clearing, and settlement activities designated as systemically important.

[1] *See,* Bank of International Settlements, Positions in Global Over-the-Counter (OTC) Derivatives Markets at End-June 2010, Monetary and Economic Department (Nov. 2010), *http://www.bis.org/publ/otc__hy1011.pdf.*

Public Consultation

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

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

Coordination With the CFTC and Other Regulators

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

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

Finally, we recognize that other jurisdictions are also developing regulatory frameworks that will address many of the areas covered by Title VII. The manner and extent to which we and foreign regulators regulate derivatives will affect both U.S. and foreign entities and markets. Consequently, as we progress with the implementation of Title VII, we will continue to consult with regulatory counterparts abroad in an effort to promote robust and consistent standards and avoid conflicting requirements, where possible. The SEC and CFTC are, in fact, directed by the legislation to consult and coordinate with foreign regulators on the establishment of consistent international standards governing swaps, security-based swaps, swap entities, and security-based swap entities. We believe that bilateral discussions with foreign regulators, as well as our engagement in the IOSCO Task Force on OTC Derivatives Regulation, which the SEC cochairs, and our participation in other international forums will help us achieve this goal.

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

Rulemaking

Actions Already Taken

The SEC has taken significant steps in implementing the rulemaking required by Titles VII and VIII of the Act. To date, the SEC has proposed a number of rulemakings required by these titles.

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

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

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

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

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

Our staff also is working closely with the Federal Reserve Board and the CFTC to develop, as required by Title VIII of the Act, a new framework to supervise systemically important financial market utilities, including clearing agencies registered with the SEC, that are designated by the Financial Stability Oversight Council as systemically important. For example, SEC staff has been actively coordinating with the other agencies to develop rules regarding submission of notices by designated financial market utilities with respect to rules, procedures, or operations that could materially affect the risks presented by such designated financial market utilities. The SEC proposed these rules in December. In addition, in March, the Financial Stability Oversight Council, of which the SEC is a member, issued a notice of proposed rulemaking regarding the criteria and analytical framework for designating financial market utilities under Title VIII and the processes and procedures that would be used to make such designations.

Our staff also has been actively coordinating with the other agencies on the new authority granted to the SEC and CFTC to develop standards for designated financial market utilities. Moreover, the SEC and CFTC staffs have begun working with staff from the Federal Reserve Board to jointly develop risk management supervision programs for designated financial market utilities pursuant to Title VIII. The SEC, CFTC, and Federal Reserve Board also are working together closely to prepare a joint report to Congress required under Title VIII that will make recommendations for improving consistency in the oversight of designated clearing entities, promoting robust risk management, and monitoring the effects of such risk management on the stability of the financial system.

Upcoming Actions

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

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

Anticipated Completion of Rulemaking

We are working to complete the rulemaking proposal and adoption process under Titles VII and VIII and are mindful of Congress' deadlines for implementation. Nonetheless, this is a very challenging task. The OTC derivatives markets are large and interconnected. The issues are complex and do not lend themselves to easy solutions. We are progressing at a deliberate pace, taking the time necessary to thoughtfully consider the issues raised by the various rulemakings before proposing specific rules. We are taking a similar approach as we move toward consideration of final rules. As we do so, we are also devoting careful thought to sequencing the implementation of final rules in such a way that market participants will have sufficient time to develop the infrastructure necessary to comply. We understand that getting the rules right and implementing them in the right order is important, and this will continue to guide our efforts in coming months.

Impact of Rulemaking on Existing Markets

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

Conclusion

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

PREPARED STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

APRIL 12, 2011

Good afternoon Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I thank you for inviting me to today's hearing on implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC). I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation. I am pleased to testify alongside my fellow regulators from the Securities and Exchange Commission (SEC), Federal Reserve and Treasury Department.

The Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Act. The Act amended the Commodity Exchange Act (CEA) to establish a comprehensive new regulatory framework for swaps and made similar amendments to securities laws for security-based swaps. Title VII of the Act was enacted to reduce risk, increase transparency and promote market integrity within the financial system by, among other things:

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

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

Title VIII of the Dodd-Frank Act

The CFTC has overseen clearinghouses for decades. Title VIII of the Dodd-Frank Act provides for enhanced oversight of these clearinghouses. In close consultation with our fellow domestic and international regulators, and particularly with the Federal Reserve and the SEC, the CFTC proposed rulemakings on risk management for clearinghouses. These rulemakings take account of relevant international standards, particularly those developed by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS–IOSCO).

The Dodd-Frank Act gives the Financial Stability Oversight Council (FSOC) and the Federal Reserve Board important roles in clearinghouse oversight by authorizing the Council to designate certain clearinghouses as systemically important and by permitting the Federal Reserve to recommend heightened prudential standards in certain circumstances.

The FSOC proposed a rule last month that complements the CFTC's rulemaking efforts. Public input will be valuable in determining how the Council should apply statutory criteria to determine which clearinghouses qualify for designation as systemically important.

Implementation

The Dodd-Frank Act is very detailed, addressing all of the key policy issues regarding regulation of the swaps marketplace. To implement these regulations, the Act requires the CFTC and the SEC, working with our fellow regulators, to write rules generally within 360 days. At the CFTC, we initially organized our effort around 30 teams who have been actively at work. We had our first meeting with the 30 team leads the day before the President signed the law.

A number of months ago we also set up a 31st rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act.

The CFTC is working deliberatively and efficiently to promulgate rules required by Congress. The talented and dedicated staff of the CFTC has stepped up to the challenge and has recommended thoughtful rules—with a great deal of input from each of the five Commissioners—that would implement the Act. We have thus far proposed rulemakings or interpretive orders in 28 of the 31 areas.

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

1. We began soliciting views from the public immediately after the Act was signed and prior to approving proposed rulemakings. This allowed the agency to receive input before the pens hit the paper.
2. We hosted a series of public, staff-led roundtables to hear ideas from the public prior to considering proposed rulemakings.

3. We engaged in significant outreach with other regulators—both foreign and domestic—to seek input on each rulemaking.
4. Information on both staff's and Commissioners' meetings with members of the public to hear their views on rulemakings has been made publicly available at cftc.gov.
5. The Commission held public meetings to consider proposed rulemakings. The meetings were webcast so that the Commission's deliberations were available to the public. Archive webcasts are available on our Web site as well.

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

Second, we are consulting heavily with both other regulators and the broader public. We are working very closely with the SEC, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Controller of the Currency and other prudential regulators, which includes sharing many of our memos, term sheets and draft work products. We also are working closely with the Treasury Department and the new Office of Financial Research. As of Friday, CFTC staff has had 598 meetings with other regulators on implementation of the Act.

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

Specifically, we have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the U.K. Financial Services Authority and the new European Securities and Markets Authority. Three weeks ago, I traveled to Brussels to meet with the European Parliament's Economic and Monetary Affairs Committee and discuss the most important features of swaps oversight reform.

We also have shared documents with the Japanese Financial Services Authority and consulted with Members of the European Parliament and regulators in Canada, France, Germany, and Switzerland.

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

We also are soliciting broad public input into the rules and have set up mailboxes for the public to comment directly prior to the Commission's rulemaking process. As of yesterday, we had received 2,907 submissions from the public through the e-mail inboxes as well as 8,991 official comments in response to notices of proposed rulemaking.

For the vast majority of proposed rulemakings, we have solicited public comments for a period of 60 days. On some occasions, the public comment period lasted 30 days.

Additionally, many individuals have asked for meetings with either our staff or Commissioners to discuss swaps regulation. As of yesterday, we have had 675 such meetings. We are now posting on our Web site a list of all of the meetings CFTC staff and I have with outside organizations, as well as the participants, issues discussed and all materials given to us.

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

One component that we have asked the public about is phasing of implementation. The Dodd-Frank Act gave the CFTC flexibility as to setting implementation or effective dates of the rules to implement the Dodd-Frank Act. For example, even if we finish finalizing rules in a particular order, that doesn't mean that the rules will be required to become effective in that order. Effective dates and implementation schedules for certain rules may be conditioned upon other rules being finalized, their effective dates and the associated implementation schedules. For instance, the effective dates of some final rules may come only after the CFTC and SEC jointly finalize the entity or product definitions rules.

The Commission has the authority to phase implementation dates based upon a number of factors, including asset class, type of market participant and whether the requirement would apply to market platforms, like clearinghouses, or to specific transactions, such as real time reporting. For example, a rule might become effective for one asset class or one group of market participants before it is effective for other asset classes or other groups of market participants. We are looking to phase in implementation, considering the whole mosaic of rules. We look forward to hearing from market participants and regulators, both in the U.S. and abroad, regarding the phasing of implementation.

End User Margin

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

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

Conclusion

Before I close, I will briefly address the resource needs of the CFTC. The futures marketplace that the CFTC currently oversees is approximately $36 trillion in notional amount. The swaps market that the Act tasks the CFTC with regulating has a notional amount roughly seven times the size of that of the futures market and is significantly more complex. Based upon figures compiled by the OCC, the largest 25 bank holding companies currently have $277 trillion notional amount of swaps.

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

The CFTC currently is operating under a continuing resolution that provides funding at an annualized level of $168.8 million. The President requested $261 million for the CFTC in his proposed fiscal year (FY) 2011 budget. This included $216 million and 745 full-time equivalent employees for prereform authorities and $45 million to provide half of the staff estimated at that time needed to implement the Act. Under the continuing resolution, the Commission has operated in FY2011 at its FY2010 level. The President's FY2012 budget request included $308 million for the CFTC and would provide for 983 full-time equivalent employees.

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

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

PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

APRIL 12, 2011

Chairman Johnson, Ranking Member Shelby, and other Members of the Committee, I appreciate this opportunity to provide the Federal Reserve Board's views on the implementation of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Board's responsibilities with respect to over-the-counter (OTC) derivatives fall into three broad areas: consultation and coordination with other authorities, both domestic and international; efforts to strengthen the infrastructure of derivatives markets; and supervision of many derivatives dealers and market participants.

Consultation and Coordination

The Dodd-Frank Act requires that the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) consult with the Board on the rules they are crafting to implement several provisions of title VII. Immediately after passage of the act, the staff from the commissions and the Board met to fashion a process for this consultation; at the Board, we identified members of the staff with relevant expertise, both here and across the Federal Reserve System. Our staff have commented on proposed rules of the commissions at each stage of the development process to date. In providing feedback, we have tried to bring to bear our experience from supervising dealers and market infrastructure as well as our familiarity with markets and data sources to assist the commissions.

Important coordination activities related to derivatives regulation also are occurring within international groups. Most prominently, the Group of Twenty (G-20) leaders have set out commitments related to reform of the OTC derivatives markets that, when implemented by national authorities, will form a broadly consistent international regulatory approach. Work on the G-20 commitments is being done by numerous groups of technical and policy experts, and staff members from the Federal Reserve are actively participating in these groups.

More generally, the Board participates in many international groups that serve as vehicles for coordinating policies related to the participants and the infrastructure of derivatives markets. These groups include the Basel Committee on Banking Supervision (Basel Committee), which has recently enhanced international capital, leverage, and liquidity standards for derivatives, and the Committee on Payment and Settlement Systems, which is working with the International Organization of Securities Commissions to update international standards for systemically important clearing systems, including central counterparties that clear derivatives instruments, and trade repositories. Public consultation on these revised international standards is currently under way.

The goal of all of these efforts is to develop a consistent international approach to the regulation and supervision of derivatives products and market infrastructures as well as to the sound implementation of the agreed-upon approaches. Our aim is to promote both financial stability and fair competitive conditions to the fullest extent possible.

Infrastructure Issues

The Dodd-Frank Act addressed both the infrastructure of the derivatives markets and the regulation and supervision of its dealers and major participants. Central counterparties are given an expanded role in the clearing and settling of swap and security-based swap (hereafter referred to as "swap") transactions, and the Board believes benefits can flow from this reform. Since 2005, Federal Reserve staff members have worked with market participants to strengthen the infrastructure for OTC derivatives, including developing and broadening the use of central clearing mechanisms and trade repositories. Market participants have already established central counterparties that provide clearing services for some OTC interest rate, energy, and credit derivatives contracts. If properly designed, managed, and overseen, central counterparties offer an important tool for managing counterparty credit risk, and thus they can reduce risk to market participants and to the financial system. Both central counterparties and trade repositories also support regulatory oversight and policymaking by providing more-comprehensive data on the derivatives markets. The Board is committed to continuing to work with other authorities, both in the United States and abroad, to ensure that a largely consistent international approach is taken to central counterparties and trade repositories and that their risk-reducing benefits are realized.

Title VIII of the act complements the role of central clearing in title VII through heightened supervisory oversight of systemically important financial market utilities, including systemically important facilities that clear swaps. This heightened oversight is important because financial market utilities such as central counterparties concentrate risk and thus have the potential to transmit shocks throughout the financial markets. The Financial Stability Oversight Council is responsible for designating utilities as systemically important. Through its role on the council, the Board helped develop the designation process that was released for comment in March. Separately, the Board is also seeking comment on proposed risk-management standards that would apply to those designated utilities supervised by the Board under title VIII.[1] As part of title VIII, the Board was given new authority to provide designated utilities with access to Reserve Bank accounts, payment services, and emergency collateralized liquidity in unusual and exigent circumstances. We are carefully considering ways to implement this authority in a manner that protects taxpayers and limits any rise in moral hazard.

Supervisory Issues

Although central counterparties will provide an additional tool for managing counterparty credit risk, enhancements to the risk-management policies and procedures for individual market participants will continue to be a high priority for supervisors. As the reforms outlined in the act are implemented, the most active firms in bilateral OTC markets likely will become active clearing members of central counterparties. As such, the quality of risk management at these firms importantly affects the ability of the central counterparty to manage its risks effectively and to deliver risk-reducing benefits to the markets.

Capital and margin requirements are central to the prudential regulation of financial institutions active in derivatives markets as well as to the internal risk-management processes of such firms. Title VII requires that the CFTC, the SEC, and prudential regulators adopt capital and margin requirements for the noncleared swap activity of swap dealers and major swap participants. The Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration are responsible for adopting capital and margin requirements for swap dealers and major swap participants that are banks or other prudentially regulated entities. The commissions are responsible for adopting capital and margin requirements for swap dealers and major swap participants that are not supervised by a prudential regulator. The prudential regulators and the commissions are consulting in developing the rules, and all agencies must, to the maximum extent practicable, adopt comparable standards.

Earlier today, the Board and the other prudential regulators released for public comment a proposed rule on capital and margin requirements. Our proposal will be open for public comment for 60 days, and we look forward to receiving the public's comments.

For capital, our proposal relies on the existing regulatory capital requirements, which already specifically address the unique risks of derivatives transactions. Beyond the current requirements, the Board and the other U.S. banking agencies played an active role in developing the recent Basel III enhancements to capital requirements agreed to by the Basel Committee in December 2010. Basel III will, among other things, strengthen the prudential framework for OTC derivatives by increasing OTC derivatives' risk-based capital and leverage requirements and by requiring banking firms to hold an additional buffer of high-quality, liquid assets to address potential liquidity needs resulting from their derivatives portfolios.

Our proposal for margin imposes initial and variation margin requirements on the noncleared swaps held by swap dealers or major swap participants that have a prudential regulator. For swaps with a nonfinancial end user counterparty, the proposed rule would not specify a minimum margin requirement. Rather, it would allow a banking organization that is a dealer or major participant to establish a threshold, based on a credit exposure limit that is approved and monitored as part of the credit approval process, below which the end user would not have to post margin. For swaps with other counterparties, the proposal would cap the allowable threshold for unsecured credit exposure on noncleared swaps. In addition, the proposal would only apply a margin requirement to contracts entered into after the new requirement becomes effective.

A much discussed part of the act is the requirement that banks push portions of their swap activity into affiliates or face restrictions on their access to the discount window or deposit insurance. Under the push-out provisions, banking organizations

[1] Board of Governors of the Federal Reserve System (2011), "Federal Reserve Seeks Comment on Proposed Rule Related to Supervision of Designated Financial Market Utilities", press release, March 30, *www.federalreserve.gov/newsevents/press/other/20110330a.htm.*

with deposit insurance or access to the Federal Reserve's discount window will have to reorganize some of their derivatives activity, pushing certain types of swaps out of subsidiary banks and into distinct legal entities that will require their own capitalization and separate documentation of trades with existing customers. The act permits domestic banks to continue to engage in derivatives activities that have been a traditional focus of banks, including hedging activities and dealing in interest rate swaps, currency swaps, certain cleared credit default swaps, and other swaps that reference assets that banks are eligible to hold. However, because of the specific language contained in the act, this exemption for traditional bank derivatives activities does not apply to U.S. branches of foreign banking firms that by law have access to the Federal Reserve's discount window. A possibly unintended effect of the act's push-out provision may be to require some foreign firms to reorganize their existing U.S. derivatives activities to a greater extent than U.S. firms. Proposed rules to implement this section are still under development by the banking agencies.

Conclusion

As the implementation process for the act continues, the challenge facing the Board is to enhance supervision, oversight, and prudential standards of major derivatives market participants in a manner that promotes more-effective risk management and reduces systemic risk, yet retain the significant benefits of derivatives to the businesses and investors who use them to manage financial market risks. The Board is working diligently to achieve these goals.

PREPARED STATEMENT OF MARY J. MILLER

ASSISTANT SECRETARY FOR FINANCIAL MARKETS, DEPARTMENT OF THE TREASURY

APRIL 12, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to testify today about Treasury's role in implementing the derivatives provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

As you know, the President signed the Dodd-Frank Act into law almost 9 months ago. The Act established a framework for the country to build a stronger, safer, and more competitive financial system. It creates safeguards to protect consumers and investors, end taxpayer bailouts, and improve the transparency, efficiency, and liquidity of U.S. markets. The Dodd-Frank Act's derivatives provisions are an important part of that framework.

During the 9 months since the Dodd-Frank Act became law, the Treasury Department, other parts of the Administration, and independent regulatory agencies have been working diligently to build out the framework according to the directions provided by the statute. As we implement the Dodd-Frank Act, we have focused on advancing the best interests of consumers, investors, and taxpayers while also preserving the best attributes of and improving upon a financial system that encourages investment and promotes growth.

As other Treasury officials have previously testified before this Committee, several broad principles guide our efforts:

1. We are moving as quickly as we can to carry out the intent of Congress and meet the deadlines that the Dodd-Frank Act established, but we are also moving carefully to make sure that as we implement the Act, we get it right.
2. We are bringing full transparency to the process so that as many stakeholders as possible have a seat at the table, so that the American people know who is at that table, so that proposed rules and even advance notices of proposed rulemakings and requests for comments are published, and so that anyone who wants to comment can do so.
3. We are creating a more coordinated regulatory process. We will eliminate gaps that allowed risks to grow unchecked and permitted a race to the bottom in certain areas. The Financial Stability Oversight Council (FSOC) is playing a key role in these efforts by bringing together the financial regulatory agencies to help develop consistent and comparable regulations and supervisory regimes across different agencies.
4. We are building a level playing field that treats market participants equally, whether they are banks or nonbanks, and whether they are domestic or foreign institutions. We are setting high standards in the United States and working

diligently with our international counterparts to encourage them to set similar standards.

5. We are crafting rules of the road that will provide U.S. investors and institutions the confidence, the certainty, and the incentives they need to invest capital, develop innovative products and services, and compete globally.
6. Finally, we are committed to keeping Congress fully informed of our progress on a regular basis.

Just as these guiding principles apply broadly to Dodd-Frank Act implementation efforts, they also apply to implementation of the Dodd-Frank Act's derivatives provisions in particular.

Our partners at the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the Board of Governors of the Federal Reserve System (Federal Reserve Board), all of whom are represented here today, have been and will continue to be instrumental in achieving the goals of the Dodd-Frank Act. As you will hear from Chairman Gensler, Chairman Schapiro and Governor Tarullo, their agencies' roles in implementing the Act's derivatives provisions are particularly important.

While Treasury has a more limited role than the CFTC, SEC, and Federal Reserve Board in building Dodd-Frank's new derivatives regulatory framework, the Secretary of the Treasury (Secretary) does have certain specific statutory responsibilities under the Dodd-Frank Act and has other responsibilities in his capacity as the Chairman of the FSOC.

Starting with the specific responsibilities under the Dodd-Frank Act, Congress gave the Secretary the authority to determine whether foreign exchange (FX) swaps and forwards should be exempted from the definition of "swap" in the Commodity Exchange Act (CEA) (7 U.S.C. ch. 1). Foreign exchange swaps and forwards generally are subject to the requirements of the CEA. For these instruments, the most significant requirements under the regulatory regime enacted by the Dodd-Frank Act would be central clearing and exchange trading requirements for foreign exchange swaps and forwards, unless the Secretary determines that they "(I) should not be regulated as swaps under [the CEA]; and (II) are not structured to evade [the Dodd-Frank Act] in violation of any rules promulgated by the [CFTC]" pursuant to the Dodd-Frank Act. [1]

The statute limits the scope of a determination to foreign exchange swaps and forwards and does not allow the Secretary to exempt other foreign exchange derivatives, such as foreign exchange options, currency swaps, and nondeliverable forwards. These other foreign exchange derivatives do not satisfy the narrow definition of a "foreign exchange swap" or "foreign exchange forward" and, therefore, may not be exempted.

Under the CEA as amended by the Dodd-Frank Act, and for purposes of the Secretary's determination, an FX swap is defined as "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange" and "(B) a reverse exchange of [those two currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange." [2] Likewise, the CEA as amended narrowly defines an FX forward as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." [3]

In determining whether to exempt foreign exchange swaps and forwards, the Secretary must consider the following five statutory factors set forth by the Dodd-Frank Act:

1. Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States;
2. Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps;
3. The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;
4. The extent of adequate payment and settlement systems; and

[1] 7 U.S.C. 1a(47)(E)(i).
[2] 7 U.S.C. 1a(25).
[3] 7 U.S.C. 1a(24).

5. The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.[4]

If the Secretary determines that foreign exchange swaps or forwards should be exempted from the CEA's definition of "swap," Treasury must provide a written determination to Congress that contains: (1) "an explanation of why [FX] swaps and [FX] forwards are qualitatively different from other classes of swaps in a way that would make the [FX] swaps and [FX] forwards ill-suited for regulation as swaps;" and (2) "an identification of the objective differences of [FX] swaps and [FX] forwards with respect to standard swaps that warrant an exempted status."[5]

Consistent with Treasury's commitment to an open and transparent process, on October 28, 2010, we published a Notice and Request for Comments (Notice) in the Federal Register to solicit public comment on a wide range of issues relating to whether foreign exchange swaps and foreign exchange forwards should be exempt from the definition of the term "swap" under the CEA. We received approximately thirty comments in response to the Notice, and Treasury staff has also conducted its own, independent analysis of the issue, including extensive discussions with a range of regulators, end users, dealers, and other interested parties.

We know that this is an issue that market participants and other stakeholders are interested in, and we recognize that the Committee is also closely following this issue. Like other areas of Dodd-Frank implementation and consistent with the guiding principles identified above, this is an area where we want to move expeditiously. Regardless of the decision the Secretary pursues, market participants need to know what the regulatory regime will look like and to be able to plan and prepare for that regime. But it is also critical that we take enough time to be confident that we are making the right decision for the safety and soundness of the markets.

In addition to his specific duties under the Dodd-Frank Act, the Secretary also has more general responsibilities with respect to the Act's derivatives provisions in his capacity as Chairman of the FSOC. In March, the FSOC held its fourth meeting and approved the publication of a Notice of Proposed Rulemaking (NPRM) regarding the FSOC's designation of financial market utilities (FMUs) as systemically important.

FMUs exist in many financial markets to support and facilitate the transfer, clearing, and settlement of financial transactions, and they form a critical part of the Nation's financial market infrastructure. FMUs' functions and interconnectedness with many parts of the market can help manage and reduce risk, but if they are poorly operated could also concentrate risk. Title VIII of systemic risks they might create if not properly managed and supervised. To address the potential for such risks, the Act seeks to enhance the regulation and supervision of systemically important FMUs to promote robust risk management and safety and soundness.

The FSOC published an advance notice of proposed rulemaking regarding the criteria for designating systemically important FMUs on December 21, 2010. After receiving, reviewing, and analyzing comments received in response to the advance notice and performing additional work, at its March meeting the FSOC approved the publication of the NPRM. The NPRM was published in the Federal Register on March 28, 2011, and the comment period will be open for 60 days for any interested party to submit comments on the proposed rule.

Title VIII of the Dodd-Frank Act also gives the FSOC the responsibility of designating systemically important payment, clearing, and settlement (PCS) activities that occur at financial institutions other than FMUs. These PCS activities could occur between financial institutions transacting with each other or between a financial institution and one of its customers. The FSOC's member agencies and staff have started examining this issue as well, and the FSOC will proceed in the coming months with the necessary rulemaking to establish the criteria and procedures for the FSOC's designation of PCS activities as systemically important.

One final area I would like to touch on is the importance of the comparability of international standards that will apply to the financial regulatory framework in general, including derivatives regulation. The United States will set high standards and take the steps that are necessary for the safety and soundness of our financial system. But today's financial system is highly interconnected, mobile, and global. It is important that we pursue as level an international playing field as possible not only to protect the competiveness of U.S. financial markets and institutions but also to ensure that the critically important reforms we implement here cannot be evaded or rendered ineffective by lax standards elsewhere.

[4] 7 U.S.C. 1b(a).
[5] 7 U.S.C. 1b(b).

With respect to the international derivatives regulatory framework, significant globally coordinated work has already occurred, but more remains to be done. Treasury and our international counterparts are focused on making certain that critical over-the-counter derivative market infrastructure is subject to appropriate oversight. A key element of our current discussions is ensuring that we have cooperative oversight frameworks in place to address the information needs of supervisors in different jurisdictions.

We will continue to work at home and with our international counterparts to build a regulatory framework for derivatives that will help our financial system become safer and sounder and a sound platform on which we can build strong financial markets that will fuel the Nation's economic growth.

PREPARED STATEMENT OF THOMAS C. DEAS, JR.

VICE PRESIDENT AND TREASURER, FMC CORPORATION

APRIL 12, 2011

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

FMC Corporation was founded almost 130 years ago to provide spray equipment to farmers. Today in addition to making agricultural chemicals farmers apply to protect their crops, our 5,000 employees have worked hard to make FMC a leading manufacturer and marketer of a whole range of agricultural, specialty and industrial chemicals. FMC has achieved this longevity by continually responding to our customers' needs with the right chemistry delivered at the right price. This year marks our 80th anniversary of listing on the New York Stock Exchange. In 1931 FMC sought access to the U.S. equity market as the largest and most available pool of capital to support our growing business. Today in 2011 the most responsive financial market in the world is the over-the-counter (OTC) derivatives market. I had the valuable experience of negotiating and executing some of the very first derivatives—currency swaps—going back to 1984. I have seen the market grow from its inception in the mid-1980s to its current size by adapting and responding to market participants' needs. The customization available in the OTC derivatives market is key to FMC's and other end users' ability to hedge business risks in a cost-effective way. The standardized contracts available on existing and proposed derivatives exchanges will not provide this customized match to our underlying business exposures.

We support this Committee's efforts to redress the problems with derivatives we experienced during the financial crisis in 2008. I want to assure you that FMC and other end users were not and are not engaging in risky speculative derivatives transactions from which some of that turmoil arose. We are very concerned by the assertion several regulators have made that the Act's requirement for swap dealers to post margin should also be extended to end users. This would require us to hold aside scarce cash and immediately available credit to meet margin calls and would be a significant new economic burden. At the time the Dodd-Frank Act was passed, end users understood we would be exempt from having to post cash margin. I want to emphasize that FMC and other end users employ OTC derivatives solely to manage underlying business risks. We are offsetting risks—not creating new ones.

Please allow me to illustrate our use of derivatives with specific examples. FMC is the world's largest producer of natural soda ash, the principal input in glass manufacturing, and is one of the largest employers in the State of Wyoming. We are also developing innovative new environmental applications that scrub sulfur compounds from flue gases of factories and power plants. We can mine and refine soda ash products in southwestern Wyoming, ship them to South Asia, and deliver them at a lower cost and with higher quality than competing Chinese producers. Energy is a significant cost element in producing soda ash and FMC protects against unpredictable fluctuations in future energy costs with OTC derivatives to hedge natural gas prices. These derivatives are done with several banks, all of which are also supporting FMC through their provision of almost $1 billion of credit. Our banks do not require FMC to post cash margin to secure mark-to-market fluctuations in the value of derivatives, but instead price the overall transaction to take this risk into account. This structure gives us certainty so that we never have to post cash margin while the derivative is outstanding. However, if we are required by the regulators to post margin, we will have to hold aside cash and readily available credit to meet those margin calls. Depending on the extent of price movements, margin might have to be posted within the trading day as well as at the close of trading. Because failure to meet a margin call would be like bouncing a check, and would constitute a default, our corporate treasury would act very conservatively in holding cash or immediately available funds under our bank lines of credit to assure we could meet any future margin call in a timely fashion and with a comfortable cushion.

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

FMC and other members of the Business Roundtable estimated that BRT-member companies would have to hold aside on average $269 million of cash or immediately available bank credit to meet margin calls. In our world of finite limits and financial constraints, this is a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. In fact, the study extrapolated the effects across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs. The effect on the many thousands of end users beyond the S&P 500 would be proportionately greater. We would also have to make a considerable investment in information systems that would replicate much of the technology in a bank's trading room for marking to market and settling derivatives transactions.

Let me give you a direct example of why our banks have agreed that cash margin is not necessary for FMC's derivatives trades. Because we are always hedging an underlying business risk, if a current valuation of a derivative is underwater, then the risk we are hedging must be in the money, resulting in a net neutral position. To illustrate, FMC sells agricultural chemicals to farmers who need them at planting time, but want to defer payment until harvest time. FMC agrees with the farmer that he can pay in bushels of soybeans when he harvests his crop. FMC then enters into a customized derivative with one of our banks that exactly matches the amount and timing of the future delivery of soybeans. As the price of soybeans fluctuates, the valuation of the derivative changes by an equal and opposite amount in relation to the bushels of soybeans. This results in no net gain or loss when the derivative and the underlying exposure are valued together at any point in the future. We benefit from not having unpredictable demands on our liquidity. For this balanced structure, we agree to a small markup payable at maturity of the soybean derivative transaction I've just described. This is far cheaper in both financial and administrative cost than if we had to keep idle cash or immediately available credit to meet cash margin postings and undertake significant information systems investments. Customized OTC derivatives allow us to expand sales and provide added value to our customers, while reducing our risk.

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

Let me take a moment to summarize some of our principal concerns with the implementation of derivatives regulation:

- First, we are concerned that the regulators will impose margin on end user trades, diverting billions of dollars from productive investment and employment into an idle regulatory levy.
- Second, even if the final regulations clearly exempt end users from margin requirements, we still have the risk that the regulators will require swap dealers to hold excessive capital in reserve against uncleared over-the-counter derivatives—with the cost passed on to end users as they manage their business risks. We believe that swap dealers' capital requirements should be appropriate to the

actual loss experience of the specific type of derivative. The unintended consequence of punitive capital requirements could be for some end users to cease hedging risks and for others to use foreign markets.

- Finally, we are concerned that regulators will make customized derivatives prohibitively expensive through margin and increased capital requirements, with the effect of forcing us into standardized derivatives from common trading facilities that will not provide the exact match we seek with our underlying business exposures. It is the customization available with OTC derivatives that is so valuable to us and makes the derivatives effective in hedging our exposures.

The cumulative effect of these regulations could mean that U.S.-based manufacturers with substantial exports could no longer economically hedge their foreign exchange risk with derivatives. As a result they could be forced to move production offshore to match their costs directly with the currencies of their customers. I urge you to inquire into this looming problem that could increase the credit spreads for OTC derivatives by a factor of five or more.

I know many people who suffered through the financial turmoil of 2008 are tempted to label all derivatives as risky bets that should be curtailed. However, I hope these examples of prudent use of derivatives by my company and other end users who form the backbone of our country's economy have demonstrated the wisdom of the end user exemptions that we believe to have been the legislative intent.

Chairman Gensler and other regulators have been very forthcoming and open in soliciting input from us. We appreciate being involved, but we have only a few weeks until the deadline for finalizing rules. The end user exemption we thought was clear is still uncertain and only a very few of the 105 rules required by July 15 have been published. I urge you to extend the statutory date by which rules must be promulgated until the remaining uncertainties can be clarified and we can be assured the rules will operate effectively when taken together.

Thank you for your time. I would be happy to respond to any questions you may have.

PREPARED STATEMENT OF LEE OLESKY

CHIEF EXECUTIVE OFFICER, TRADEWEB MARKETS LLC

APRIL 12, 2011

Tradeweb Markets LLC (Tradeweb) appreciates the opportunity to provide testimony to the Senate Committee on Banking, Housing, and Urban Affairs (the "Committee") with respect to the regulatory framework for and implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") under the proposed regulations from the Commodity Futures Trading Commission (CFTC) and U.S. Securities and Exchange Commission ("SEC", together with the CFTC, the "Commissions").

I. Background on Tradeweb

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

Founded as a multidealer online marketplace for U.S. Treasury securities in 1997, Tradeweb has been a pioneer in providing market data, electronic trading and trade processing in OTC marketplaces for over 10 years, and has offered electronic trading in OTC derivatives on its institutional dealer-to-customer platform since 2005. Active in 20 global fixed income, money market and derivatives markets, with an aver-

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[1] Tradeweb operates the dealer-to-customer and odd-lot platforms through its registered broker-dealer, Tradeweb LLC, which is also registered as an alternative trading system (ATS) under Regulation ATS promulgated by the SEC under the Securities Exchange Act of 1934. Tradeweb operates its inter-dealer platform through its subsidiary, Hilliard Farber & Co., Inc., which is also a registered broker-dealer and operates Dealerweb as an ATS. In Europe, Tradeweb offers its institutional dealer-to-customer platform through Tradeweb Europe Limited, which is authorized and regulated by the U.K. Financial Services Authority as an investment firm with permission to operate as a Multilateral Trading Facility. In addition, Tradeweb Europe Limited has registered branch offices in Hong Kong, Singapore, and Japan and holds an exemption from registration in Australia.

age daily trading volume of more than $250 billion, Tradeweb's leading institutional dealer-to-customer platform enables 2,000 institutional buy-side clients to access liquidity from more than 40 sell-side liquidity providers by putting the liquidity providers in real-time competition for client business in a fully disclosed electronic auction process. These buy-side clients comprise the majority of the world's leading asset managers, pension funds, and insurance companies, as well as most of the major central banks.

Since we began trading interest rate swaps in 2005, the notional amount of interest rate derivatives traded on Tradeweb has exceeded $6.5 trillion from more than 75,000 trades. Tradeweb has spent the last 5 years building on its derivatives functionality to enhance real-time execution, provide greater price transparency and reduce operational risk. Today, the Tradeweb system provides its institutional clients with the ability to (i) view live, real-time IRS (in six currencies, including U.S., Euro, Sterling, Yen), and Credit Default Swap Indices (CDX and iTraxx) prices from swap dealers throughout the day; (ii) participate in live, competitive auctions with multiple dealers at the same time, and execute an array of trade types (*e.g.,* outrights, spread trades, or rates switches); and (iii) automate their entire workflow with integration to Tradeweb so that trades can be processed in real-time from Tradeweb to customers' middle and back offices, to third-party affirmation services like Markitwire and DTCC Deriv/SERV, and to all the major derivatives clearing organizations. Indeed, in November 2010, Tradeweb served as the execution facility for the first fully electronic multidealer-to-customer interest rate swap trade to be cleared in the U.S., and in February 2011, Tradeweb completed the first fully electronic multidealer-to-customer credit default swap trade to be executed and cleared in the U.S. Tradeweb's existing technology maintains a permanent audit trail of the millisecond-by-millisecond details of each trade negotiation and all completed transactions, and allows parties (and will allow SDRs and DCOs) to receive trade details and access post-trade affirmation and clearing venues. With such tools and functionality in place, Tradeweb is providing the OTC marketplace with a front-end swap execution facility.

As additional background, Tradeweb was established in 1997 with financial backing from four global banks that were active in, and interested in expanding and fostering innovation in, fixed income (U.S. Government bond) trading. After 7 years of growth and expansion into 15 markets globally, in 2004, Tradeweb's bank-owners (which had grown from four to eight over that time) sold Tradeweb to The Thomson Corporation, which wholly owned it until January 2008. Although the original bank-owners continued to be a resource for Tradeweb from 2004 to 2008, The Thomson Corporation recognized that bank ownership was an important catalyst of Tradeweb's development and sold through a series of transactions a strategic interest in Tradeweb to a consortium comprised of ten global bank owners. Today, Tradeweb is majority owned by Thomson Reuters Corporation (successor to The Thomson Corporation) and minority stakes are held by the bank consortium and Tradeweb management. Accordingly, Tradeweb was launched by market participants and has benefited from their investment of capital, market expertise and efforts to develop and foster more transparent and efficient markets. With the support of its ownership and its board comprised of market and nonmarket participants, Tradeweb has, since its inception, brought transparency and efficiency to the OTC fixed income and derivatives marketplace.

II. Summary

Since 1998, Tradeweb has been operating a regulated electronic marketplace for the OTC fixed income marketplace and has played an important role in providing greater transparency and improving the efficiency of the trading of fixed income securities and derivatives. Indeed, Tradeweb has been at the forefront of creating electronic trading solutions which support price transparency and reduce systemic risk, the objectives of Title VII of the Dodd-Frank Act. Given that it has the benefit of offering electronic trading solutions to the buy-side and sell-side, Tradeweb believes that it can provide the Committee with a unique and valuable perspective on the regulatory framework for and the implementation of Title VII.

At the outset, Tradeweb is very supportive of the Dodd-Frank Act and its stated goals. We believe that increased price transparency and operational efficiency will lead to a reduction in systemic risk in connection with the trading of derivatives. However, it is important for this Committee, Congress as a whole, and the regulators to understand and give due consideration to the needs of market participants in promulgating rules for and implementing Title VII. The aim must be to achieve the goals of the Act without materially disrupting the market and the liquidity it provides to end users who use derivatives to manage their varying risk profiles. Market participants need confidence to participate in these markets and if careful consideration is not given to what the rules say and how they will ultimately be implemented, we fear that this confidence could be materially shaken.

As part of the Dodd-Frank Act, Congress created a new type of registered entity—known as a swap execution facility or "SEF." Congress expressly created SEFs to promote the trading of swaps on regulated markets, and provide a broader level of price transparency for end users of swaps. While the definition of a SEF has been the subject of much debate and speculation, the plain language of the Dodd-Frank Act requires the Commissions to recognize the distinction between SEF's on the one hand and designated contract markets (DCMs) or exchanges on the other. There was a recognition by Congress that alternatives to traditional DCMs and exchanges were necessary, particularly in light of the current working market structure and manner in which OTC derivatives trade. We applaud the direction of the regulation, but want to ensure that the Commissions adopt rules that are clear and allow for flexibility in the manner of execution for market participants.[2] This will give the end users choices, confidence and liquidity, and will do so in a regulated framework that promotes the trading of swaps, in an efficient and transparent manner on regulated markets.

To that end, the rules relating to Title VII must be flexible enough so as not to deter the trading of swaps on regulated platforms. By ensuring that the rules retain sufficient flexibility to allow end users to elect where and how they transact business, the Commissions will provide for the most competitive execution of trades and encourage the greatest liquidity in the market. Accordingly, the rules should not unduly limit the choices of execution methods available for market participants to manage their risks efficiently and effectively, or overly prescribe the manner in which market participants can choose to interact with each other to manage such risks (*e.g.,* requiring a Request for Quote (RFQ) to be transmitted to a minimum of five market participants). If the rules regarding how market participants must interact with each other from a trading perspective and accessing liquidity are arbitrary and artificially prescriptive, and thus not flexible enough to accommodate the varying methods of execution, market participants simply will not participate and will seek alternative, less efficient markets to manage their risk. We certainly do not believe that is the ultimate goal of Title VII.

Further, the Dodd-Frank Act clearly contemplates that a SEF should have broad, reasonable discretion to establish how it implements the required regulatory framework. Overly prescriptive rules on the registration and administration of SEFs and their compliance with the Core Principles could place an unreasonable burden on existing swaps trading platforms prior to the effective date of the final rules and may also discourage new entrants into the swaps market. Congress and the Commissions should thoughtfully implement the rules to provide electronic swaps trading platforms with the flexibility required by the Dodd-Frank Act.

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

Because of the overlapping nature of the proposed rules from the CFTC and SEC on each aspect of Title VII—including SEFs—we believe it is imperative that the Commissions cooperate in developing final rules, which should be aligned to the greatest extent possible. Bifurcated rulemaking with respect to the swaps market will result in confusion and lack of confidence in the marketplace and could potentially drive participants away from the market altogether. It is also critically important that there is a consistent approach between regulators globally as overly rigid regulation in one jurisdiction will materially impact how other regulators promulgate rules in an effort to maintain a harmonized approach to overseeing the derivatives markets. The potential result is a movement of the market outside the U.S., and that would likewise be an unfortunate unintended consequence.

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[2] The term "swap execution facility" has been defined in the Dodd-Frank Act as a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that: (A) facilitates the execution of swaps between persons; and (B) is not a designated contract market. The Dodd-Frank Act amends Section 1a of the Commodities Exchange Act with a new paragraph (50, and Section 761(a)(6) of the Dodd-Frank Act amends Section 3(a) of the Securities Exchange Act of 1934 by adding a new paragraph (77) (defining a "security-based swap execution facility"). We refer to both as a SEF in this submission.

Finally, there has been a great deal of discussion recently about how best to implement Title VII and the currently proposed rules. There is no doubt that an overly hasty or ill thought-out timetable for implementation could directly impact the health of the derivatives markets by disenfranchising the interconnected members of this complex ecosystem, and implementing these regulations in one "big bang" is unrealistic. We believe the marketplace needs greater certainty in terms of how and when these regulations will be implemented, and we encourage Congress and the Commissions to seek public comment on these issues.

Tradeweb is supportive of the goals to reform the derivatives markets and indeed we provide the very solutions the regulation seeks to achieve, but we are concerned that the Commissions may overreach in their interpretation and implementation of Dodd-Frank, and in doing so create unintended consequences for end users and the marketplace as a whole.

III. Background on the OTC Rates and Credit Derivatives Marketplace

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

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

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

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

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

IV. Key Considerations for SEF Rulemaking

SEFs

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

Consistent with the goals of the Dodd-Frank Act, for institutional users, a SEF should (i) provide pretrade price transparency through any appropriate mechanism that allows for screen-based quotes that provide an adequate snapshot of the market (*e.g.,* through streaming prices for standardized transactions and competitive real time quotes for larger or more customized transactions), (ii) incorporate a facility through which multiple participants can trade with each other (*i.e.,* must have competition among liquidity providers), (iii) have objective standards for participation that maintain the structure of liquidity providers (like swap dealers) providing liquidity to liquidity takers (institutional buy-side clients), (iv) have the ability to adhere to the core principles that are determined to be applicable to SEFs, (v) provide access to a broad range of participants in the OTC derivatives market, allowing such participants to have access to trades with a broad range of dealers and a broad range of DCOs; (vi) allow for equal and fair access to all the DCOs and allow market participants the choice of DCO on a per trade basis, and (vii) have direct connectivity to all the SDRs.

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

Ownership and Governance

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

The success story of Tradeweb may not have been possible if overly prescriptive governance and ownership limits had been imposed at the time. It was highly unlikely that under those circumstances, any market participants would have made an investment. Moreover, beyond the initial seed capital, the banks' participation also allowed Tradeweb to continue to invest in its infrastructure and evolve with the market—thus building the robust and scalable architecture that has allowed it to expand to 20 markets, survive 9/11 (Tradeweb's U.S. office was in the North Tower of the World Trade Center), and develop connectivity with over 2,000 institutions globally. Under the proposed rules of the CFTC and the SEC, ownership and independent director limits will be imposed on the different registered entities that will provide the technological infrastructure to the swaps market—from trading to clearing. Tradeweb believes that independent directors are a very good idea, in terms of bringing an independent perspective to the governing board, but their duties must be consistent with other board members. However, artificial caps on ownership or excessive minimum voting requirements for independent directors on the board (such as 51 percent of the voting power) go too far. As a practical matter, ownership limits will impair registered entities such as trading platforms and clearing organizations, from raising capital, and overly expansive independent director requirements will likewise hurt investment because investors will lack a sufficient say in how their investment will be governed. Moreover, Dodd-Frank provides other, more direct, ways in which to mitigate conflicts of interest, and employing each of these tools in a reasonable fashion will, in the aggregate, address the potential conflicts of interest without negatively impacting investment of capital and innovation in the marketplace.

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

Implementation

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

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

PREPARED STATEMENT OF TERRENCE A. DUFFY

EXECUTIVE CHAIRMAN, CME GROUP INC.

APRIL 12, 2011

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

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

The financial crisis focused well-warranted attention on the lack of regulation of OTC financial markets. We learned a number of important lessons and Congress crafted legislation that, we hope, reduces the likelihood of a repetition of that disaster. However, it is important to emphasize that regulated futures markets and futures clearinghouses operated flawlessly. Futures markets performed all of their essential functions without interruption and, despite failures of significant financial firms, our clearinghouse experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk. Dodd-Frank was adopted to impose a new regulatory structure on a previously opaque and unregulated market—the OTC swaps market. It was not intended to reregulate the robustly regulated futures markets.

For example, while Congress granted the Commission the authority to adopt rules respecting core principles, it did not direct it to eliminate principles-based regulation. Yet the Commission has proposed specific requirements for multiple Core Principles—almost all Core Principles in the case of designated contract markets (DCMs)—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

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

Further, the principles-based regime of the CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearinghouses permitted U.S. exchanges to regain their competitive position in the global market. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA. Indeed, U.S. futures exchanges have operated more efficiently, more economically and with fewer complaints under this system than at any time in their history. The transition to an inflexible regime threatens to stifle growth and innovation in U.S. exchanges and thereby drive market participants overseas. As further discussed below, this will certainly impact the relevant job markets in the United States.

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

In our view, many of the Commission's proposals are inconsistent with DFA, not required by DFA, and/or impose burdens on the industry that require an increase in CFTC staff and expenditures that could never be justified if an adequate cost-benefit analysis had been performed. I will discuss below the Commission's failure to comply with the Congressionally mandated cost-benefit process, the need to sequence Dodd-Frank rulemaking appropriately, and the potential negative impact on U.S. markets of regulatory proposals.

A. Lack of Consideration of Costs of Regulatory Proposals

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

The explicit cost-benefit analysis included in the more than 30 rulemakings to date and the Commission's testimony in a number of congressional hearings indicate that those responsible for drafting the rule proposals are operating under the mistaken interpretation that Section 15(a) of the CEA excuses the Commission from performing any analysis of the direct, financial costs and benefits of the proposed regulation. Instead, the Commission contends that Congress permitted it to justify its rule making based entirely on speculation about unquantifiable benefits to some segment of the market. The drafters of the proposed rules have consistently ignored the Commission's obligation to fully analyze the costs imposed on third parties and on the agency by its regulations.

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

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

Commissioner Sommers reiterated her concern with the lack of cost-benefit analysis performed by the Commission in her March, 30, 2011, testimony before the Subcommittee on Oversight and Investigations of the House Committee on Financial Services. Commissioner Sommers noted that "the Commission typically does not perform a robust cost-benefit analysis at either the proposed rule stage or the final rule stage" and noted that "while we do ask for comment from the public on the costs and benefits at the proposal stage, we rarely, if ever, attempt to quantify the costs before finalizing a rule."

B. Sequencing of Rulemakings Under Dodd-Frank

Chairman Gensler has recently disclosed his plan for the sequencing of final rulemakings under DFA. He has divided the rulemakings into three categories: early, middle, and late. We agree that sequencing of the rules is critical to meaningful public comment and effective implementation of the rules to implement DFA. Many of the rulemakings required by DFA are interrelated. That is, DFA requires many intertwined rulemakings with varying deadlines. Market participants, including CME cannot fully understand the implications or costs of a proposed rule when that proposed rule is reliant on another rule that is not yet in its final form. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect.

We agree with many, but not all aspects of the Chairman's proposed sequencing agenda and have recently proposed an alternative sequencing agenda to the Commissioners. We recommend that in Phase 1 (early), the Commission focus on rules that are necessary to bring the previously unregulated swaps market into the sound regulatory framework that exists for futures markets. This set of major rulemakings represents the largest amount of change for the industry and cannot be satisfactorily addressed in a timely manner if key elements of the regulatory framework for swaps clearing are not determined until the middle or late stages of the rulemaking process. Further, the regulatory framework for reducing systemic risk in OTC derivatives was the central focus of DFA and therefore should have the highest priority.

We suggest that Phase II (middle) deal with exchange-trading requirements for swaps, including the definition of and requirements for swap trading facilities, business conduct standards for swap dealers and requirements for swap data repositories. While we support efforts to increase transparency in swaps markets, we believe these rulemakings are less critical in time priority than the clearing mandate and related clearing rules that will reduce systemic risk.

Finally, we recommend that the Commission leave those rulemakings that deal with DCMs and position limits for Phase III (late). As I mention throughout my testimony, the exchange-traded derivatives market operated flawlessly during the financial crisis, and the proposed rules affecting DCMs and position limits, which as discussed below, often represent an overstepping of the Commission's authority under DFA, represent incremental changes to an already robust regulatory scheme.

With respect to the phasing in of the mandatory clearing rules for swaps, some have suggested that the clearing requirement first be applied to dealer-to-dealer swaps and then later applied to dealer-to-customer swaps. CME Group strongly disagrees with this approach insofar as it may limit clearing competition and customer choice and because, more importantly, it will disadvantage customers who are preparing for central counterparty clearing of swaps but are unable to complete their preparations due to the uncertainty associated with the lack of final rules. Sell-side and buy-side participants may elect to support or prefer different clearing solutions depending on how they are owned and operated, the membership requirements associated with each clearinghouse, and the risk management and default management features associated with each clearing solution. Different clearinghouses have already adopted differing approaches to these features, enhancing competition and the proliferation of different business models. Sequencing dealer-to-dealer clearing prior to dealer-to-customer clearing lacks any rational justification and simply limits the availability of competing clearing models, potentially limiting competition, which Congress expressly provided for in DFA.

The theory behind phasing in dealer-to-dealer swaps first is that dealers will be prepared to begin clearing swaps before buy-side participants are likewise prepared. This rationale, however, is not based in fact. An overwhelming number of buy-side participants are already clearing or ready to clear or will be ready to clear in the near future. Ten buy-side firms are already clearing at CME Group. Another 30 are testing with us and have informed us that they are planning to be prepared to clear no later than July 15. Another 80 buy-side firms are in the pipeline to clear with us and would like to be ready to clear voluntarily approximately 3–6 months before mandated to do so. Also, UBS recently conducted a comprehensive study (March 10, 2011) of OTC derivatives market participants to gauge the readiness on the buy-side for this transition. Their study found that buy-side firms are increasingly prepared to clear OTC derivatives, reporting that 73 percent of firms are already clearing or preparing to clear, 71 percent expect to begin clearing within 12 months, and 82 percent expect that the majority of their OTC businesses will be cleared within 2 years. Claims that buy-side participants are not ready to clear are simply false and will disadvantage buy-side firms that wish to reduce bilateral clearing risks by adopting central counterparty clearing as soon as possible.

We believe that the most efficient way to implement the clearing mandate is to phase in the mandate on a product-class by product-class basis. Once the CFTC defines "class," it can mandate that large classes of instruments, such as 10-year interest rate swaps, be cleared regardless of the counterparties to the trade. This approach will (i) preserve customer choice in clearing, (ii) bring the largest volume of swaps into clearinghouses as soon as possible, and (iii) allocate the Commission's limited resources in an efficient manner. CME Group's letter to Chairman Gensler, which discusses our position on both sequencing of rulemaking and sequencing of implementation of the clearing mandate in greater detail, is attached for your reference as Exhibit A.

The Commission should avoid creating an unlevel playing field among large swap market participants—both in terms of freedom to choose among competing clearing offerings and in terms of their ability to reduce bilateral credit risks in a timely fashion. Congress wisely recognized that major swap participants that are not swap dealers can also pose systemic risks to the marketplace; hence the Commission should sequence rules applying to swap dealers and major swap participants at the same time.

This Congress can mitigate some of the problems that have plagued the CFTC rulemaking process by extending the rulemaking schedule so that professionals, including exchanges, clearinghouses, dealers, market makers, and end users can have their views heard and so that the CFTC will have a realistic opportunity to assess those views and measure the real costs imposed by its new regulations. Otherwise, the unintended adverse consequences of those ambiguities and the rush to regulation will impair the innovative, effective risk management that regulated exchanges have provided through the recent financial crisis and stifle the intended effects of financial reform, including the clearing of OTC transactions.

C. Impact of Regulatory Proposals on U.S. Markets

Several Commissioners clearly recognize the potential unintended consequences and the potential detrimental effects of a prescriptive, rather than principles-based, regime upon the markets. Commissioner Dunn, for example, expressed concern that if the CFTC's "budget woes continue, [his] fear is that the CFTC may simply become a restrictive regulator. In essence, [it] will need to say 'No' a lot more . . . No to anything [it does] not believe in good faith that [it has] the resources to manage" and that "such a restrictive regime may be detrimental to innovation and competition."[1] Commissioner O'Malia has likewise expressed concern regarding the effect

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

of proposed regulations on the markets. More specifically, the Commissioner has expressed concern that new regulation could make it "too costly to clear." He noted that there are several "changes to [the] existing rules that will contribute to increased costs." Such cost increases have the effect of "reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach?"[2]

Additionally, concern has been expressed regarding unduly stringent regulation driving major customers overseas; indeed, we have already seen this beginning to happen with only the threat of regulation. For example, Commissioner Sommers has noted that she was troubled by the lack of analysis of swap markets and of whether the proposal would "cause price discovery in the commodity to shift to trading on foreign boards of trade," and that "driving business overseas remains a long standing concern."

The CFTC's apparent decision to impose a multitude of prescriptive rules on both DCMs and swap execution facilities (SEFs) may have a detrimental effect on employment in the United States. The principles-based regulation of futures markets had a transformative effect on U.S. futures markets over the past decade. Since the Commodity Futures Modernization Act of 2000 (CFMA), which converted the CEA from a rules-based to principles-based regime, the futures markets have experienced unparalleled growth and innovation and have been able to regain and maintain a competitive position in the global market. The principles-based regime has allowed U.S. futures exchanges to keep pace with rapidly changing technology and market needs by introducing new products, processes, and methods of compliance and avoiding stifling regulatory review. The adoption by the CFTC of a prescriptive regime will stifle this innovation, make U.S. futures markets less attractive to traders, and in the end can only result in the loss of jobs as the markets lose their ability to compete.

Most notably, the newly prescriptive regime, as well as other rules proposed by the Commission, are not in harmony with international regulators. This creates an incentive for market participants to move their business to international exchanges where they may be subject to less prescriptive regimes, threatening negative consequences for U.S. exchanges. While the Commission has been working to induce international regulators to be equally prescriptive, that effort seems to be failing as other jurisdictions are alert to the value of snapping up the business that the Commission will drive off shore. The threat of prescriptive position limits and restrictions on hedging in the U.S. are already driving business overseas or into unregulated markets. Additionally, broad, undefined prohibitions on so-called "disruptive" trading practices and trading strategies will drive liquidity providers from the U.S. markets and impair hedging and price discovery. The CFTC should be careful not to adopt restrictions that tilt the competitive playing field in favor of overseas mar-

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innovation and competition, but it would allow us to fulfill our duties under the law, with the resources we have available." Commissioner Michael V. Dunn, Opening Statement, Public Meeting on Proposed Rules Under Dodd-Frank Act (January 13, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/dunnstatement011311.html.*

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

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

"For example, there are several changes to our existing rules that will contribute to increased costs, including more stringent standards for those clearinghouses deemed to be systemically significant. The Commission staff has also recommended establishing a new margining regime for the swaps market that is different from the futures market model because it requires individual segregation of customer collateral. I am told this will increase costs to the customer and create moral hazard by reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach?" Commissioner Scott D. O'Malia, Derivatives Reform: Preparing for Change, Title VII of the Dodd-Frank Act: 732 Pages and Counting, Keynote Address (January 25, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-3.html.*

kets. Such a tilt will result in both a loss of jobs in the U.S. and less cost-efficient hedging for persons in business in the U.S.

Conclusion

Attached to my testimony are just a few examples where the Commission has proposed rules inconsistent with DFA or that impose unjustified costs and burdens on both the industry and the Commission. As previously noted, CME Group has great concern about the number of unnecessary and overly burdensome rule proposals aimed at the regulated futures markets. The goal of Dodd-Frank was to bring transparency, safety, and soundness to the over-the-counter market, not reregulate those markets which have operated transparently and without default. However, given the CFTC has determined to issue numerous rules above and beyond what is statutorily required by DFA, we ask this Congress to extend the rulemaking schedule under DFA to allow time for industry professionals of various viewpoints to fully express their views and concerns to the Commission and for the Commission to have a realistic opportunity to assess and respond to those views and to realistically assess the costs and burdens imposed by the new regulations. To this end, we urge the Congress to ensure that the Commission performs a proper cost-benefit analysis, taking into account real financial costs to market participants, before the proposal or implementation of rules promulgated under DFA. The imposition of unnecessary costs and restrictions on market participants can only result in the stifling of growth of the U.S. futures industry, send market participants to overseas exchanges, and in the end, result in harm to the U.S. economy and loss of American jobs. We urge the Congress to ensure that implementation of DFA is consistent with the Congressional directives in the Act and does not unnecessarily harm hedging and risk transfer markets that U.S. companies depend upon to reduce business risks and increase economic growth.

APPENDIX

CONCERNS REGARDING SPECIFIC RULEMAKINGS

We are concerned that many of the Commission's proposed rulemakings go beyond the specific mandates of DFA, and are not legitimately grounded in evidence and economic theory. I will now address, in turn, several proposed rules issued by the Commission that illustrate these problems.

1. Advance Notice of Proposed Rulemaking on Protection of Cleared Swaps Customers Before and After Commodities Broker Bankruptcies[3]

In its Advanced Notice of Proposed Rulemaking (ANPR) regarding segregation of customer funds, the Commission notes that it is considering imposing an "individual segregation" model for customer funds belonging to swaps customers. Such a model would impose unnecessary costs on derivatives clearing organizations (DCOs) and customers alike. As noted in the ANPR, DCOs have long followed a model (the "baseline model") for segregation of collateral posted by customers to secure contracts cleared by a DCO whereby the collateral of multiple futures customers of a futures commission merchant (FCM) is held together in an omnibus account. If the FCM defaults to the DCO because of the failure of a customer to meet its obligations to the FCM, the DCO is permitted (but not required), in accordance with the DCO's rules and CFTC regulations, to use the collateral of the FCM's other futures customers in the omnibus account to satisfy the FCM's net customer futures obligation to the DCO. Under the baseline model, customer collateral is kept separate from the property of FCMs and may be used exclusively to "purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers."[4] A DCO may not use customer collateral to satisfy obligations coming out of an FCM's proprietary account.

In its ANPR, the Commission suggests the possibility of applying a different customer segregation model to collateral posted by swaps customers, proposing three separate models, each of which requires some form of "individual segregation" for customer cleared-swap accounts. Each of these models would severely limit the availability of other customer funds to a DCO to cure a default by an FCM based on the failure of a customer to meet its obligations to the DCO. The imposition of any of these alternative models first, is outside of the Commission's authority under DFA and second, will result in massive and unnecessary costs to DCOs as well as to customers—the very individuals such models are allegedly proposed to protect.

[3] 75 Fed. Reg. 75162 (proposed Dec. 2, 2010) (to be codified at 17 C.F.R. pt. 190).
[4] *See,* Reg. 1.20(a).

CME Group recognizes that effective protection of customer funds is, without a doubt, critical to participation in the futures and swaps markets. This fact does not, however, call for a new segregation regime. The baseline model has performed this function admirably over the years, with no futures customers suffering a loss as a result of an FCM's bankruptcy or default. There is no reason to believe it will not operate as well in the swaps market. DFA did nothing to change this segregation regime as applied to futures, and a focus of Dodd-Frank is to bring the OTC swaps market into a regulatory scheme similar to that which allowed the futures markets to function flawlessly throughout the financial crisis. To this end, it is nonsensical that Congress would intend to require a different scheme of segregation of customer funds and as a result, a different margining and default model than that currently used in the futures markets. Imposing such a conflicting model would complicate the function of DCOs intending to clear both futures and swaps. Indeed, the statutory language adopted in Section 724 of DFA does nothing to compel such a result.

The imposition of a different customer segregation system could undermine the intent behind DFA by imposing significantly higher costs on customers, clearing members, and DCOs intending to clear swaps and injecting moral hazard into a system at the customer and FCM levels. A change from the baseline model would interfere with marketplace and capital efficiency as DCOs may be required to increase security deposits from clearing members. That is, depending on the exact methodology employed, DCOs may be forced to ask for more capital from clearing members. Based on CME Group's initial assessments, these increases in capital requirements would be substantial. For example, CME Group's guarantee fund would need to double in size. Aside from these monetary costs, adoption of a segregation model would create moral hazard concerns at the FCM level. That is, the use of the new proposed models could create a disincentive for an FCM to offer the highest level of risk managements to its customers if the oversight and management of individual customer risk was shifted to the clearinghouse and continue to carry the amount of excess capital they do today.

Imposition of the suggested systems could increase costs and decrease participation in the CFTC-regulated cleared-swaps market because customers may be unable or unwilling to satisfy resultant substantially increased margin requirements. FCMs would face a variety of increased indirect costs, such as staffing costs, new systems and compliance and legal costs and direct costs such as banking and custodial fees. FCMs would likely, in turn, pass these costs on to customers. Additionally, smaller FCMs may be forced out of business, larger FCMs may not have incentive to stay in business, and firms otherwise qualified to act as FCMs may be unwilling to do so due to the risk and cost imposed upon the FCM model by individualized segregation. This could lead to a larger concentration of customer exposures at fewer FCMs, further increases to margin and guarantee fund requirements, and further increased costs to customers. All of these consequences would lead to decreased participation in U.S. futures and swaps exchanges and result in loss of jobs in the United States.

2. Proposed Rulemaking on Position Limits[5]

A prime example of a refusal to regulate in strict conformance with DFA, is the Commission's proposal to impose broad, fixed position limits for all physically delivered commodities. The Commission's proposed position limit regulations ignore the clear Congressional directives, which DFA added to Section 4a of the CEA, to set position limits "as the Commission finds are necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of" a commodity.[6] Without any basis to make this finding, the Commission instead justified its position limit proposal as follows:

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

[5] 76 Fed. Reg. 4752 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 1, 150–151).

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

> 4752 at 4754 (January 26, 2011), Position Limits for Derivatives. (Emphasis supplied.)

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

> Despite what some believe is a mandate for the commission to set position limits within a definite period of time, the Dodd-Frank legislation actually qualifies CFTC's position-limit authority. Section 737 of the Dodd-Frank act amends the Commodity Exchange Act so that Section 4A–A2A states, "The commission shall, by rule, establish limits on the amount of positions as appropriate." The act then states, "In subparagraph B, for exempt commodities, the limit required under subparagraph A shall be established within 180 days after the date of enactment of this paragraph." When subparagraphs A and B are read in conjunction, the act states that when position limits are required under subparagraph A, the commission shall set the limits within 180 days under paragraph B. Subparagraph A says the position-limit rule should be only prescribed when appropriate.
>
> Therefore, the 180-day timetable is only triggered if position limits are appropriate. In regard to the word "appropriate," the commission has three distinct problems. First, the commission has never made an affirmative finding that position limits are appropriate to curtail excessive speculation. In fact, to date, the only reports issued by the commission or its staff failed to identify a connection between market trends and excessive speculation. This is not to say that there is no connection, but it does say the commission does not have enough information to draw an affirmative conclusion.
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> The second and third issues relating to the appropriateness of position limits are regulated to adequacy of information about OTC markets. On December 8, 2010, the commission published a proposed rule on swap data record keeping and reporting requirements. This proposed rule is open to comment until February 7, 2011, and the rule is not expected to be final and effective until summer at the earliest. Furthermore, the commission has yet to issue a proposed rulemaking about swap data repositories. Until a swap data repository is set up and running, it is difficult to see how it would be appropriate for the commission to set position limits.

CME is not opposed to position limits and other means to prevent market congestion; we employ limits in most of our physically delivered contracts. However, we use limits and accountability levels, as contemplated by the Congressionally approved Core Principles for DCMs, to mitigate potential congestion during delivery periods and to help us identify and respond in advance of any threat to manipulate our markets. CME Group believes that the core purpose that should govern Federal and exchange-set position limits, to the extent such limits are necessary and appropriate should be to reduce the threat of price manipulation and other disruptions to the integrity of prices. We agree that such activity destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery and we have the greatest incentive and best information to prevent such misconduct.

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

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

3. Proposed Rulemaking on Mandatory Swaps Clearing Review Process[7]

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

This proposed regulation is one among several proposals that impose costs and obligations whose effect and impact are contrary to the purposes of Title VII of DFA. The costs in terms of time and effort to secure and present the information required by the proposed regulation would be a significant disincentive to DCOs to voluntarily undertake to clear a "new" swap. The Commission lacks authority to transfer the obligations that the statute imposes on it to a DCO. The proposed regulation eliminates the possibility of a simple, speedy decision on whether a particular swap transaction can be cleared—a decision that the DFA surely intended should be made quickly in the interests of customers who seek the benefits of clearing—and forces a DCO to participate in an unwieldy, unstructured, and time-consuming process to determine whether mandatory clearing is required. Regulation Section 39.5(b)(5) starkly illustrates this outcome. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. Completion is determined in the sole discretion of the Commission. Only then does the 90-day period begin to run. This process to enable an exchange to list a swap for clearing is clearly contrary to the purposes of DFA.

4. Conversion From Principles-Based to Rules-Based Regulation[8]

Some of the CFTC's rule proposals are explained by the ambiguities created during the rush to push DFA to a final vote. For example, Congress preserved and expanded the scheme of principles-based regulation by expanding the list of core principles and granting self regulatory organizations "reasonable discretion in establishing the manner in which the [self regulatory organization] complies with the core principles." Congress granted the Commission the authority to adopt rules respecting core principles, but did not direct it to eliminate the principles-based regulation, which was the foundation of the CFMA. In accordance with CFMA, the CFTC set forth "[g]uidance on, and Acceptable Practices in, Compliance with Core Principles" that operated as safe harbors for compliance. This approach has proven effective and efficient in terms of appropriately allocating responsibilities between regulated DCMs and DCOs and the CFTC.

We recognize that the changes instituted by DFA give the Commission discretion, where necessary, to step back from this principles-based regime. Congress amended the CEA to state that boards of trade "shall have reasonable discretion in establishing the manner in which they comply with the core principles, unless otherwise determined by the Commission by rule or regulation. *See, e.g.,* DFA §735(b), amending Section 5(d)(1)(B) of the CEA. But the language clearly assumes that the principles-based regime will remain in effect except in limited circumstances in which more specific rules addressing compliance with a core principle are necessary. The Commission has used this change in language, however, to propose specific requirements for multiple Core Principles—almost all Core Principles in the case of

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

DCMs—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

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

Further, the principles-based regime of the CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearinghouses permitted U.S. exchanges to regain their competitive position in the global market. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA. Indeed, U.S. futures exchanges have operated more efficiently, more economically and with fewer complaints under this system than at any time in their history. The transition to an inflexible regime threatens to stifle growth and innovation in U.S. exchanges and thereby drive market participants overseas. This, I noted earlier, will certainly impact the relevant job markets in the United States.

(a) Proposed Rulemaking Under Core Principle 9 for DCMs

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

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

The Commission justifies the 85 percent requirement only with its observations as to percentages of various contracts traded on various exchanges. It provides no support evidencing that the requirement will provide or is necessary to provide a "competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade," as is required under Core Principle 9. Further, Core Principle 9, as noted above, expressly permits DCMs to authorize off-exchange transactions including for exchanges to related positions pursuant to their rules.

The imposition of the proposed 85 percent exchange trading requirement will have extremely negative effects on the industry. It would significantly deter the development of new products by exchanges like CME. This is because new products generally initially gain trading momentum in off-exchange transactions. Indeed, it takes years for new products to reach the 85 percent exchange trading requirement proposed by the Commission. For example, one suite of very popular and very liquid foreign exchange products developed and offered by CME would not have met the 85 percent requirement for 4 years after it was initially offered. The suite of products' on-exchange trading continued to increase over 10 years, and it now trades only 2 percent off exchange. Under the proposed rule, CME would have had to delist this suite of products.[9]

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

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

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

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

5. Provisions Common to Registered Entities[10]

The CFMA streamlined the procedures for listing new products and amending rules that did not impact the economic interests of persons holding open contracts. These changes recognized that the previous system required the generation of substantial unnecessary paperwork by exchanges and by the CFTC's staff. It slowed innovation without a demonstrable public benefit.

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

Self-certification has been in effect for 10 years and nothing has occurred to suggest that this concept is flawed or that registered entities have employed this power recklessly or abusively. During 2010, CME launched 438 new products and submitted 342 rules or rule amendments to the Commission. There was no legitimate complaint respecting the self-certification process during this time. Put simply, the existing process has worked, and there is no reason for the Commission to impose additional burdens, which are not required by DFA, to impair that process.

Section 745 of DFA merely states, in relevant part, that "a registered entity may elect to list for trading or accept for clearing any new contract, or other instrument,

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

[10] 75 Fed. Reg. 67282 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pt. 40)

or may elect to approve or implement any new rule or rule amendment, by providing to the Commission a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act)." DFA does not direct the Commission to require the submission of all documents supporting the certification nor to require a review of the legal implications of the product or rule with regard to laws other than DFA. Essentially, it requires exactly what was required prior to the passage of DFA—a certification that the product, rule or rule amendment complies with the CEA. Nonetheless, the Commission has taken it upon itself to impose these additional and burdensome submission requirements upon registered entities.

The new requirements proposed by the CFTC will require exchanges to prematurely disclose new product innovations and consequently enable foreign competitors to introduce those innovations while the exchange awaits CFTC approval. This, again, inhibits the ability of U.S. exchanges to compete, drives market participants overseas and impairs job growth in the United States. Moreover, given the volume of filings required by the Notice of proposed rulemaking, the Commission will require significant increases in staffing and other resources. Alternatively, the result will be that these filings will not be reviewed in a timely manner, further disadvantaging U.S. exchanges. Again, we would suggest that the Commission's limited resources should be better aligned with the implementation of the goals of DFA rather than "correcting" a well-functioning and efficient process.

First, the proposed rules require a registered entity to submit "all documentation" relied upon to determine whether a new product, rule or rule amendment complies with applicable Core Principles. This requirement is so vague as to create uncertainty as to what is actually required to be filed. More importantly, this requirement imposes an additional burden on both registered entities, which must compile and produce all such documentation, and the Commission, which must review it. It is clear that the benefits, if any, of this requirement are significantly outweighed by the costs imposed both on the marketplace and the Commission.

Second, the proposed rules require registered entities to examine potential legal issues associated with the listing of products and include representations related to these issues in their submissions. Specifically, a registered entity must provide a certification that it has undertaken a due diligence review of the legal conditions, including conditions that relate to contractual and intellectual property rights. The imposition of such a legal due diligence standard is clearly outside the scope of DFA and is unnecessarily vague and impractical, if not impossible, to comply with in any meaningful manner. An entity, such as CME, involved in product creation and design is always cognizant that material intellectual property issues may arise. This requirement would force registered entities to undertake extensive intellectual property analysis, including patent, copyright, and trademark searches in order to satisfy the regulatory mandates, with no assurances that any intellectual property claim is discoverable through that process at a particular point in time. Again, this would greatly increase the cost and timing of listing products without providing any corresponding benefit to the marketplace. Indeed, the Commission itself admits in its NOPR that these proposed rules will increase the overall information collection burden on registered entities by approximately 8,300 hours per year. [11]

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

6. Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest[12]

The Commission's proposed rules regarding the mitigation of conflicts of interest in DCOs, DCMs, and SEFs (Regulated Entities) also exceed its rulemaking authority under DFA and impose constraints on governance that are unrelated to the purposes of DFA or the CEA. The Commission purports to act pursuant to Section 726 of DFA but ignores the clear boundaries of its authority under that section, which it cites to justify taking control of every aspect of the governance of those Regulated Entities. Section 726 conditions the Commission's right to adopt rules mitigating conflicts of interest to circumstances where the Commission has made a finding that

[11] 75 Fed. Reg. at 67290.

[12] 75 Fed. Reg. 63732 (proposed October 18, 2010) (to be codified at 17 C.F.R. pts. 1, 37, 38, 39, 40).

the rule is "necessary and appropriate" to "improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest in connection with a swap dealer or major swap participant's conduct of business with, a [Regulated Entity] that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment." (Emphasis added.) The "necessary and appropriate" requirement constrains the Commission to enact rules that are narrowly tailored to minimize their burden on the industry. The Commission failed to make the required determination that the proposed regulations were "necessary and proper" and, unsurprisingly, the proposed rules are not narrowly tailored but rather overbroad, outside of the authority granted to it by DFA and extraordinarily burdensome.

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

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

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

7. Prohibition on Market Manipulation[13]

The Commission's proposed rules on Market Manipulation, although arguably within the authority granted by DFA, are also problematic because they are extremely vague. The Commission has proposed two rules related to market manipulation: Rule 180.1, modeled after SEC Rule 10b-5 and intended as a broad, catch-all provision for fraudulent conduct; and Rule 180.2, which mirrors new CEA Section 6(c)(3) and is aimed at prohibiting price manipulation. See 75 Fed. Reg. at 67658. Clearly, there is a shared interest among market participants, exchanges and regulators in having market and regulatory infrastructures that promote fair, transparent and efficient markets and that mitigate exposure to risks that threaten the integrity and stability of the market. In that context, however, market participants also desire clarity with respect to the rules and fairness and consistency with regard to their enforcement.

As to its proposed Rule 180.1, the Commission relies on SEC precedent to provide further clarity with respect to its interpretation and notes that it intends to implement the rule to reflect its "distinct regulatory mission." However, the Commission

[13] 75 Fed.Reg. 67657-62 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pt. 180).

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

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

8. Antidisruptive Practices Authority Contained in DFA[14]

Rules regarding Disruptive Trade Practices (DFA Section 747) run the risk of being similarly vague and resulting in chilling market participation. The CFTC has recently issued a Proposed Interpretive Order which provides guidance regarding the three statutory disruptive practices set for in DFA Section 747.[15] CME Group applauds the Commission's decision to clarify the standards for liability under the enumerated disruptive practices and supports the Commission's decision to refrain from setting forth any additional "disruptive practices" beyond those listed in the statute. We believe, however, that in several respects, the proposed interpretations still do not give market participants enough notice as to what practices are illegal and also may interfere with their ability to trade effectively.

For example, the Commission interprets section 4c(a)(5)(A), Violating Bids and Offers, "as prohibiting any person from buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price" regardless of intent.[16] However, certain existing platforms allow trading based on considerations other than price. Without an intent requirement, these platforms do not "fit" under the regulations, and presumably will be driven out of business. Similarly, market participants desiring to legitimately trade on bases other than price will presumably be driven to overseas markets.

Further, the Commission states that section 4c(a)(5)(B), Orderly Execution of Transactions During the Closing Period, applies only where a participant "demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period." However, the Commission goes on to state that "market participants should assess market conditions and consider how their trading practices and conduct affect the orderly execution of transactions during the closing period." In so stating, the Commission seems to impose an affirmative obligation on market participants to consider these factors before executing any trade. This, first, directly conflicts with the scienter requirements also set forth by the Commission and thus interferes with the ability of market participants to determine exactly what conduct may give rise to liability. Second, such an affirmative obligation will interfere with the ability of market participants to make advantageous trades, especially in the context of a fast-moving, electronic trading platform. The end result of both these issues is that, if the Interpretive Order goes into effect as written, market participation will be chilled, participants will move to overseas markets and jobs will be lost in the U.S. futures industry.

[14] 75 Fed. Reg. 67301 (proposed November 2, 2010) (to be codified at 17 C.F.R. pt. 1).
[15] 76 Fed. Reg. 14943 (proposed March 18, 2011).
[16] 76 Fed. Reg. 14946 (proposed March 18, 2011).

Section 747 of DFA, which authorizes the Commission to promulgate additional rules if they are reasonably necessary to prohibit trading practices that are "disruptive of fair and equitable trading," is exceedingly vague as written and does not provide market participants with adequate notice as to whether contemplated conduct is forbidden. If the Interpretive Order does not clearly define "disruptive trade practices," it will discourage legitimate participation in the market and the hedging and price discovery functions of the market will be chilled due to uncertainty among participants as to whether their contemplated conduct is acceptable.

9. Effects on OTC Swap Contracts

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

PREPARED STATEMENT OF IAN AXE

CHIEF EXECUTIVE, LCH.CLEARNET GROUP LIMITED

APRIL 12, 2011

Chairman Johnson, Ranking Member Shelby, Members of the Committee, my name is Ian Axe and I am Chief Executive of LCH.Clearnet Group Ltd (the "Group"). On behalf of the Group, I would like to thank the Committee for asking me here today.

LCH.Clearnet is the world's leading independent clearinghouse group. Formed out of the merger of the London Clearing House Ltd and Clearnet SA, we continue to operate two clearinghouses, LCH.Clearnet Limited[1] in London and LCH.Clearnet SA[2] in Paris. Additionally we have a fast-growing presence in the U.S. to support our rapidly expanding U.S. swaps activity. We opened a New York office in late 2009 and staff numbers have since grown quickly. Our New York head count has already doubled in the year to date.

We are a user-owned, user-governed organization, being 83 percent owned by our clearing members, and 17 percent owned by exchanges such as the NYSE Euronext group. We have been clearing commodities for 120 years, and LCH.Clearnet Limited has been registered with and regulated by the Commodity Futures Trading Commission (CFTC) as a Derivatives Clearing Organization (DCO) since 2001. We serve major international exchanges and trading platforms, as well as a range of over-the-counter ("OTC" or "swaps") markets and we clear a broad range of asset classes, including cash equities, exchange-traded derivatives, energy, freight, interest rate swaps, and euro- and British pound-denominated bonds and repos.

OTC Clearing Expertise

LCH.Clearnet Limited pioneered the development of OTC clearing in 1999 with our SwapClear and RepoClear services, respectively the market-leaders in global interest rate swap and European repo clearing. In addition, our London arm clears a range of OTC freight, energy, and commodity products, while LCH.Clearnet SA clears European OTC index-based credit default swaps and repo products.

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[1] LCH.Clearnet Ltd. is regulated by, *inter alia,* the Financial Services Authority of the United Kingdom and by the Commodity Futures Trading Commission (as a "Derivatives Clearing Organization") of the United States.

[2] LCH.Clearnet SA is regulated as a Credit Institution and Clearing House by a regulatory college consisting of, amongst others, the market regulators and central banks from the jurisdictions of: France, Netherlands, Belgium, and Portugal. It is also regulated as a Recognized Overseas Clearing House by the U.K. Financial Services Authority.

LCH.Clearnet Limited currently clears over 50 percent of the global interest rate swap market. This represents trades with a total notional principal of over $276 trillion in 14 currencies with tenors out to as far as 50 years. Last year SwapClear cleared over 120,000 trades involving U.S. counterparties with a notional value in excess of $64 trillion. Of the total swaps portfolio cleared, approximately $91 trillion is in U.S. dollars.

We recently extended this capability to include a Futures Commission Merchant (FCM) clearing service for U.S. end user clients. We currently have 12 FCMs offering such services, and have since successfully cleared our first trades under the FCM structure.

We are working closely with market participants to expand our service in the U.S. and have set up formal working groups with FCMs and buyside firms. Our Buyside Advisory Committee meets monthly to discuss the development of the service. It comprises representatives from a number of large U.S. firms, including Citadel, BlackRock, the D.E. Shaw Group, the Federal Home Loan Banks, and Freddie Mac amongst others.

SwapClear is the largest swaps clearing service globally and is widely recognized as a major contributor to financial stability.[3] This important capability was put to the test during the collapse of Lehman Brothers. LCH.Clearnet Limited was required to default-manage Lehman Brothers' cleared portfolio of 66,000 interest rate swap trades across five major currencies, with a notional value in excess of $9 trillion. Together with SwapClear clearing members, who are contractually obligated to participate in the default management process and to bid in the ensuing auctions, LCH.Clearnet Limited successfully neutralized and sold off the entire swap portfolio.

The management of the default involved:

- At default (Monday, 15 September 2008) SwapClear clearing members seconded their experienced traders to work alongside LCH.Clearnet Limited's risk management team to execute hedges and to neutralize the market risk on the defaulter's portfolio. All participants adhered to strict confidentiality rules.
- Over the ensuing days, LCH.Clearnet Limited's risk position was constantly reviewed and recalibrated, and additional hedges were executed by the default management group in response to the changing portfolio and volatile market.
- From Wednesday, September 24 to Friday, October 3, competitive auctions of the five hedged currency portfolios were successfully completed and the group transferred all 66,000 trades to the successful bidders, all of whom were surviving SwapClear clearing members.

The success of the default management process was largely due to the strong commitment and contractual relationship between the SwapClear clearing members and LCH.Clearnet Limited. The process was wholly reliant on SwapClear clearing members' dedicated resources, including key and experienced front office, risk, and operations personnel who worked closely alongside the clearinghouse, in our offices.

LCH.Clearnet Limited used only 35 percent of Lehman Brothers' margin in managing the default and returned the remaining funds, in excess of $850 million, to their administrators. No LCH.Clearnet Limited counterparties incurred any loss as a result of the default, and the clearing services operated by the Group continued to function in full, with no disruption to member firms or clients, before, during or after the Lehman Brothers' default. The Group thereby fulfilled its commitment to its members, clients and the wider financial system by ensuring market integrity and providing much-needed stability at a critical juncture.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Group supported the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") because of the new law's provisions in Title VII designed to reduce risk and increase transparency in the OTC derivatives market through mandated clearing.

The Group strongly supports the policy goals underpinned by the Dodd-Frank Act, and believes that this important piece of legislation will do much to improve stability in the marketplace and much reduce the risk of the taxpayer funding further bailouts.

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[3] "Deciphering the 2007–08 Liquidity and Credit Crunch", Markus K. Brunnermeier, Princeton University, *Journal of Economic Perspectives,* May 2008: *http://www.newyorkfed.org/research/conference/2008/rmm/Brunnermeier.pdf*.

"New Developments in Clearing and Settlement Arrangements for OTC Derivatives", Committee on Payment and Settlement Systems, BIS, Basel; March 2007. Link: *http://www.bis.org/publ/cpss77.htm.*

In particular we welcome both stronger risk management and heightened financial standards for clearinghouses; a greater level of supervision for clearinghouses; mandatory clearing obligations and trade reporting requirements.

We have been following the U.S. rulemaking process closely, and applaud both the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) for the thoughtfulness and openness with which they have approached these important matters. We have been invited to participate in the Agencies' roundtables; have attended their open meetings; responded to their proposed rulemakings and met with their Commissioners.

At the same time we are directly involved in the legislative proposals in Europe and are closely following the development of the European Markets and Infrastructure Regulation (EMIR). The EMIR proposal, which governs clearinghouses and trade repositories, was put forward by the European Commission in September, and is now working its way through the European Parliament and Council.

We believe it is of paramount importance that the legislation and detailed rules emerging from the U.S. and EU, as well as the timetables for implementation and adherence, are as closely aligned as possible. This harmonization should ensure that: there is no opportunity for regulatory arbitrage; capital is able to flow freely and that economic recovery is not constrained.

Clearinghouses such as our own are global operations, supporting global markets. Divergences in risk standards for clearinghouses amongst key jurisdictions such as the U.S. and EU will likely lead to the balkanization of clearing; such an outcome would result in a significant increase in the amount of capital tied up in clearing and be prejudicial for the economy, for jobs and for the recovery.

While we have generally supported the rules promulgated by the CFTC and SEC and commend their efforts to remain in close dialogue with supervisors in the EU, we have been concerned by the emergence of some notable differences in their proposals to those under consideration in Europe.

Our three greatest areas of concern in this regard include the differences between the U.S. and Europe in rules governing: (1) the Mitigation of Conflicts of Interest; (2) Risk Management Requirements; and (3) Protection of Cleared Swaps.

Requirements Regarding the Mitigation of Conflicts of Interest

Sections 726(a) and 765 of the Dodd-Frank Act empower the CFTC and SEC to adopt rules mitigating conflicts of interest with respect to any DCO or Clearing Agency that clears swaps or security-based swaps. These rules may include numerical limits on the control of, or the voting rights with respect to, such a DCO or Clearing Agency by a specified market participant (Enumerated Entity).

LCH.Clearnet has long recognized that there are potential conflicts of interest in clearinghouses. Although LCH.Clearnet's substantial OTC derivatives clearing book plainly evidences the contrary, it is entirely possible that clearinghouse shareholders who deal in OTC derivatives may have an interest in seeing that the clearinghouse does not clear the instruments in which they deal. Equally, exchanges may have an interest in ensuring that a clearinghouse in which they are shareholders does not clear instruments traded on competing exchanges, execution facilities or in the OTC market. End users shareholders may meanwhile have an interest in ensuring that a clearinghouse keeps margin requirements and other associated costs artificially low.

In recognition of the potential conflicts, LCH.Clearnet's corporate charter prohibits any individual shareholder from exercising votes representing more than five percent of the shares in issue, even if a shareholder actually holds a number of shares amounting to more than 5 percent of the total number of shares in issue. This measure has effectively ensured that neither a single shareholder nor a small group of shareholders—whatever their origin or collective interests—has been able to dominate management of LCH.Clearnet's clearinghouses and determine their policies, such as which asset classes will be cleared.

At the same time, the direct involvement of market participants in our clearinghouses has facilitated innovation. Their expertise has directly contributed to our ability to develop complex and technically challenging services such as those we offer to the OTC marketplace. For this reason, we would caution that any regulation that limits the aggregate involvement of Enumerated Entities in clearinghouses might risk limiting innovation in OTC clearing, as well as stifling competition and increasing the cost of business in the U.S.

During passage of the Dodd-Frank Act, Congress correctly rejected the imposition of aggregate ownership and voting caps on clearinghouses. We have therefore been concerned to see proposals emerge from the Agencies [4] that would re-introduce such caps. Any such aggregate restriction on clearinghouse ownership or governance would, in our view, lead to increased cost, with no commensurate benefits. Rather, we believe that individual limitations on voting rights such as those already in place at LCH.Clearnet, coupled with the obligations to minimize and resolve conflicts of interest that clearinghouses will be subject to, [5] should be sufficient to allay concerns about corporate governance within clearinghouses.

Minimizing jurisdictional differences in rules such as those mitigating conflicts in clearinghouses will be key to keeping costs low and to reducing implementation challenges. In this regard we would respectfully observe that in Europe, where we have been closely tracking EMIR's progress through the legislature, there have been no proposals to attempt to limit clearinghouse ownership or voting rights by groups of entities—either from the European Commission, the European Parliament, or the European Council. Indeed, the restrictions on the ownership of shares or voting interests of the type proposed by the Agencies would likely be deemed contrary to the fundamental freedoms set out in the primary EU Treaty (the Treaty on the Functioning of the European Union, "TFEU"), in particular, those protecting the freedom of establishment and the free movement of capital. [6]

Risk Management Requirements

LCH.Clearnet acknowledges and endorses the Dodd-Frank requirement that clearinghouses permit "fair and open access."

The Group employs open and transparent membership eligibility criteria for each market that it clears. The criteria are approved by both our clearinghouses. Risk Committees and Boards of Directors, all of which are chaired by independent directors, and the criteria are subject to subsequent regulatory approval. We are committed to exploring all the ways in which we can expand our membership, whilst maintaining the highest standards of risk management and ensuring the safe and sound operation of our clearinghouses.

We have been concerned by the Agencies' proposed membership requirements for clearinghouses offering OTC clearing services. [7] The Agencies propose to enforce the separation of participation in clearinghouses from risk underwriting and default management responsibilities.

We have seen no such requirements in the European Commission's EMIR Proposal, nor during its subsequent passage through the European Parliament and European Council.

In our view, the SEC's and CFTC's proposed requirements for access to clearinghouses, whilst founded on important policy considerations, risk watering down our well-tested and proven default management processes, upon which the integrity of our clearinghouses depend.

Absent clear default management rules that ensure the protection of surviving members, clearinghouses such at our own would face significant technical challenges that would put at risk our ability to extend and develop our OTC clearing services. As such, the proposed rules would seem to run contrary both to the Agencies' intent and to their statutory and prudential responsibilities.

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[4] RIN 3038 AD01, "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest". RIN 3235-AK7, "Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with respect to Security-Based Swaps Under Regulation MC".

[5] CFTC Proposed Rule 39.25(a), 75 Fed.Reg. 63732, 63750 (October 18, 2010). There is a similar provision contained in SEC Proposed Rule 17Ad-25, 76 Fed.Reg. 14472, 14539 (March 16, 2011).

[6] The provisions of the TFEU relating to free movement of capital provide that "all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited." The EU's Supreme Court (the European Court of Justice, "ECJ") has consistently found that, for these purposes, capital movements include "direct investment in the form of participation in an undertaking by way of shareholding or the acquisition of securities on the capital market . . . and . . . the possibility of participating effectively in the management of a company or in its control."

The free movement of capital and freedom of establishment are fundamental tenets of the TFEU, and any exceptions to these rules would needs therefore to be justified by overarching public policy requirements. Moreover, the TFEU sets out that "only the Council, acting in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament, adopt measures which constitute a step backwards in Union law as regards the liberalization of the movement of capital to or from third countries." Accordingly, such an amendment would require unanimity amongst Member States.

[7] RIN 3038-AC98 Risk Management Requirements for Derivatives Clearing Organizations, 21 January 2011.

RIN 3235-AL13 Clearing Agency Standards for Operation and Governance, 3 March 2011.

In undertaking to clear certain swaps products, particularly those that are long-dated and less liquid than exchange-traded futures, a clearinghouse needs to rely on clearing member participation in the event of a default. We firmly believe that access criteria for OTC clearing members must be proportionate to the risk each member introduces into the system and should be contingent on default management and risk underwriting participation, such that the integrity of the clearinghouse is fully protected and there is no cost to or impact on other members, their customers or the wider financial system.

CPSS–IOSCO,[8] the global organization of securities and futures regulators, has recently endorsed this view. The March 2011 report by CPSS–IOSCO on Financial Market Infrastructures stipulates:

> An OTC derivatives CCP may need to consider requiring participants to agree in advance to bid on the defaulting participant's portfolio and, should the auction fail, accept an allocation of the portfolio. A CCP that employs such procedures should carefully consider, where possible, the risk profile and portfolio of the receiving participant before allocating positions so as to minimize additional risk for the surviving participant.[9]

In the interests of harmonization, we would also draw the Committee's attention to the submission made by the U.K.'s Financial Services Authority[10] to the CFTC on this matter. The letter stated:

> Risk management standards for CCPs must be anchored in the characteristics of the products being cleared, and the FSA recognizes that different product types may require different clearing models. This can extend to participant eligibility in models where the clearing members are required to perform specific actions to assist in a member default, for example Interest Rate Swap clearing models that include an obligation to bid for, or be allocated, portfolios from the defaulting clearing member.

SwapClear clearing members must be able to demonstrate that they can support a swaps book from a front office, risk, technology, and operations perspective. We rely on surviving clearing members: to be able to hedge a defaulting member's swaps portfolio; to provide liquidity for such hedging; to bid on hedged portfolios; and, if necessary, to accept a forced allocation of swaps.

LCH.Clearnet regularly tests and confirms that its clearing members maintain such a capability. This model was the basis upon which we successfully managed the Lehman Brothers default.

Upon reviewing the Agencies' proposed rules for access, we have asked ourselves whether the proposals would improve or reduce our ability to manage a large member or client default, and have concluded that such proposals still need work to ensure they would not be detrimental to our ability to do so.

Our SwapClear membership is expanding continually, and now includes 50 direct clearing members from North America, Europe, and Asia. In addition, we recently extended this capability to include an FCM clearing service for U.S. end users, and have since successfully cleared our first trades under the FCM structure. Firms that do not meet our direct membership criteria, or do not wish to commit to the risk underwriting and default management responsibilities, are thus able to access the clearinghouse under the full protections of the well-proven FCM structure.

We are open to keeping our SwapClear admission criteria under constant review and to materially modifying the current entry requirements for members. Provided that potential members prove they have the required risk underwriting and default management capabilities and commit to full participation in both, we will welcome their entry.

Futurization of Swaps

The Group has a number of concerns regarding the apparent "futurization" of Swaps in the provisions set out by the CFTC in its Risk Management Requirements Rules for DCOs[11] and other proposed rulemakings.

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[8] Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions (CPSS–IOSCO).

[9] Principles for Financial Market Infrastructures CPSS–IOSCO Consultative Report, March 2011 (p. 64).

[10] *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31986&SearchText=*

[11] RIN 3038-AC98 Risk Management Requirements for Derivatives Clearing Organizations, 21 January 2011.

Among other requirements, the CFTC proposes that DCOs use a margining methodology that is ill-suited and inefficient for swaps clearing. Again there has been no evidence of such requirements in Europe.

In this regard we would respectfully point to the recent report from CPSS–IOSCO. This explicitly recognizes that swaps have unique characteristics, which may require clearinghouses to employ different risk management methods than they would for futures or cash instruments.

The CPSS–IOSCO report said:

> In addition to typical risk-management tools used by CCPs in listed markets, CCPs in OTC derivatives markets may employ other risk-management processes designed for the unique risks of the cleared OTC derivatives product. Participant requirements, margin requirements, financial resources and default procedures are particular areas where a CCP may need to consider additional tools tailored for OTC derivatives markets.

Protection of Cleared Swaps

The CFTC recently sought comment [12] through an Advanced Notice of Proposed Rulemaking (ANPR) on the most appropriate customer protection regime for cleared swaps. In our view the introduction of a customer protection model that insulates clients from such fellow-customer risk would best uphold one of the key aims of the Act—that of protecting consumers. It would also ensure that the protections and safeguards afforded to the U.S. client base are at least as strong as those that will be offered to customers in Europe, as required under EMIR. [13]

In the ANPR consultation the CFTC asked respondents which of four client protection models would be most appropriate for customers clearing swaps. [14] As LCH.Clearnet stated in its response to the ANPR, [15] we believe that customers should above all be able to preserve the collateral protections they are offered in the bilateral uncleared swaps environment.

Under current bilateral swaps market practice, some clients are able to negotiate for individual segregation of collateral that they post as margins. The collateral posted by clients that have made such arrangements, although subject to other risks, is not subject to the risk of the default of other market participants that have entered into transactions with their swaps counterparts. These clients—many of them pension funds, long-term savings institutions, Government and related fiscal authorities and other real money investors—believe it is inappropriate that they should be subject to an additional risk (that of fellow-customers) when clearing their swaps positions.

At the specific request of customers in Europe, LCH.Clearnet has developed a client clearing model that protects nondefaulting clients from the risks of defaulting clients. We believe that this client-clearing model is closely aligned to one of the models proposed by the Commission in its ANPR, Option 2, or "Legal Segregation With Commingling."

This model improves on the protections afforded in the bilateral swaps marketplace, by enabling the clearinghouse to offer clients portability of swaps margin-related collateral and market risk positions in the event of a clearing member's default. It is structured so as to enable the clearinghouse to identify and cover the risks associated with an individual customer's portfolio as if the clearinghouse were required to take on its management in isolation, as could happen in the event of a member default. This construct also enables the clearinghouse to monitor client profiles individually and to maximize the likelihood of the transfer of such clients' risks and positions in the event of their clearing member(s) defaulting.

Having implemented the above outlined model in Europe, the Group is confident that it gives rise to no further costs than the CFTC's other proposed models, either at the clearinghouse or at the clearing member level.

Further, LCH.Clearnet can confirm that the implementation of this clearing model has not changed the structure of resources that protect the clearinghouse following a default; it has not required an increase in margin collateral levels, nor has it caused the clearinghouse to raise clearing member contributions to the default fund.

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[12] RIN 3038–AD99 Protection of Cleared Swaps Customers Before and after Commodity Broker Bankruptcies, 2 December 2010.

[13] *http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf,* Article 37.

[14] Option (1) Full Physical Segregation; Option (2) Legal Segregation with Commingling; Option (3) Moving Customers to the Back of the Waterfall; Option (4) Baseline Model.

[15] *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27157&SearchText=*

LCH.Clearnet looks forward to extending its existing SwapClear client clearing service to U.S. end users under the well-proven FCM structure. At the same time, we believe that the important client protection mechanisms outlined above and described the CFTC in its ANPR under "Option 2, Legal Segregation with Comingling" would best preserve the interests of the investors and other clients clearing swaps through FCMs. The introduction of such client-level protections would also, we believe, ensure closer harmonization with those protections afforded in Europe.

Conclusion

As stated at the start of this testimony, LCH.Clearnet is supportive of the goals of the Dodd-Frank Act. We also believe that the CFTC and SEC have approached the rulemaking process with care and thoroughness, and commend the Commissioners and staff for their hard work.

We applaud the Agencies for their engagement with the industry and with authorities in the EU and further afield. Nonetheless, we do believe that it would be helpful to reconcile the differences between the U.S. and EU proposals, particularly with regard to: mitigation of conflicts of interest; risk management requirements; and the protection of cleared swaps, all of which we have outlined in this testimony.

We would respectfully urge the Committee to ensure that the final rules promulgated by the Agencies are aligned as closely as possible with those being finalized in the EU. Such a commonality of approach should reduce the cost of business, the tendency for regulatory arbitrage and the likelihood of flight of capital.

LCH.Clearnet looks forward to fulfilling its role in support of this important statutory initiative and to growing our U.S. operations so that more U.S. end users can benefit from the risk mitigation provided through our clearing services.

In closing, LCH.Clearnet would like to thank the Committee for inviting us to discuss the new derivatives regulatory framework. We appreciate the opportunity and the Committee's interest in our concerns.

PREPARED STATEMENT OF JENNIFER PAQUETTE

CHIEF INVESTMENT OFFICER, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION

APRIL 12, 2011

Thank you, Chairman Johnson and Ranking Member Shelby, for holding this hearing on the derivatives regulatory framework. As investors that utilize derivatives, we have a keen interest and I appreciate the opportunity to testify.

Before I begin, it might be helpful to provide some background on my investment experience and the organization I represent. I have worked for large investment managers and broker dealers in research, portfolio management, and institutional sales capacities. For the last 8 years, I have served as the Chief Investment Officer of the Colorado Public Employees' Retirement Association (COPERA). My remarks will include a brief overview of COPERA, our interest in the derivatives market and concerns we have regarding the Commodity Futures Trading Commission (CFTC) proposed rulemaking on Business Conduct Standards for Swap Dealers and Major Swap participants with Counterparties, RIN 3038-AD25.

COPERA and Derivatives

COPERA invests $39 billion in assets on behalf of almost half-a-million former and current employees of Colorado State government, public schools, universities, colleges, cities, and many units of local government. We manage this diversified, institutional portfolio with a long-term investment horizon which spans many decades. Investments include global stocks, bonds, real estate, alternatives, timber, and commodities and we use derivatives in a number of asset categories.

We employ derivatives in a number of ways. Global stock managers will use currency forwards to mitigate currency risk. Stock index futures are used to gain timely exposure to markets in support of our strategic objectives and to reduce risk. Total return swaps are utilized by bond managers to gain exposure to specific indexes and to enhance diversification.

For example, a bond manager may enter into a total return swap. In such a swap, COPERA would agree to pay a cash rate plus a spread in exchange for receiving the total return of a bond index for a specific time period. During that period, collateral would be posted as the value of the swap changes with the market. For a reasonable cost, COPERA would benefit from the diversification of a broad index without incurring the transaction costs of purchasing all the underlying index securities. A swap of this nature can help control risk in addition to enhancing the expression of our portfolio strategy.

While derivatives investments are modest in size compared to our overall market value, they are very helpful tools which we have used in our portfolio management process for many years. Current rule making is extensive and happening at a rapid pace. While I will share a few general comments before concluding, I would like to focus my testimony on proposed CFTC regulations on business conduct standards for swap dealers and major swap participants with counterparties.

Business Conduct Standards

CFTC proposals include public pension plans as a Special Entity. We are concerned that the proposed business conduct standards as they apply to a Special Entity could adversely affect pension plans like ourselves. In order for a Special Entity to enter into a swap, the swap dealer would need to have a reasonable basis to believe that the Special Entity has a representative that meets certain requirements. The objective may be to protect vulnerable or gullible parties in the swap market. While this may be well intentioned, it would create significant issues.

We are concerned that there is a conflict of interest for one of the parties to a transaction also being responsible for determining who is qualified to represent the other side of a transaction. Should a Special Entity be deemed to not have a qualifying representative, the swap dealer would need to have this determination reviewed by its Chief Compliance Officer. This appears to address concern that a Special Entity could be deemed unqualified in error but the assessment still remains with the Swap Dealer's organization. I am also concerned that this determination will not happen quickly enough in the context of trades that are sometimes done in a matter of hours. Finally, giving swap dealers veto ability may impair negotiations regarding transactions.

While it is difficult to know how this rule would work in practice, we are concerned that our pension plan could be a less desirable market participant due to potentially higher compliance costs and potential liability. We may be left to deal with less desirable counterparties, if we could find any at all to do business with.

In an effort to provide a constructive approach to the concerns raised, a number of public plans, representing $720 billion in assets under management, submitted a comment letter on February 18, 2011, to the Commodity Futures Trading Commission. I have attached the letter as an appendix for your consideration. In brief, the alternative approach would provide another supplemental way to meet the independent representative requirement. The Special Entity, or its advisor, would be able to voluntarily elect to undergo a certification process which would involve passage of a proficiency exam developed by the CFTC or by another organization as deemed appropriate.

Public plans have resources and expertise to manage their institutional assets. COPERA's team of investment professionals manage complex portfolios internally and oversee external investment managers. Like many of our peers, our investment staffs include those that have earned professional designations, are well educated and have many years of experience in the markets. We are knowledgeable about using derivatives to hedge certain investments and mitigate risk. We believe some modifications to the proposed rule as discussed in the letter would be beneficial to the retirement security of our members.

Closing Remark

We value the efforts of this Committee, regulatory entities and others involved in this comprehensive approach to improving derivatives regulation. These efforts to reduce risk and promote a healthy financial system are valuable and essential. Inviting and considering public comment on rule making, in addition to adequately resourcing and providing oversight to those charged with these important responsibilities, is in our collective best interests. On behalf of Colorado PERA, I thank you very much for the opportunity to speak with you today.

EXHIBIT A

February 18, 2011

By Hand Delivery

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Proposed Regulations on Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, RIN 3038 – AD 25

Dear Mr. Stawick:

I. INTRODUCTION

We are pleased to submit this comment letter, on behalf of the undersigned Public Pension Funds (Funds), who in aggregate represent $720 billion in assets under management, regarding the regulations proposed by the Commodity Futures Trading Commission (CFTC) on business conduct standards for swap dealers (SDs) and major swap participants (MSPs) with counterparties.[1] We have concerns with the proposed regulations; but, we have set forth a positive alternative proposal in this letter.

Our Funds are classified as governmental plans under Section 3 (32) of the Employee Retirement Income Security Act of 1974 (ERISA), and therefore come within the definition of a "Special Entity" under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which enacted a new Section 4s of the Commodity Exchange Act (CEA) that will become effective in July to govern the registration and regulation of SDs and MSPs. To fulfill obligations to our members, we invest in a wide variety of asset classes, including alternative investment management, global equity, global fixed income, inflation-linked assets, and real estate. As part of our investment and risk management policies, we have authorized the use of certain derivatives. The authorized derivatives include futures,

[1] 75 Fed. Reg. 80637 (December 22, 2010).

forwards, swaps, structured notes and options. Accordingly, we have an interest in the regulation of the swap market.

II. CURRENT PROPOSALS AND CONCERNS

The objective of protecting vulnerable or gullible parties in the swap market may be well-intentioned. However, the proposed business conduct standards for SDs and MSPs, as they would apply when SDs and MSPs deal with a Special Entity, could be wholly unworkable and adversely affect pension fund members. In particular, we are concerned about the proposed regulations that would require that an SD or MSP that offers to enter into, or enters into, a swap with a Special Entity have a reasonable basis to believe that the Special Entity has a representative who is independent of the SD or MSP and who meets certain other requirements.[2],[3] We are also concerned about the proposed regulations regarding: (1) the

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[2] Under Proposed Regulation 23.450, a SD or MSP must have a reasonable basis to believe that the Special Entity has a representative who is independent of the SD or MSP (although not necessarily independent of the Special Entity) and that:

(1) has sufficient knowledge to evaluate the transaction and risks;
(2) is not subject to statutory disqualification from registration applicable to futures professionals;
(3) undertakes a duty to act in the best interests of the Special Entity;
(4) makes appropriate and timely disclosures to the Special Entity; and
(5) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap.

[3] Proposed Regulation 23.450(d)(2) further proposes that an SD or MSP could rely upon representations made by the Special Entity about the independent representative, provided such representations are sufficiently detailed. Relevant considerations would include:

(1) The nature of the relationship between the Special Entity and the representative and the duties of the representative, including the obligation of the representative to act in the best interests of the Special Entity;
(2) The representative's capability to make hedging or trading decisions, and the resources available to the representative to make informed decisions;
(3) The use by the representative of one or more consultants;
(4) The general level of experience of the representative in financial markets and specific experience with the type of instruments, including the specific asset class, under consideration;
(5) The representative's ability to understand the economic features of the swap involved;
(6) The representative's ability to evaluate how market developments would affect the swap; and
(7) The complexity of the swap or swaps involved.

treatment of recommendations to counterparties, and (2) when SDs will be considered to be acting as an advisor to Special Entities.[4]

Although the CFTC proposals might appear to provide SDs and MSPs that would want to enter into swap transactions with Special Entities a means to do so, the process could be unworkable in some cases. Specifically, there is an inherent conflict of interest for one of the parties to a transaction also to be responsible for determining who might represent the other side of a transaction. The proposed independent representative requirement would give undue influence to an SD or MSP to determine who qualifies to fill that role.[5]

Swaps have not previously been subject to regulation in the United States, so there is a lack of precedents for parties and their counsel to rely upon in deciding whether particular transactions could be lawfully entered into. Certain of the proposed relevant terms, such as "best interests," "fair pricing," and "appropriateness," are quite vague. The SD or MSP would nonetheless be required to make judgments as to the competency of a particular representative, in effect performing functions customarily performed by a regulatory body or self-regulatory organization.

Moreover, the proposed solution to the inherent conflict of interest between an SD or MSP and a Special Entity, requiring the SD or MSP to make a written record of any determination that a person did not qualify as a representative and to submit such determination to its Chief Compliance Officer for review, is inadequate, because such a review will remain in-house at the SD or MSP without any independent analysis. SDs and MSPs would have substantial discretion in determining who qualifies as an independent representative and this could be exercised in a completely arbitrary fashion, leaving a Special Entity without recourse.

Separately, even those SDs and MSPs that would wish to comply with the CFTC's requirements in a conscientious manner may find the requirements vague and intrusive, forcing them to make very difficult judgments. The SDs and MSPs could be expected to at least pass on these extra compliance costs to the Special Entity in the price of their offers or, if they conclude that the potential liability is too great, simply not offer to deal with Special Entities at all with respect to those customized swaps that would not be traded on designated contract

[4] More specifically, Proposed Regulation 23.431 provides that, in the case of a high-risk bilateral swap, the SD provide a scenario analysis, designed with the counterparty, to allow the counterparty to assess its risks. However, by providing such a scenario analysis, the SD is at risk for running afoul of the requirements contained in Proposed Regulations 23.434 and 23.440, which, taken together, provide that an SD recommending a swap to a Special Entity is acting as an advisor to the Special Entity.

[5] 75 Fed. Reg. 80637, 80653 & n.127.

markets or swap execution facilities.[6] Therefore, in the guise of attempting to protect a Special Entity, the proposed regulations may make it impractical for SDs and MSPs to deal with Special Entities due to the increased and unquantifiable risks, additional costs and other burdens involved. SDs and MSPs would be encouraged to take their business to end users or other entities that are not Special Entities, because off-exchange transactions with entities other than Special Entities would provide greater legal certainty and be less costly and cumbersome to complete. Special Entities would be left to deal with less desirable counterparties, if they could find any at all. In the case of our Funds, this could result in dramatically limiting the ability to enter into certain swaps that may benefit our portfolios and the interests of our members.

Therefore, we respectfully request that the CFTC consider an alternative approach that would achieve the same goal without causing undue hardship to entities like us and our members. The alternative approach is outlined below.

III. ALTERNATIVE APPROACH

We respectfully request that the CFTC consider an alternative approach to the independent representative issue. The alternative approach would provide another, supplemental way to meet the independent representative requirements. Under the proposal that we are putting forward, the Special Entity would be able to elect, on an entirely voluntary basis, whether it relies on the framework set forth in the CFTC proposed regulation or the alternative approach outlined below.

Under the alternative approach, SDs and MSPs would be permitted to enter into off-exchange swap transactions with a Special Entity so long as the Special Entity had a representative, either internally or at a third-party, certified as able to evaluate swap transactions. The SD and MSP would be permitted to rely on the certification broadly for all aspects of the transaction with the Special Entity.[7] Further, this would eliminate possible confusion among

[6] Proposed Regulation 23.450, pursuant to paragraph (g) thereof, would not apply to a swap that is initiated on a designated contract market or swap execution facility where the SD or MSP does not know the identity of the Special Entity.

[7] For example, as noted previously, by providing the scenario analysis in the case of a high-risk bilateral swap as required in Proposed Regulation 23.431, an SD could run afoul of the requirements contained in Proposed Regulations 23.434 and 23.440, which, taken together, provide than an SD recommending a swap to a Special Entity is acting as an advisor to the Special Entity. Under the alternative approach, the SD would be permitted to rely on the certification of the independent representative for the purposes of these requirements. Consequently, because the representative is able to independently assess the information, communications between the SD and the certified independent representative would not be a recommendation.

SDs and MSPs about the extent to which they can rely upon the representations from a Special Entity.

This certification process would involve passage of a proficiency examination to be developed by the CFTC or by an appropriate self-regulatory organization, such as the National Futures Association (NFA) or another recognized testing organization. To maintain the status of a certified independent representative after passing the examination, the person would be required to complete periodic ethics training, similar to that required of registrants.[8] These requirements are intended to be in furtherance of Dodd-Frank and the proposed regulation.

Under the alternative approach, the requirement to be independent of an SD or MSP would remain. However, persons employed by a Special Entity that have extensive experience in the swaps and other financial markets could presumably qualify for the certification and thus not be blocked from serving as an independent representative by an SD or MSP. The alternative approach would be voluntary, so no person would be forced to take a test to serve as an independent representative.

This alternative approach is within the CFTC's authority. Dodd-Frank Section 731 requires SDs and MSPs to comply with any duty established by the CFTC for an SD or MSP with respect to a counterparty that is an eligible contract participant (ECP) within the meaning of subclause (I) or (II) of clause (vii) of CEA Section 1a(18). That clause of the ECP definition, which was amended by Dodd-Frank, relates to government entities. It is the *preceding* clause of the ECP definition that refers to a government employee benefit plan and other pension plans. Although it is unclear that the CFTC has authority to adopt any requirements with respect to independent representatives of a government plan, the CFTC appears to have relied upon a phrase in the Joint Explanatory Statement of the Committee of Conference on Dodd-Frank that refers to "pension funds" as its authority for the proposals regarding independent representatives of Special Entities. However, even pension funds are separately denoted from government plans under the Dodd-Frank Special Entity definition,[9] and the Joint Explanatory Statement is clearly at odds with the plain and very detailed statutory provision. This statutory construction certainly leaves open to substantial question whether proposed Regulation 23.450 should apply to government plans at all, strengthening the case for an alternative approach.[10] Additionally and by way of background, the CFTC

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[8] *See* Appendix B to Part 3 of the CFTC's Regulations – Statement of Acceptable Practices With Respect To Ethics Training.

[9] CEA Section 4s(h)(2)(C)(iii) and (iv), which are tracked in proposed Regulation 23.401 as paragraphs (3) and (4) under the proposed regulatory definition of the term "Special Entity."

[10] 75 Fed. Reg. 80637, 80651 & nn.106 and 107. As was noted when ERISA was adopted, "State and local governments must be allowed to make their own determination of the best method to protect the pension rights of municipal and state employees. These are questions of state and local sovereignty and the Federal government should not interfere." I Legislative

David A. Stawick
February 18, 2011
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has similarly provided for an alternative approach in the case of introducing brokers (IBs), which can be analogized to the proposed alternative approach for certification of independent representatives.[11]

We envision our recommendation for a process to certify independent representatives through testing and training, bringing greater legal certainty to the interaction of SDs, MSPs and entities like us without giving any party undue influence over the other.

IV. CONCLUSION

We believe we have outlined a reasonable alternative to what could be unworkable proposals regarding independent representatives for Special Entities. We fully understand that it will take time to create the testing framework discussed above, so should the proposal advance, it may be necessary to delay the effective date of the independent representative provision of the regulations to permit implementation of the alternative approach.

We would welcome the opportunity to discuss this alternative recommendation in greater detail with Commissioners and staff at your convenience. Please feel free to contact Anne Simpson of CalPERS at 1-916-795-9672 if you have any questions or wish to discuss this matter further.

History of the Employee Retirement Income Security Act of 1974, 97th Cong., 2d Sess. 224 (Comm. Print 1976). This rationale was also cited by the CFTC when it excluded governmental plans from the definition of commodity pools under CFTC Regulation 4.5. *Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements*, 50 Fed. Reg. 15868 (April 23, 1985), *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. CCH ¶22,550, at 30,376.

[11] The IB registration category was created by Congress as part of the CFTC's reauthorization in 1982. One aspect of those amendments authorized the CFTC to adopt minimum financial requirements for IBs and, in 1983, the CFTC proposed minimum adjusted net capital requirements for IBs, requiring all IBs to maintain their own amount of highly liquid assets. Many IBs, which had previously operated as "agents" of futures commission merchants (FCMs), commented that they would be unable to meet the proposed requirements and would be forced out of business. Several FCMs that had used extensive networks of these former "agents" suggested that they be permitted to guarantee the obligations of IBs under the CEA in lieu of IBs being required to maintain their own capital. This "alternative" minimum capital requirement resulted in the CFTC developing a standard form guarantee agreement between an FCM and an IB that has proven to be very successful and the preferred method of operation by IBs (approximately two-thirds of IBs conduct business this way). The CFTC could rely upon the resources of FCMs to back up IBs in most cases, and those FCMs that wished to use IBs extensively could do so with a guarantee agreement, which was voluntary for both sides, in effect a win-win-win situation.

Sincerely,

Joseph A. Dear
Chief Investment Officer
California Public Employees'
Retirement System

Craig A. Husting
Chief Investment Officer
Public School & Education Employees'
Retirement System of Missouri

Alan H. Van Noord
Chief Investment Officer
Pennsylvania Public School Employees'
Retirement System

Charles W. Grant
Chief Investment Officer
Virginia Retirement System

Timothy Walsh
Chief Investment Officer
New Jersey Division of Investments

Robert V. Newman
Executive Director
Utah Retirement Systems

Rick Dahl
Chief Investment Officer
Missouri State Employees'
Retirement System

Robert L. Borden
Chief Executive Officer
South Carolina Retirement
System Investment Commission

Keith Bozarth
Executive Director
State of Wisconsin Investment
Board

Jennifer Paquette
Chief Investment Officer
Colorado PERA

Ronnie Jung
Executive Director
Teacher Retirement System
of Texas

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM MARY L. SCHAPIRO

Q.1. How will market data provided through swap data repositories be used to inform your rulemaking about appropriate block trade rules and reporting requirements?

A.1. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARY L. SCHAPIRO

Q.1. Numerous public commenters have expressed their concerns that there may be conflicting regulations related to similar products. For example, the proposed block trade regulation is different for CFTC-regulated swaps and SEC-regulated securities-based swaps. The CFTC proposal included tests to determine block trades, while the SEC proposal asks for public comment on what the definition of a block trade should be. How will you reconcile these differences? Should similar products, such as index and single-name CDS, be treated differently?

A.1. Response not provided.

Q.2. At the hearing, you noted that some differences between the two Commissions' rules may be appropriate given differences in the nature of the products that you regulate. If the SEC and CFTC were merged, as some have recommended, would product differences necessitate two different regulatory frameworks for swap execution facilities?

A.2. Response not provided.

Q.3. How is your agency leveraging human and information technology resources from other domestic regulators? How is your agency leveraging human and technology resources from oversees regulators? How is your agency leveraging existing private industry technologies?

A.3. Response not provided.

Q.4. A frequently stated concern is that the rulemaking process has been very haphazard and uncoordinated. Market participants feel limited in their ability to comment on particular rules without understanding the bigger picture. Would it make sense for the Securities and Exchange Commission and the Commodity Futures Trading Commission to jointly propose and put out for public comment a plan for reproposing and adopting rules?

A.4. Response not provided.

Q.5. Chairman Schapiro's testimony stated that "As we move toward adoption the objective of consistent and comparable requirements will continue to guide our efforts [to coordinate with the CFTC and other regulators]." Given the fact that so many of the SEC's proposed rules differ substantially from the CFTC's proposed rules on the same issue, please explain how you will accomplish this objective? Will harmonization require one or both of your agencies tor repropose certain rules?

A.5. Response not provided.

Q.6. Does the Commission need additional statutory authority in order to allow market participants to continue to legally engage in swap transactions pending exemption of final rules?

A.6. Response not provided.

Q.7. Chairman Schapiro, you have been asked previously whether you think that you need more time to adopt derivatives rules. Neither you nor Chairman Gensler has clearly requested more time, but both of you have indicated that you will not be able to comply with the statute's July rulemaking deadline. Why don't you simply ask Congress for more time? Would extending the rulemaking deadline allow for easier coordination with the Europeans, who are not attempting to hold themselves to the same timeline?

A.7. Response not provided.

Q.8. How does your agency define the term "clearing" with respect to swaps (or security-based swaps)? Which activities are encompassed within that definition?

A.8. Response not provided.

Q.9. Swap data repositories and security-based swap data repositories may not share information with regulators other than their primary regulator unless they obtain an indemnification agreement. Please describe how this provision would work in practice. Are there any issues that would impede the implementation of this provision?

A.9. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM MARY L. SCHAPIRO

Q.1. On April 12, the banking regulators released their proposal on "Margin and Capital Requirements for Covered Swap Entities." The proposal requires dealer banks and significant counterparties to post two way initial margin and to hold that margin at third party custodian banks. This margin would be limited to immediately available cash funds and high-quality, highly liquid U.S. Government and agency obligations. Re-hypothecation of such amounts would be prohibited. What are the costs associated with tying up margin in segregated accounts at custodian banks? Have you quantified the impact this requirement will have on liquidity?

A.1. Response not provided.

Q.2. The margin and capital requirements proposal takes a risk-based approach by distinguishing between four separate types of derivatives counterparties. The proposal extends the definition of financial end user to include any government of any foreign country or any political subdivision, agency, or instrumentality thereof in the world. How would margin and capital requirements apply to the dealings of the foreign subsidiary of a U.S. financial institution that enters into a swap? What about a U.S. financial institution that enters into a swap with a foreign government? Would the foreign subsidiary of a U.S. institution that enters into a swap with a foreign government be required to post margin in U.S. Treasuries?

A.2. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM GARY GENSLER

Q.1. How will market data provided through swap data repositories be used to inform your rulemaking about appropriate block trade rules and reporting requirements?

A.1. On December 7, 2010, the Commission proposed regulations relating to the Real-time Reporting of Swap Transaction Data. Under the proposed rule, swap data repositories would use a two-pronged formula to calculate the appropriate minimum block trade sizes for certain categories of swaps. Minimum block trade sizes would be reevaluated on an annual basis based on swap transaction data received over the previous year. Those swaps that have a notional size above the minimum notional or principal amount determined by a swap data repository would be subject to a time delay in reporting. The Commission has received public comments on the proposed rule and will move forward to consider a final rule after staff has had the opportunity to summarize them for consideration and after Commissioners are able to discuss them and provide feedback to staff.

Q.2. Will the margin rules proposed this morning (April 12, 2011) at the FDIC on behalf of the prudential regulators and at the CFTC require commercial end users to post margin directly to swap dealers beyond what would ordinarily be required by current swap dealer practices of mitigating counterparty exposure? If so, what role will the prudential regulators and the CFTC play in both establishing and supervising these credit thresholds going forward? Additionally, how do the prudential regulators and the CFTC define noncash collateral that could be used to satisfy end user margin requirements?

A.2. To ensure the financial integrity of swap dealers and security-based swap dealers, Congress directed that prudential regulators, the SEC, and the CFTC to establish capital and margin requirements. The CFTC's proposed rule would not require margin for uncleared swaps to be paid or collected on transactions involving nonfinancial end users hedging or mitigating commercial risk.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM GARY GENSLER

Q.1. How does your agency define the term "clearing" with respect to swaps (or security-based swaps)? Which activities are encompassed within that definition?

A.1. The Dodd-Frank Wall Street Reform and Consumer Protection Act defines the term "cleared swap" to mean any swap that is, directly or indirectly, submitted to and cleared by a derivatives clearing organization (DCO) registered with the Commodity Futures Trading Commission (CFTC). Under the Commodity Exchange Act, a DCO enables each party to the agreement, contract, or transaction to substitute the credit of the DCO for the credit of the parties. The DCO also mutualizes or transfers credit risk among DCO participants by providing, on a multilateral basis, for the settlement or netting of obligations resulting from such agreements, contracts, or transactions.

Q.2. Swap data repositories and security-based swap data repositories may not share information with regulators other than their primary regulator unless they obtain an indemnification agreement. Please describe how this provision would work in practice. Are there any issues that would impede the implementation of this provision?

A.2. Under the provision, domestic and foreign authorities, in certain circumstances, would be required to provide written agreements to indemnify SEC and CFTC-registered trade repositories, as well as the SEC and CFTC, for certain litigation expenses as a condition to obtaining data directly from the trade repository regarding swaps and security-based swaps. Regulators in foreign jurisdictions have raised concerns regarding the potential effect of the provision. However, I believe that the indemnification provision need not apply in the case of a trade repository registered with the CFTC that is also registered in a foreign jurisdiction and the foreign regulator, acting within the scope of its jurisdiction, seeks information directly from the trade repository. Under the CFTC's proposed rules regarding trade repositories' duties and core principles, foreign regulators would not be subject to the indemnification and notice requirements if they obtain information that is in the possession of the CFTC.

Q.3. Numerous public commenters have expressed their concerns that there may be conflicting regulations related to similar products. For example, the proposed block trade regulation is different for CFTC-regulated swaps and SEC-regulated securities-based swaps. The CFTC proposal included tests to determine block trades, while the SEC proposal asks for public comment on what the definition of a block trade should be. How will you reconcile these differences? Should similar products, such as index and single-name CDS, be treated differently?

A.3. Section 712(a)(7) of the Dodd-Frank Act recognized the differences between CFTC- and SEC-regulated products and entities. It provides that, in adopting rules, the CFTC and SEC shall treat functionally or economically similar products or entities in a similar manner, but are not required to treat them in an identical manner. The Commissions work toward consistency in the agencies' respective rules to the extent possible through our close consultation and coordination since the enactment of the Dodd-Frank Act. This close coordination has benefited the rulemaking process and will strengthen the markets for both swaps and security-based swaps.

Q.4. At the hearing, you noted that some differences between the two Commissions' rules may be appropriate given differences in the nature of the products that you regulate. If the SEC and CFTC were merged, as some have recommended, would product differences necessitate two different regulatory frameworks for swap execution facilities?

A.4. The CFTC's proposed SEF rule will provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other market participants. It also will allow them to make indications of interest—or what is often referred to as "indicative quotes"—to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors, and Main Street businesses both the flexibility to execute and trade by a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandates for transparency and competition where multiple market participants can communicate with one another and gain the benefit of a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, whereby they would reach out to a minimum number of other market participants for quotes. It also allows that, for block transactions, swap transactions involving nonfinancial end users, swaps that are not "made available for trading" and bilateral transactions, market participants can get the benefits of the swap execution facilities' greater transparency or, if they wish, would still be allowed to execute by voice or other means of trading.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world, many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the SEC to harmonize approaches, the CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and will move forward to consider a final rule only after staff has had the opportunity to summarize them for consideration and after Commissioners are able to discuss them and provide feedback to staff.

Q.5. How is your agency leveraging human and information technology resources from other domestic regulators? How is your agency leveraging human and technology resources from oversees regulators? How is your agency leveraging existing private industry technologies?

A.5. The Commission and other regulators have been working closely with the Office of Financial Research (OFR) to help develop a strategy for managing initial data required by the OFR to monitor and study systemic risk in the U.S. financial markets. The CFTC also has coordinated with the OFR in the development of a universal Legal Entity Identification standard that is consistent with the Commission's and the SEC's rulemakings. Through the Financial Stability Oversight Council (FSOC), the CFTC is providing both data and expertise relating to a variety of systemic risks, how those risks can spread through the financial system and the economy, and potential ways to mitigate those risks. Commission staff also coordinates with Treasury and other Council member agencies on each of the studies and proposed rules issued by the FSOC.

The Commission has memorandums of understanding with foreign regulators that relate to sharing of information. The Commission leverages private industry technologies through its work with self-regulatory organizations. With regard to specific upcoming technology needs, the agency has solicited the input of industry experts through individual meetings and staff roundtable meetings. In addition, the Commission's Technology Advisory Committee chaired by Commissioner Scott O'Malia includes members from industry and provides valuable assistance to the Commission.

To leverage existing private industry technologies, CFTC makes extensive use of Commercial Off-the-shelf products. The eLaw (automated law office support for enforcement activities), automated trade surveillance, and financial risk management programs all rely primarily on such products. The Commission also uses tools and services used by Self Regulatory Organizations (SROs) and the National Futures Association (NFA) for financial reporting and examinations.

The Commission also uses products and services of other agencies whenever practical. For example the Department of Transportation provides services for financial management and the Department of Agriculture services payroll processing.

Q.6. A frequently stated concern is that the rulemaking process has been very haphazard and uncoordinated. Market participants feel limited in their ability to comment on particular rules without understanding the bigger picture. Would it make sense for the Securities and Exchange Commission and the Commodity Futures Trading Commission to jointly propose and put out for public comment a plan for reproposing and adopting rules?

A.6. To address these issues, the Commission reopened most of its comment periods that had closed and extended some existing comment periods so that the public could provide comments in the context of the entire mosaic of proposed rules. That extended comment period closed on June 3, 2011. In addition, on May 2 and 3, CFTC and SEC staff held roundtable sessions to obtain public input with regard to implementation dates of the various rulemakings. Prior to the roundtable, on April 29, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. The Commission has also accepted written comments on that subject.

Q.7. Chairman Schapiro's testimony stated that "As we move toward adoption the objective of consistent and comparable requirements will continue to guide our efforts [to coordinate with the CFTC and other regulators]." Given the fact that so many of the SEC's proposed rules differ substantially from the CFTC's proposed rules on the same issue, please explain how you will accomplish this objective? Will harmonization require one or both of your agencies tor repropose certain rules?

A.7. Section 712(a)(7) of the Dodd-Frank Act recognizes the differences between CFTC- and SEC-regulated products and entities. It provides that, in adopting rules, the CFTC and SEC shall treat functionally or economically similar products or entities in a similar manner, but are not required to treat them in an identical manner. The Commissions work towards consistency in the agencies' respective rules to the extent possible through close consultation and coordination since the enactment of the Dodd-Frank Act. This close coordination has benefited the rulemaking process and will strengthen the markets for both swaps and security-based swaps.

In approaching any final rule, the Commission will be guided by an examination of whether the connection between the proposed rule and the final rule is sufficient for the final rule to be considered a logical outgrowth of the proposed rule.

Q.8. Does the Commission need additional statutory authority in order to allow market participants to continue to legally engage in swap transactions pending exemption of final rules?

A.8. On July 14, 2011, the CFTC issued an order that would provide relief until December 31, 2011, or when the definitional rulemakings become effective, whichever is sooner, from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This includes provisions that do not directly rely on a rule to be promulgated, but do refer to terms that must be further defined by the CFTC and SEC, such as "swap" and "swap dealer."

The order also would provide relief through no later than December 31, 2011, from certain CEA requirements that may result from the repeal, effective on July 16, 2011, of some of sections 2(d), 2(e), 2(g), 2(h), and 5d.

Q.9. The Department of Justice (DOJ) recently submitted a letter (DOJ letter) on a proposed CFTC rule regarding ownership limitations and governance requirements for designated clearing organizations (DCOs), designated contract markets and swap execution facilities. Were there any relevant communications, written or oral, between the CFTC and DOJ's Antitrust Division prior to submission of the DOJ letter? If so, please explain. Please include a list all DOJ and CFTC individuals involved in those communications and a description of the nature of those communications. Please explain who initiated those communications, whether anyone from the CFTC or from the White House requested or directed anyone in the DOJ to send the letter; and whether anyone from the CFTC or from the White House reviewed and/or edited the letter before it was submitted.

A.9. The Commission received the comments of the Department of Justice on December 28, 2010. Prior to that submission, staff from the Antitrust Division advised CFTC staff of the desire to discuss topics relating to competition in derivatives trading. Those topics implicated the work of 16 of the CFTC's rulemaking teams. While these initial communications to schedule discussions occurred prior to DOJ's comment submission, substantive discussions between CFTC and DOJ staff took place in a meeting on January 14, 2011.

Q.10. Swap customers have the choice to transact in the jurisdiction offering the most attractive environment, in terms of price, ease of settlement, legal and regulatory certainty, among other factors. Explain how you are coordinating with foreign regulators to ensure there is a set of harmonized rules among well-regulated markets. Are you concerned that swap transactions will migrate to markets that operate under a more favorable regulatory environment? If that happens, what are the threats to the financial stability of the United States?

A.10. The Commission is actively consulting and coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC cochairs. Our discussions have focused on clearing and trading requirements, clearinghouses more generally and swaps data reporting issues, among other topics.

As we do with domestic regulators, the CFTC shares many of our memos, term sheets and draft work product with international regulators. We have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the U.K. Financial Services Authority, the new European Securities and Markets Authority, the Japanese Financial Services Authority and regulators in Canada, France, Germany, and Switzerland. Two weeks ago, I met with Michel Barnier, the European Commissioner for Internal Market and Services, to discuss ensuring consistency in swaps market regulation.

Both the CFTC and European Union are moving forward on addressing the key objectives the G-20 set forth in September 2009, including clearing through central counterparties, trading on exchanges or electronic trading platforms, record keeping, reporting, and higher capital requirements for noncleared swaps.

Through consultation, regulators are working to bring consistency to oversight of the swaps markets. In September of last year, the European Commission (EC) released its swaps proposal. The European Council and the European Parliament are now considering the proposal. Similar to the Dodd-Frank Act, the European Commission proposal covers the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps, and credit default swaps. It is important that all standardized swaps—including exchange-traded swaps—are subject to mandatory central clearing. The proposal includes requirements for central clearing of swaps, robust oversight of central counterparties, and reporting of all swaps to a trade repository.

The EC also is considering revisions to its existing Markets in Financial Instruments Directive (MiFID), which includes a trade execution requirement, the creation of a report with aggregate data on the markets similar to the CFTC's Commitments of Traders reports, and accountability levels or position limits on various commodity markets.

Q.11. The CFTC recently proposed position limits that will impose additional costs on OTC derivative market participants. However a recent joint report by the U.K. Financial Services Authority and HM Treasury warns "The U.K. Authorities would urge caution in the application of any specific position limit power, and the expectation that these regulatory tools might achieve the objective of reduced price volatility, or manipulation, as there appears to be no conclusive evidence that this may be the case." In other words, position limit regulation imposes real costs, with little or no benefit. What analysis has the CFTC done to examine the impact of position limits on liquidity? What are the results of that analysis? How can the CFTC justify imposing position limits on OTC derivative market participants when a proper cost-benefit analysis could show that the costs do not justify the benefits? If the United States is the only jurisdiction to adopt aggressive position limits, will OTC derivatives transactions simply migrate oversees?

A.11. In its proposed rulemaking, the CFTC considered the proposal's impact on liquidity. In addition, the Commission sought public comment specifically with regard to expected effects on liquidity. The Commission will thoroughly and carefully review submitted public comments before proceeding to consider final rules.

The Dodd-Frank Act mandates that the CFTC set aggregate position limits for certain physical commodity derivatives across the derivatives markets. The Act broadened the CFTC's position limits authority to include aggregate position limits on certain swaps and certain linked contracts traded on foreign boards of trade in addition to U.S. futures and options on futures. Congress also narrowed the exemptions traditionally available from position limits by modifying the definition of *bona fide* hedge transaction.

Position limits have served since the Commodity Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce. When the CFTC set position limits in the past, the agency sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. Integrity is enhanced when participation is broad and the market is not overly concentrated.

The CFTC strives to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but additionally are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual, and policy bases for its rulemakings. With the proposed rule on position limits, the Commission sought public comment regarding costs and benefits. As part of the process, the Commission has received more than 12,000 comments, including comments from market participants, public interest groups, and individuals. The Commission will review these comments thoroughly and will respond to them in developing a final rule.

Q.12. Chairman Gensler, in a recent speech, your colleague Commissioner Sommers noted that the proposals issued by the CFTC thus far "contain cursory, boilerplate cost-benefit analysis sections in which [you] have not attempted to quantify the costs." Are your fellow Commissioner's comments valid? If not, why not? As Chairman of the CFTC, do you believe that it is important for the other Commissioners to have confidence in the integrity of the CFTC's rulemaking process? If so, what steps can you take to ensure that the CFTC's cost-benefit analysis is improved and satisfies all of the CFTC's Commissioners?

A.12. The CFTC strives to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but additionally are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual, and policy bases for its rulemakings.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns in each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices and address compliance costs consistent with the obligations of the CFTC to promote market integrity, reduce risk and increase transparency as directed in Title VII of the Dodd-Frank Act. Information from each of these meetings—including full transcripts of the roundtables—is available on the CFTC's Web site and has been factored into each applicable rulemaking.

With each proposed rule, the Commission has sought public comment regarding costs and benefits.

Q.13. Chairman Gensler, you were actively engaged in the legislative drafting process. The Dodd-Frank Act contains aggressive rulemaking deadlines. Knowing what you do now, do you wish that you had advocated for more reasonable deadlines?

A.13. The Dodd-Frank Act had a deadline of 360 days after enactment for completion of the bulk of our rulemakings—July 16, 2011. Both the Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. We have coordinated closely with the SEC on these issues. On July 14, the CFTC granted temporary relief from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This order enables the Commission to continue its progress in finalizing rules.

Q.14. The CFTC proposed changes to Rule 4.5, which could have meaningful implications for registered investment companies. These changes were not required by Dodd-Frank. Why is the CFTC contemplating a broad reach into the regulation of registered investment companies, which are already heavily regulated by the SEC?

A.14. The CFTC and the SEC proposed a joint rule to require reporting by investment advisers to private funds that are also registered as commodity pool operators or commodity trading advisors with the CFTC. The joint proposed rule would require private fund investment advisers with assets under management totaling more than $150 million to provide the SEC with financial and other trading information. Private fund investment advisers with assets under management totaling more than $1 billion would be subject to heightened reporting requirements. Separately, the CFTC proposed a rule that would bring similar reporting to CPOs and CTAs with assets under management greater than $150 million that are not otherwise jointly regulated. This is to ensure that similar entities in the asset management arena are regulated consistently. The CFTC proposed rule would repeal certain exemptions issued under Part 4 of the Commission's regulations so the Commission will have a more complete picture of the activity of operators of and advisors to pooled investment vehicles in the commodities marketplace. The Commission is reviewing the comments received on the proposal. In addition, Commission staff has held discussions with SEC staff and plans to hold a public roundtable discussion.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM GARY GENSLER

Q.1. In March, a Stanford Professor published a study noting that index positions and managed-money spread positions had the largest impact on futures prices. Specifically, the study noted that "increased in flows into index funds . . . predict higher subsequent futures prices." What is the CFTC doing (or has it done) to examine this issue? What implications does this issue have on price? Are index and hedge funds having an increasing impact on commodity market dynamics? If so, how?

A.1. The Commission obtains comprehensive data on futures markets participants through its large trader reporting system. The Commission's rule on large swap trader reporting, will add to that data. Large trader data is collected for surveillance and regulatory purposes. In addition, to enhance market transparency, the Commission publishes reports with the data in aggregated form and subdivided by trader type. It is clear that the derivatives markets have changed significantly. The markets have become much more electronically traded. Instead of being traded in the pits, more than 80 percent of futures and options on futures were traded electronically in 2010. In addition, the makeup of the market has changed. In contrast with the early days of the CFTC, swap dealers now comprise a significant portion of the markets. Also, investors today treat commodities as an asset class for passive index investment. Based on published CFTC data, financial actors, such as swap dealers, managed money accounts, and other noncommercial reportable traders, make up a significant majority of many of the futures markets.

For example, market data as of June 28, 2011, shows that only about 13 percent of gross long positions and about 19 percent of gross short positions in the WTI crude oil market were held by producers, merchants, processors, and users of the commodity. Similarly, only about 10 percent of gross long positions and about 39 percent of gross short positions in the Chicago Board of Trade wheat market were held by producers, merchants, processors, and users of the commodity. Finally, based upon CFTC data, the vast majority of trading volume in key futures markets—up to 80 percent in many markets—is day trading or trading in calendar spreads. Thus, only a modest proportion of average daily trading volume results in reportable traders changing their net long or net short futures positions for the day. This means that only about 20 percent or less of the trading is done by traders who bring a longer-term perspective to the market on the price of the commodity. The Commission recently published on its Web site historical data on directional position changes to enhance market transparency.

Q.2. Recently, the *Los Angeles Times* reported that more and more Americans are engaging in foreign currency trading, encouraged by the advertising of the two largest U.S. brokers, FXCM Inc and Gain Capital Holdings, Inc., and they "are losing money in spectacular fashion." Gain and FXCM recently reported that U.S. customers amounted to approximately $777 billion and $667 billion in annual trading volume respectively. The *LA Times* article also noted that between 72 percent and 79 percent of these customers lost money each quarter last year. Are you concerned about this emerging trend? What is the CFTC doing to regulate this area? What additional regulation is needed?

A.2. On September 10, 2010, the CFTC published final rules to provide for the regulation of off-exchange retail foreign currency transactions. The rules implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Food, Conservation, and Energy Act of 2008, which, together, provided the CFTC with broad authority to register and regulate entities wishing to serve as counterparties to, or to intermediate, retail foreign exchange (forex) transactions. These rules of the road are to help protect the American public in the largest area of retail fraud that the CFTC oversees. All CFTC registrants involved in soliciting and selling retail forex contracts to consumers now have to comply with rules to protect the investing public.

The final forex rules put in place requirements for, among other things, registration, disclosure, record keeping, financial reporting, minimum capital, and other business conduct and operational standards. Specifically, the regulations require the registration of counterparties offering retail foreign currency contracts as either futures commission merchants (FCMs) or retail foreign exchange dealers (RFEDs), a new category of registrant. Persons who solicit orders, exercise discretionary trading authority, or operate pools with respect to retail forex also will be required to register, either as introducing brokers, commodity trading advisors, commodity pool operators (as appropriate), or as associated persons of such entities.

The rules include financial requirements designed to ensure the financial integrity of firms engaging in retail forex transactions and robust customer protections. For example, FCMs and RFEDs are required to maintain net capital of $20 million plus 5 percent of the amount, if any, by which liabilities to retail forex customers exceed $10 million. Leverage in retail forex customer accounts will be subject to a security deposit requirement to be set by the National Futures Association within limits provided by the Commission. All retail forex counterparties and intermediaries are required to distribute forex-specific risk disclosure statements to customers and comply with comprehensive record keeping and reporting requirements.

The disclosures identified in the referenced news stories were due to CFTC rule requirements.

Q.3. Do you have a concern that commodities prices—both oil and food—are increasingly being affected by forces outside of normal supply and demand fundamentals? Is true price discovery being affected by trading instruments and traders, rather than by market fundamentals?

A.3. At its core, the mission of the CFTC is to ensure the integrity and transparency of derivatives markets so that hedgers and investors may use them with confidence. Though the CFTC is not a price-setting agency, rising prices for basic commodities—energy in particular—highlight the importance of having effective market oversight that ensures integrity and transparency.

A specific critical reform of the Dodd-Frank Act relates to position limits. Position limits have served since the Commodity Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce. The Dodd-Frank Act directs the Commission to establish position limits for both futures and swaps in a very specific manner. It directs the Commission to establish speculative position limits for futures contracts for agricultural commodities and exempt commodities (including crude oil, gasoline, and other energy commodities), and to concurrently establish limits on swaps that are economically equivalent to those futures contracts. It also requires the Commission to establish aggregate limits across the futures and swaps markets. The Commission published a proposed rule to implement these statutory directives and received over 12,000 comments from the public. The Commission is evaluating the comments received before proceeding to a final rulemaking. It is essential to complete the task of implementing the aggregate position limits regime, which were congressionally mandated to guard against the burdens of excessive speculation and foster orderly markets.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM GARY GENSLER

Q.1. In the past you have said that you are working to reach "agreement" with international regulators on reform of the swaps market because reform cannot be accomplished alone. What form will those agreements take? How will they be enforced? And what steps will you take if international regulatory bodies set standards that differ greatly from those in the United States?

A.1. As we work to implement the derivatives reforms in the Dodd-Frank Act, we are actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC cochairs with the Securities and Exchange Commission (SEC). The CFTC, SEC, European Commission, and European Securities Market Authority are coordinating through a technical working group.

The Dodd-Frank Act recognizes that the swaps market is global and interconnected. It gives the CFTC the flexibility to recognize foreign regulatory frameworks that are comprehensive and comparable to U.S. oversight of the swaps markets in certain areas. In addition, we have a long history of recognition regarding foreign participants that are comparably regulated by a home country regulator. The CFTC enters into arrangements with international counterparts for access to information and cooperative oversight. The Commission has signed memoranda of understanding with regulators in Europe, North America, and Asia.

Q.2. In many sections of the statute such as real time reporting, position limits, and Swap Execution Facilities (SEFs) the CFTC is required to assess the impact on liquidity of its proposals. I have not seen in the relevant notices of proposed rulemakings, any significant discussion of the impact on liquidity. Has the CFTC reviewed how its real time reporting, SEF and position limit proposals will affect market liquidity? If so, what are the results of that review? If not, why not?

A.2. In its proposed rulemakings, the CFTC considered how the rule proposals might affect liquidity in the swap markets through discussions with market participants, domestic and international regulators, and other interested parties. The CFTC addressed those issues in the rulemakings. In addition, the Commission has sought public comment specifically with regard to expected effects on liquidity. The Commission will thoroughly and carefully review submitted public comments before proceeding to consider final rules.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM DANIEL K. TARULLO

Q.1. Will the margin rules proposed this morning (April 12, 2011) at the FDIC on behalf of the prudential regulators and at the CFTC require commercial end users to post margin directly to swap dealers beyond what would ordinarily be required by current swap dealer practices of mitigating counterparty exposure? If so, what role will the prudential regulators and the CFTC play in both establishing and supervising these credit thresholds going forward? Additionally, how do the prudential regulators and the CFTC define noncash collateral that could be used to satisfy end user margin requirements?

A.1. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DANIEL K. TARULLO

Q.1. How can the Federal Reserve assure us that clearinghouses that are designated to be systemically important financial market utilities and have access to Federal Reserve discount and borrowing privileges do not undertake unsafe and unsound business practices because of the interplay between profit pressures and aggressive regulatory mandates?

A.1. Response not provided.

Q.2. A recent letter from the American Benefits Council and the Committee on Investment of Employee Benefit Assets raised questions about the process by which the Federal Reserve Bank of New York has been working with swap dealers to develop commitments with respect to trading, confirmation, clearing, and reporting of swap transactions. Decisions made in these negotiations will affect dealers' counterparties, such as Main Street corporations, pension funds, and hedge funds. What is the Federal Reserve Bank of New York doing to take into account the perspective of nondealer market participants? How are these negotiations being coordinated with SEC and CFTC rulemaking?

A.2. Response not provided.

Q.3. On April 12, 2011, the Federal Reserve and other prudential regulators proposed rules to establish minimum capital and margin requirements for prudentially regulated swap market participants. Do you believe that Congress intended to exempt end users from margin requirements? What are the differences between the Fed's margin rules and the other prudential regulators' margin rules? For each difference, please explain why they differ.

A.3. Response not provided.

Q.4. Why did the Fed specify prescriptive margin calculation models that isolate swap risk rather than considering a prudentially regulated swap market participants' entire credit relationship with end users? Please explain how the Fed determined the key assumptions on margin calculations, including the determinations of the number of standard deviations, the time period over which it is applied, and the data that is used as inputs.

A.4. Response not provided.

Q.5. Please explain how the proposed margin rules provide incremental credit exposure-reducing benefits, beyond existing or other forthcoming prudential regulatory requirements including the Basel III standards.

A.5. Response not provided.

Q.6. How does your agency define the term "clearing" with respect to swaps (or security-based swaps)? Which activities are encompassed within that definition?

A.6. Response not provided.

Q.7. Swap data repositories and security-based swap data repositories may not share information with regulators other than their primary regulator unless they obtain an indemnification agreement. Please describe how this provision would work in practice. Are there any issues that would impede the implementation of this provision?

A.7. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM DANIEL K. TARULLO

Q.1. Title VII of the Dodd-Frank Act, largely overseen by the SEC and CFTC, will require firms to keep additional capital for over-the-counter trades, so that they will be able to pay up, if the trade moves against them. At the same time, the Volcker Rule, which is overseen by banking regulators, as well as the SEC and CFTC, also imposes capital requirements. These provisions require regulators to impose additional capital charges for any proprietary trading by the nonbank financial companies supervised by the board [((a)(2)) and ((f)(4))], and explicitly authorizes regulators to impose additional capital charges on banking entities, for even permitted activities such as market-making. [((d)(3))] And, of course, the Treasury Department and banking regulators are working with their international counterparts to effectively implement new Basel requirements on capital. What work is the Federal Reserve doing, whether independently or in coordination with the Department of the Treasury, the prudential regulators, the SEC, or CFTC, to help enhance the capital requirements for trading positions, as directed by not just the derivatives title, but also the Volcker Rule?

A.1. Response not provided.

Q.2. Recently, the Federal Reserve, after conducting stress tests, allowed some banks to increase dividends or buy back shares. JPMorgan, for example, not only announced an increase in its dividends, but also announced that it would buy back as much as $15 billion in stock. As part of the Federal Reserve's most recent stress tests, how did the Federal Reserve take into account all potential liabilities that may arise in light of all the issues (alleged violations of State real property laws, securities laws, Federal tax laws, and others) raised as a result of faulty foreclosure procedures, the so-called robo-signing issues? That is, by allowing several firms to pay higher dividends and/or buy back stock, is the Federal Reserve certifying that these robo-signing issues do not present a material risk to the banks?

A.2. Response not provided.

Q.3. The Federal Open Market Committee (FOMC) authorized temporary dollar liquidity swap arrangements with 14 foreign central banks between December 12, 2007, and October 29, 2008. The arrangements expired on February 1, 2010. Federal Reserve data reflects that during October and November 2008, the Federal Reserve extended over $550 billion in swap lines to foreign banks.[1] What specific factors were considered by the Federal Reserve in taking this action? What other options were considered? Was intervention considered effective? Why or why not?

A.3. Response not provided.

Q.4. The Federal Reserve extended swap arrangements with 14 central banks; however, it published data on its swap lines with 10 foreign banks. Were the other 4 banks involved in the Federal Reserves' swap lines?

A.4. Response not provided.

Q.5. In May 2010, the FOMC authorized additional swap lines with five central banks through August 1, 2011. According to Federal Reserve data, only the European Central Bank participated (through the end of the data period provided—October 2010). What facts and circumstances necessitated this intervention? Why did other banks (Bank of Canada, the Bank of England, the Bank of Japan, and the Swiss National Bank) not participate?

A.5. Response not provided.

Q.6. Do any swap facilities remain operational? If so, please provide additional data regarding to whom swap lines were extended and the amounts extended. If they are no longer operational, please provide the same requested data.

A.6. Response not provided.

Q.7. The Federal Reserve extended $3.221 billion to Banco de Mexico from April 23, 2009, to January 12, 2010. (The $3.221 billion was provided in three separate arrangements, each of which ma-

[1] Using the date on which the U.S. dollars were extended to the foreign central bank in exchange for the receipt of foreign currency net of maturities. *See, http:///www.federalreserve.gov/newsevents/reform__swaplines.htm.*

tured in 88 days and was immediately renewed.) What facts and circumstances necessitated this intervention?

A.7. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM DANIEL K. TARULLO

Q.1. On April 12, the banking regulators released their proposal on "Margin and Capital Requirements for Covered Swap Entities." The proposal requires dealer banks and significant counterparties to post two way initial margin and to hold that margin at third party custodian banks. This margin would be limited to immediately available cash funds and high-quality, highly liquid U.S. Government and agency obligations. Re-hypothecation of such amounts would be prohibited. What are the costs associated with tying up margin in segregated accounts at custodian banks? Have you quantified the impact this requirement will have on liquidity?

A.1. Response not provided.

Q.2. The margin and capital requirements proposal takes a risk-based approach by distinguishing between four separate types of derivatives counterparties. The proposal extends the definition of financial end user to include any government of any foreign country or any political subdivision, agency, or instrumentality thereof in the world. How would margin and capital requirements apply to the dealings of the foreign subsidiary of a U.S. financial institution that enters into a swap? What about a U.S. financial institution that enters into a swap with a foreign government? Would the foreign subsidiary of a U.S. institution that enters into a swap with a foreign government be required to post margin in U.S. Treasuries?

A.2. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARY J. MILLER

Q.1. How does your agency define the term "clearing" with respect to swaps (or security-based swaps)? Which activities are encompassed within that definition?

A.1. The Department of the Treasury does not define the term "clearing" in any regulations. The Commodity Exchange Act, as modified by the Dodd-Frank Wall Street Reform and Consumer Protection Act, defines the term "derivatives clearing organization" as a clearinghouse, clearing association, clearing corporation, or similar entity, facility, system, or organization that, (i) substitutes/novates the credit of the derivatives clearing organization for the credit of the parties to the transaction; (ii) arranges/provides for settlement/netting of obligations on a multilateral basis; or (iii) provides clearing services/arrangements that mutualize or transfer credit risk among participants.

The term "clearing" with respect to swaps (or security-based swaps) generally is understood to encompass the set of activities and processes that occur between the execution of a contract between counterparties and final settlement in order to ensure performance on the contract. Typical "clearing" activities or services provided by a clearinghouse or central counterparty include reduction of counterparty credit exposures, netting of offsetting bilateral positions, daily mark-to-market and collateralization (margin), and mutualization of the risk of loss.

Q.2. Swap data repositories and security-based swap data repositories may not share information with regulators other than their primary regulator unless they obtain an indemnification agreement. Please describe how this provision would work in practice. Are there any issues that would impede the implementation of this provision?

A.2. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires Swap Data Repositories (SDRs) and Security-Based Swap Data Repositories (SB–SDRs), upon request, and after notifying its primary regulator, to make data available to certain other domestic and foreign regulators. The Act further requires regulators requesting data to execute a written confidentiality and indemnification agreement with the SDR or SB–SDR prior to receiving any data. The CFTC and the SEC have proposed rules for SDRs and SB–SDRs, respectively, that require such confidentiality and indemnification agreements (see 75 FR 80808 [December 23, 2010] and 75 FR 77306 [December 10, 2010], respectively). Both agencies acknowledge in their proposed rules that certain domestic and foreign regulators may have difficulty—or even be legally prohibited—from agreeing to indemnify third parties and that the indemnification provision could "chill" requests for information or otherwise inhibit certain regulators from fulfilling their mandates. Both agencies have requested comment on the required confidentiality and indemnification agreements and are evaluating feedback.

Q.3. Secretary Geithner made the case before the Senate Committee on Agriculture in December of 2009 that foreign exchange swaps should not be treated the same as all other swaps. He explained that foreign exchange markets are different than other derivatives markets and already are subject to an elaborate regulatory framework. He cautioned, "These markets have actually worked quite well . . . we have got a basic obligation to do no harm, to make sure as we reform we do not make things worse, and our judgment is that because of the protections that already exist in these foreign exchange markets and because they are different from derivatives, have different risks, require different solutions, we will have to have a slightly different approach." Please elaborate on Secretary Geithner's statement and the importance of regulating foreign exchange swaps in a manner that takes into account their unique characteristics and their existing regulatory framework.

A.3. Treasury issued a Notice of Proposed Determination (copy enclosed) that was published in the Federal Register on May 5, 2011, to exempt foreign exchange swaps and forwards from the Commodity Exchange Act's (CEA) definition of swap. The reasons for the proposed determination are explained in the Notice.

Q.4. One of the concerns that the Investment Company Institute raised about the CFTC's proposed amendments to Rule 4.5 is that not knowing whether foreign exchange swaps and forwards will be included in the definition of "swap" affects their ability to analyze the effects that the changes to Rule 4.5 will have. Have you discussed this issue with the CFTC? More generally, are you concerned that Treasury's failure to act with respect to foreign exchange swaps and forwards impedes the ability of market participants to determine whether and how to comment on rules and to plan for compliance with Dodd-Frank?

A.4. As noted, Treasury issued a Notice of Proposed Determination on May 5, 2011 to exempt foreign exchange swaps and forwards from the definition of a swap under the CEA.

Q.5. At the hearing, I asked you whether Treasury would be conducting any studies with respect to the effects of derivatives regulation on job creation. Your answer was unclear. Please clarify your answer.

A.5. Treasury has not conducted any such studies and is not in the process of conducting any study on the effects of derivatives regulation on job creation.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM MARY J. MILLER

Q.1. Which financial institutions are most active with respect to foreign exchange swaps and foreign exchange forwards? Which of these financial institutions have received emergency Government infusions (TARP funds, capital, *etc.*)? What portion of the Government-provided funds were related to activities unrelated to foreign exchange swaps and foreign exchange forwards? How do you know?

A.1. As noted in Treasury's May 5, 2011, Notice of Proposed Determination, banks are the key players in the foreign exchange swaps and forwards market. Although a number of banks received emergency assistance during the financial crisis, we are not aware of any institutions that received such assistance due to their foreign exchange swaps or forwards activities.

Q.2. According to an analysis by Better Markets, the Federal Reserve provided $2.9 trillion to stabilize foreign exchange markets in October 2008. Please describe your understanding of the facts and circumstances that led to this infusion and whether it is reasonably possible that such a condition may reoccur.

A.2. The Federal Reserve made large amounts of dollars available to other central banks in the fall of 2008 because of the global demand for dollars related to short-term funding needs during the financial crisis. Some confusion has arisen among nonmarket participants because these forms of Federal Reserve assistance to central banks were called foreign exchange swap lines. Despite the similar sounding name, the Federal Reserve swap lines were in fact quite distinct from the foreign exchange swaps and forwards market. The steps that are being taken to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act are designed to improve the safety and soundness of the financial system and to prevent the recurrence of the need for such assistance.

Q.3. Please describe in which ways the market for foreign exchange swaps and foreign exchange forwards is different from other derivatives markets.

A.3. The enclosed May 5, 2011, Notice of Proposed Determination sets forth the reasons Treasury believes the market for foreign exchange swaps and forwards is different from other derivatives markets.

DEPARTMENT OF TRANSPORTATION

Pipeline and Hazardous Materials Safety Administration

International Standards on the Transport of Dangerous Goods; Public Meeting

AGENCY: Pipeline and Hazardous Materials Safety Administration (PHMSA), Department of Transportation.

ACTION: Notice of public meeting.

SUMMARY: This notice is to advise interested persons that PHMSA will conduct a public meeting in preparation for the 39th session of the United Nations Sub-Committee of Experts on the Transport of Dangerous Goods (UNSCOE TDG) to be held June 20–24, 2011, in Geneva, Switzerland. During this meeting, PHMSA is also soliciting comments relative to potential new work items which may be considered for inclusion in its international agenda.

Information Regarding the UNSCOE TDG Meeting

Date: Wednesday, June 8, 2011; 9:30 a.m.–12:30 p.m.

Address: The meeting will be held at the DOT Headquarters, West Building, Oklahoma City Conference Room, 1200 New Jersey Avenue, SE., Washington, DC 20590.

Registration: Pre-registration for this meeting is not required. Participants are encouraged to arrive early to allow time for security checks necessary to obtain access to the building.

Conference Call Capability/Live Meeting Information: Conference call-in and "live meeting" capability will be provided for this meeting. Specific information on call-in and live meeting access will be posted when available at *http://www.phmsa.dot.gov/hazmat/regs/international.*

FOR FURTHER INFORMATION CONTACT: Mr. Shane Kelley, Senior International Transportation Specialist, Office of Hazardous Materials Safety, Department of Transportation, Washington, DC 20590; (202) 366–0656.

SUPPLEMENTARY INFORMATION: The primary purpose of this meeting will be to prepare for the 39th session of the UNSCOE TDG. The 39th session of the UNSCOE TDG is the first of four meetings scheduled for the 2011–2012 biennium. The UNSCOE will consider proposals for the 18th Revised Edition of the United Nations Recommendations on the Transport of Dangerous Goods Model Regulations which will be implemented within relevant domestic, regional, and international regulations from January 1, 2015. Copies of proposals and the meeting agenda may be obtained from the United Nations Transport Division's Web site at: *http://www.unece.org/trans/main/dgdb/dgsubc/c32011.html.*

General topics on the agenda for the UNSCOE TDG meeting include:

• Explosives and related matters.
• Listing, classification and packing.
• Electric storage systems.
• Electronic data interchange (EDI) for documentation purposes.
• Cooperation with the International Atomic Energy Agency (IAEA).
• Global harmonization of transport of dangerous goods regulations.
• Guiding principles for the Model Regulations.
• Globally Harmonized System of Classification and Labeling of Chemicals (GHS).

In addition, PHMSA is soliciting comments on how to further enhance harmonization for international transport of hazardous materials. PHMSA has finalized a broad international strategic plan and welcomes input on items which stakeholders believe should be included as specific initiatives within this plan. PHMSA's Office of International Standards Strategic Plan can be accessed at: *http://www.phmsa.dot.gov/hazmat/regs/international.*

Following the 39th session of the UNSCOE TDG, PHMSA will place a copy of the Sub-Committee's report and a summary of the results on PHMSA's Hazardous Materials Safety Web site at *http://www.phmsa.dot.gov/hazmat/regs/international.*

PHMSA's site at *http://www.phmsa.dot.gov/hazmat/regs/international* provides additional information regarding the UNSCOE TDG and related matters such as summaries of decisions taken at previous sessions of the UNSCOE TDG.

Issued in Washington, DC, on May 2, 2011.

Magdy El-Sibaie,

Associate Administrator for Hazardous Materials Safety.

[FR Doc. 2011–10996 Filed 5–4–11; 8:45 am]

BILLING CODE 4910–60–P

DEPARTMENT OF THE TREASURY

Submission for OMB Review; Comment Request

ACTION: Notice; correction.

SUMMARY: The Department of the Treasury published a document in the **Federal Register** on April 12, 2011, inviting comments on collections of information submitted to the Office of Management and Budget (OMB) for review. This document contained incorrect references.

Correction

In the **Federal Register** of April 12, 2011, in FR Doc. 2011–8675, make the following corrections:

• Page 20449, in the second column, under *OMB Number:* 1545–1800, *Type of Review:* replace "Extension without change" with "Revision".
• Page 20449, in the second column, under *OMB Number:* 1545–1800, *Estimated Total Burden Hours:* replace "9,112" with "913,698".
• Page 20449, in the second column, under *OMB Number:* 1545–2098, *Type of Review:* replace "Extension without change" with "Revision".
• Page 20449, in the second column, under *OMB Number:* 1545–2098, *Estimated Total Burden Hours:* replace "4" with "1,000".

Dated: May 2, 2011.

Da n D olfgang,

Treasury RA Clearance Officer.

[FR Doc. 2011–10948 Filed 5–4–11; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act

AGENCY: Department of the Treasury, Departmental Offices.

ACTION: Notice of proposed determination.

SUMMARY: The Commodity Exchange Act ("CEA"), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), authorizes the Secretary of the Treasury ("Secretary") to issue a written determination exempting foreign exchange swaps, foreign exchange forwards, or both, from the definition of a "swap" under the CEA. The Secretary proposes to issue a determination that would exempt both foreign exchange swaps and foreign exchange forwards from the definition of "swap," in accordance with the relevant provisions of the CEA and invites comment on the proposed determination, as well as the factors supporting such a determination.

DATES: Written comments must be received on or before June 6, 2011, to be assured of consideration.

ADDRESSES: *Submission of Comments by mail:* ou may submit comments to: Office of Financial Markets, Department of the Treasury, 1500 Pennsylvania Avenue, NW., Washington, DC 20220.

Submission of Comments via regulations.gov: You are encouraged to submit comments electronically through the Federal eRulemaking Portal—"Regulations.gov." Go to *http://www.regulations.gov* to submit or view public comments. The Regulations.gov home page provides information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket.

Please include your name, affiliation, address, e-mail address and telephone number(s) in your comment. In general, comments received will be posted on regulations.gov without change, including any business or personal information provided. Treasury will also make such comments available for public inspection and copying in Treasury's Library, Room 1428, Department of the Treasury, 1500 Pennsylvania Avenue, NW., Washington, DC 20220, on official business days between the hours of 10 a.m. and 5 p.m. Eastern Time. You can make an appointment to inspect comments by telephoning (202) 622–0990. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not include any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

FOR FURTHER INFORMATION CONTACT: Office of Financial Markets, 1500 Pennsylvania Avenue, NW., Washington, DC 20220, (202) 622–2730, *fxproposal@treasury.gov;* Thomas E. Scanlon, Office of the General Counsel, 1500 Pennsylvania Avenue, NW., Washington, DC 20220, (202) 622–8170.

SUPPLEMENTARY INFORMATION: Title VII of the Dodd-Frank Act [1] amends the CEA, as well as Federal securities laws, to provide a comprehensive regulatory regime for swaps. Section 721 of the Dodd-Frank Act amends section 1a of the CEA, which, in relevant part, defines the term "swap" under the CEA and includes foreign exchange swaps and foreign exchange forwards in the definition.[2] Section 1a(47)(E) of the CEA authorizes the Secretary to make a written determination that "foreign exchange swaps" [3] or "foreign exchange forwards," [4] or both— (I) should not be regulated as swaps under the CEA and (II) are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the Commodity Futures Trading Commission ("CFTC") pursuant to section 721(c) of the Dodd-Frank Act.[5]

On October 28, 2010, the Department of the Treasury ("Treasury") published in the **Federal Register** a Notice and Request for Comments ("October 2010 Notice") to solicit public comment on a wide range of issues relating to whether foreign exchange swaps and foreign exchange forwards should be exempt from the definition of the term "swap" under the CEA.[6] In addition, Treasury staff has engaged in a broad outreach to representatives from multiple market segments, as well as market regulators and the Federal regulatory agencies. After assessing the comments in response to the October 2010 Notice, consulting with Federal regulators, and preliminarily considering the factors set forth in section 1b(a) of the CEA, as discussed below, the Secretary believes that proposing a determination to exempt all "foreign exchange swaps" and "foreign exchange forwards" from the definition of the term "swap" under the CEA is appropriate.

In making a determination pursuant to sections 1a(47)(E) and 1b of the CEA, the Secretary must consider the following factors

(1) Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States

(2) Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps

(3) The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements

(4) The extent of adequate payment and settlement systems and

(5) The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.[7]

Treasury is soliciting comment on this proposed determination,[8] as set forth below, which would exempt any foreign exchange swap and foreign exchange forward from the definition of the term "swap" under the CEA, as permitted by section 1a(47)(E) of the CEA.

I. Summary of Proposed Determination

The CEA, as amended by the Dodd-Frank Act, provides a comprehensive regulatory regime for swaps and derivatives, including a wide range of foreign exchange derivatives, such as foreign exchange options, currency swaps, or non-deliverable forwards ("NDFs"). Among other measures, this regulatory regime provides for clearing and exchange-trading requirements that are designed to mitigate risks, promote price transparency, and facilitate more stable, liquid markets for derivative instruments. In general, the payment obligations on currency swaps, interest rate swaps, credit default swaps, commodity swaps and other derivatives fluctuate in response to changes in the value of the underlying variables on which those derivative contracts are based. As a result, for most types of swaps and derivatives, the counterparties do not know their payment obligations and the full extent of their exposure throughout the life of the contract. Moreover, as the length of a swap or derivative contract increases, a party generally is exposed to greater counterparty credit risk. Settlement of most types of swaps and derivatives involves only payments of net amounts (not gross amounts) that are based on the change in value of the underlying variables. Given the features of most derivatives, including some types of foreign exchange derivatives, the clearing and exchange-trading requirements under the CEA would mitigate the relevant risks, notably counterparty credit risks.

Foreign exchange swaps and forwards generally are subject to the requirements of the CEA. For these instruments, the most significant requirements under the regulatory regime enacted by the Dodd-Frank Act would be the potential for mandatory central clearing and exchange trading,[9] unless the Secretary

[1] Pub. L. 111–203, title VII.

[2] 7 U.S.C. 1a(47).

[3] 7 U.S.C. 1a(25).

[4] 7 U.S.C. 1a(24).

[5] 7 U.S.C. 1(a)(47)(E)(i).

[6] 75 FR 66,426 (Oct. 28, 2010). Thirty comments were submitted in response to the October 2010 Notice.

[7] 7 U.S.C. 1b(a). In addition, section 1b(b) of the CEA provides that, "[i]f the Secretary makes a determination to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term 'swap'," the Secretary must submit a separate "determination" to the appropriate committees of Congress, which contains (1) an explanation why foreign exchange swaps and foreign exchange forwards are "qualitatively different from other classes of swaps" such that foreign exchange swaps and foreign exchange forwards are "ill-suited for regulation as swaps" and (2) an "identification of the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status" (i.e., as a result of the underlying "determination").

[8] 5 U.S.C. 553(b).

[9] 7 U.S.C. 2(h)(1)–(2). In general, this section provides that the CFTC must act for each swap, or a category of swaps, to be required to be cleared. In addition, the CEA provides several exceptions to

Continued

makes a determination that foreign exchange swaps and forwards "(I) should not be regulated as swaps under [the CEA]; and (II) are not structured to evade [the Dodd-Frank Act] in violation of any rules promulgated by the [CFTC] pursuant to section 721(c) of the [Dodd-Frank Act]." [10]

The Secretary proposes to issue a determination to exempt foreign exchange swaps and forwards because of the distinctive characteristics of these instruments. As discussed below, unlike most other derivatives, foreign exchange swaps and forwards have fixed payment obligations, are physically settled, and are predominantly short-term instruments. This results in a risk profile that is different from other derivatives, as it is centered on settlement risk, rather than counterparty credit risk. Settlement risk in foreign exchange swaps and forwards already has been addressed through the extensive use of payment-versus-payment ("PVP") settlement arrangements. Even though central clearing could reduce counterparty credit risk, that risk is relatively small in the foreign exchange swaps and forwards market. Imposing central clearing and trading requirements under the CEA on foreign exchange swaps and forwards would introduce risks and operational challenges to the current settlement arrangements that significantly outweigh the marginal benefits.

A. Foreign Exchange Swaps and Forwards Differ in Significant Ways From Other Swaps and Derivatives

Under the CEA, a "foreign exchange swap" is narrowly defined as "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange" and "(B) a reverse exchange of [those two currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange." [11] Likewise, the CEA narrowly defines a foreign exchange forward as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." [12]

The Secretary's authority to issue a determination is limited to foreign exchange swaps and forwards and does not extend to other foreign exchange derivatives. Foreign exchange options, currency swaps, and NDFs may not be exempted from the CEA's definition of "swap" because they do not satisfy the statutory definitions of a foreign exchange swap or forward.

The payment obligations on foreign exchange swaps and forwards are fixed and predetermined. While the mark-to-market value of a position in a foreign exchange swap or forward may vary based on changes in the exchange rate, the actual settlement amounts do not. These features make foreign exchange swaps and forwards more similar to funding instruments, such as repurchase agreements, which are not covered under the CEA. Businesses that sell goods in international trade, or that make investments in foreign countries, frequently ask their banks to arrange foreign exchange swaps and forwards to control the risk that their own country's currency will rise or fall against the other country's currency while the sale or investment is pending.

Foreign exchange swap and forward participants know their own and their counterparties' payment obligations and the full extent of their exposure throughout the life of the contract, whereas the counterparties to other derivatives contracts do not. Moreover, foreign exchange swap and forward contracts have a very short average length and, therefore, relative to other swaps and derivatives, create significantly lower levels of counterparty credit risk.

Settlement of foreign exchange swap and forward transactions requires the exchange of the full principal amount of the contract in two different currencies, whereas the payment obligations of most other derivatives are based on the incremental profit or loss on a transaction. The physical settlement requirement distinguishes foreign exchange swaps and forwards from other derivatives and contributes to a risk profile that is largely concentrated on settlement risk.

B. Settlement Risk Is the Main Risk and Already Is Effectively Mitigated

Settlement of foreign exchange swap and forward transactions requires the exchange of the full principal amount of the contract in two different currencies.[13] Settlement risk is the risk that one party to a foreign exchange swap or forward transaction will deliver the currency it owes its counterparty, but not receive the other currency from its counterparty. In contrast to other derivatives, including the other foreign exchange derivatives discussed above, parties' ultimate payment obligations on a foreign exchange swap or forward are known and fixed from the beginning of the contract and involve the actual exchange of a predetermined amount of principal at settlement. The physical settlement requirement distinguishes foreign exchange swaps and forwards from other derivatives and contributes to a risk profile that is largely concentrated on settlement risk.

The foreign exchange swap and forward market relies on the extensive use of PVP settlement arrangements, which permit the final transfer of one currency to take place only if the final transfer of the other currency also takes place. These settlement arrangements do not guarantee the contract but prevent payment flows from occurring if either party defaults. CLS Bank International ("CLS"), the predominant PVP settlement system, currently provides settlement services for 17 currencies that represent 4 percent of the total daily value of foreign exchange swaps and forwards traded globally.

Currently, roughly 75 percent of the entire foreign exchange market is estimated to settle without settlement risk to either party. This figure includes trades settled by PVP arrangements, as well as trades that are settled without settlement risk. (Transactions that are internally settled between corporate affiliates, cash settled, or settled across a single-bank's books for its clients are not sub ect to settlement risk.) In the foreign exchange swaps and forwards market in particular, CLS estimates that it settles more than 50 percent of foreign exchange swap and forward transactions that are sub ect to settlement risk. The use of CLS has also been growing steadily since its introduction in 2002, and CLS has announced plans to further expand its settlement services to include additional currencies, increase volume capacity and add additional settlement times.

C. Foreign Exchange Swaps and Forwards Are Subject to Less Counterparty Credit Risk Than Other Derivatives

Counterparty credit risk is the risk of economic loss if either party defaults on a contract. Counterparty credit risk increases with the length of a contract because that increases the length of time during which a counterparty could suffer from adverse developments. Foreign exchange swap and forward contracts have a very short average

the clearing and trading requirements and authorizes the CFTC to impose conditions or limitations on these exceptions.

[10] 7 U.S.C. 1a(47)(E)(i).

[11] 7 U.S.C. 1a(25).

[12] 7 U.S.C. 1a(24).

[13] By contrast, the payment obligations of most other derivatives are based on the incremental profit or loss on a transaction and either party's payment may be made with a common currency.

length. Sixty-eight percent of foreign exchange swap and forward contracts mature in less than a week, and 98 percent mature in less than a year. Other derivatives, such as interest rate swaps, generally have much longer maturity terms (*e.g.,* between two and thirty years) than foreign exchange swaps and forwards, and thus pose significantly more counterparty credit risk than foreign exchange swaps and forwards.

Central clearing could provide foreign exchange swap and forward participants with further protection against the risk of default by their counterparties (*i.e.,* the replacement cost of a transaction if a counterparty fails to perform). However, imposing a central clearing requirement on the foreign exchange swaps and forwards market raises two concerns. First, requiring central clearing may lead to combining clearing and settlement in one facility, which would create large currency and capital needs for that entity due to: (i) The sheer size and volume of the foreign exchange swaps and forwards market; and (ii) the fact that the central clearing facility would be effectively guaranteeing both settlement and market exposure to replacement cost. We believe that it is unlikely a central counterparty ("CCP") would be able to provide the settlement services required by this market, either directly or in conjunction with another service provider, such as CLS.

In addition, providing central clearing separately from settlement presents the second concern, namely: required clearing would disrupt the existing settlement process by introducing additional steps between trade execution and settlement that pose significant operational challenges. The existing settlement process for this market functions well and has been critical to mitigating this market's main source of risk. The operational challenges and potentially disruptive effects on the foreign exchange swaps and forwards market associated with adding a central clearing requirement for these instruments thus significantly outweigh the marginal benefits that central clearing would provide.

D. Key Players Within the Foreign Exchange Market Already Are Subject to Oversight

Unlike the derivatives markets, banks are the key players in the foreign exchange swaps and forwards market. Roughly 95 percent of foreign exchange swaps and forwards transactions occur between banks acting either on their own behalf or on behalf of their clients. Banks are subject to consolidated supervision, and supervisors regularly monitor their foreign exchange related exposures, internal controls, risk management systems, and settlement practices.

The foreign exchange market itself also has long been subject to comprehensive and coordinated oversight, reflecting its unique characteristics and functioning. Since the introduction of floating exchange rates in the early 1970s, G10 central banks and regulators have undertaken strong and coordinated oversight measures for the foreign exchange market, given its critical role in monetary policy and the global payments system. This global strategy, which was launched in 1996 by the Bank for International Settlements ("BIS"), resulted in the design and implementation of CLS and other PVP settlement arrangements. The Federal Reserve regularly conducts reviews of the risk management and operational processes of major foreign exchange market participants. These reviews inform Basel Committee on Banking Supervision ("BCBS") and Committee on Payment and Settlement Systems ("CPSS") updates to bank supervisory guidelines on managing foreign exchange settlement risk.

E. The Foreign Exchange Swaps and Forwards Market Already Is Highly Transparent and Traded Over Electronic Trading Platforms

Foreign exchange swaps and forwards already trade in a highly transparent market. Market participants have access to readily available pricing information through multiple sources. Approximately 41 percent and 72 percent of foreign exchange swaps and forwards, respectively, already trade across a range of electronic platforms and the use of such platforms has been steadily increasing in recent years.[14] The use of electronic trading platforms provides a high level of pre- and post-trade transparency within the foreign exchange swaps and forwards market. Thus, mandatory exchange trading requirements would not significantly improve price transparency or reduce trading costs within this market.

F. Foreign Exchange Swaps and Forwards Will Be Subject to Additional Oversight Under the CEA

ven if the Secretary determines that foreign exchange swaps and forwards should not be regulated as "swaps" under the C A, that determination would not affect the application of other provisions of the C A that will prevent evasion by market participants and improve market transparency. Commenters who oppose an exemption argue that it would create a large regulatory loophole that exacerbates systemic risk. However, all foreign exchange transactions would remain subject to the CFTC's new trade-reporting requirements, enhanced anti-evasion authority, and strengthened business-conduct standards. Notably, the creation of a global foreign exchange trade repository, plans for which are already underway, will dramatically expand reporting to regulators and the market more broadly.

[14] BIS, Greenwich Associates, Oliver Wyman analysis.

II. Background and Statutory Considerations

A. Overview

(i) Foreign xchange Swaps and Forwards istinguished From Other Swaps

Foreign exchange swaps and forwards that would be exempt from the C A's definition of "swap" under the determination are narrowly defined transactions that are qualitatively different from other derivatives. First, foreign exchange swaps and forwards involve the actual exchange of the principal amounts of the two currencies exchanged and are settled on a physical basis. Unlike many other derivative instruments (*e.g.,* interest rate swaps) whose payment obligations fluctuate daily in response to changes in the values of underlying variables, such as interest rates, the payment obligations of foreign exchange swaps and foreign exchange forwards, as defined by the C A, are fixed at the onset of the agreement and involve the actual exchange of full principal for settlement.

Second, in stark contrast to other derivatives, over 98 percent of foreign exchange swaps and forwards mature in less than one year, and 68 percent mature in less than one week. For example, interest rate swaps and credit default swaps generally have maturity terms between two and thirty years and five to ten years, respectively. Since counterparty credit risk increases as the length of a contract increases, foreign exchange swaps and forwards carry significantly lower counterparty credit risk.

Third, the use of foreign exchange swaps and forwards is distinct from other derivatives. Because of their unique structure and duration, as outlined above, foreign exchange swaps and forwards are predominantly used as short-term funding instruments similar to repurchase agreements and other money market instruments and for hedging foreign currency risks. Other derivatives, such as interest rate and currency swaps, are used for a broader range of purposes.

Fourth, foreign exchange swaps and forwards already trade in a highly transparent and liquid market. Market participants have access to readily available pricing information through multiple sources.[15] Approximately 41and 72 percent of foreign exchange swaps and forwards, respectively, already trade across a range of electronic platforms.[16] As a result, mandatory exchange trading requirements under the CEA would be unlikely to improve price transparency significantly.

These distinguishing characteristics of foreign exchange swaps and forwards result in a risk profile that is largely concentrated on settlement risk, rather than counterparty credit risk. Settlement risk is effectively addressed in the market for foreign exchange swaps and forwards by the extensive use of CLS and other PVP settlement arrangements. PVP is a foreign exchange settlement mechanism that ensures that a final transfer of one currency occurs only if a final transfer of the other currency (or currencies) takes place, thereby virtually eliminating settlement risk. CLS is a specialized settlement system that operates a multilateral PVP settlement system to reduce foreign exchange settlement risk (but not credit risk, which is mitigated by other measures). CLS, which began operations in September 2002, is now the predominant global PVP settlement system. It currently provides settlement services for 17 currencies, which represent 94 percent of the total daily value of currencies traded globally. CLS estimates that it settles 58 percent of global foreign exchange trading, through 60 settlement member banks and approximately 9,000 third-party users. According to a September 2010 Foreign Exchange Committee ("FXC") [17] survey, roughly 75 percent of foreign exchange transactions are settled without settlement risk to either party. This figure includes trades settled by CLS, settled between affiliates of the same corporation, and settled across a single bank's books for its clients.

(ii) Implications of a Determination to Exempt Foreign Exchange Swaps and Forwards From the Term "Swap" Under the CEA

If the Secretary issues a written determination to exempt foreign exchange swaps or forwards, or both, from the definition of a "swap" under the CEA, these transactions, as well as certain parties that engage in these transactions, would not be subject to some requirements under the CEA, notably the clearing and exchange-trading requirements.

However, even if the Secretary issues such a determination, foreign exchange swaps and forwards and the parties to such transactions would still be subject to trade reporting requirements, business conduct standards (including the anti-fraud provision) in section 4s(h) of the CEA and the rules promulgated thereunder by the CFTC, and anti-evasion requirements promulgated by the CFTC. In this regard, section (c) of the proposed determination—which reflects the language of section 1a(47)(E)(iii)–(iv), 1b(c) of the CEA—would provide that, notwithstanding this determination, certain requirements under the CEA would apply to any foreign exchange swap or foreign exchange forward, or to any party engaged in such a transaction, to the extent provided by such requirements.

In addition, Treasury notes that section 1a(47)(F) of the CEA contains two other provisions applicable to foreign exchange swaps and foreign exchange forwards. First, subparagraph (47)(F)(i) provides that " a ny foreign exchange swap and any foreign exchange forward that is listed and traded on or subject to the rules of a designated contract market or a swap execution facility, or that is cleared by a derivatives clearing organization, shall not be exempt from any provision of CEA , or the amendments under Title VII of the Dodd-Frank Act prohibiting fraud or manipulation." [18] Second, " n othing in subparagraph (E) which authorizes the Secretary to issue such a determination shall affect, or be construed to affect, the applicability of the CEA or the jurisdiction of the CFTC with respect to agreements, contracts, or transactions in foreign currency pursuant to section 2(c)(2) of the CEA ." [19]

(iii) Summary of Comments in Response to October 2010 Notice

Commenters who support issuing an exemption generally argue that foreign exchange swaps and forwards are functionally different from other over-the-counter ("OTC") derivatives because foreign exchange swaps and forwards, as defined by the CEA, involve an actual exchange of principal, are predominantly very short in duration and have high turnover rates. These commenters note that this market functions predominantly as a global payments market and is used significantly by end-users for hedging purposes.[20] Many corporate participants expressed concern that the additional costs associated with clearing foreign exchange swaps and forwards would adversely impact their business activities and discourage hedging activity. These commenters also cautioned that imposing mandatory clearing and exchange trading requirements on the foreign exchange market would increase systemic risk by concentrating risk in one or more clearinghouses. They also noted that central clearing could negatively affect U.S. dollar liquidity and threaten the role of the dollar as the world's reserve currency, citing the potential that such requirements could push foreign exchange transactions further offshore and challenge the Federal Reserve's ability to conduct monetary policy.

Settlement risk, they argue, is the primary risk associated with foreign exchange swaps and forwards, and they state that the settlement of trades through CLS has largely addressed these concerns.[21]

Given the short duration of foreign exchange swaps and forwards, most commenters emphasized that counterparty credit risk is not as significant a risk for these transactions (relative to other derivative transactions) and that the use of credit support annexes ("CSAs") and standard ISDA documentation mitigates this risk.

Moreover, commenters who favor an exemption maintain that foreign exchange swaps and forwards generally trade in a heavily liquid, efficient, and transparent inter-bank market, where bank regulators have substantial visibility and exercise strong regulatory oversight over the major market participants, which generally consist of either depository institutions or affiliates of depository institutions. A number of these commenters also stressed that the Federal Reserve has

[15] *See, e.g.,* comment by Global FX Division of the Securities Industry and Financial Markets Assoc., Assoc. for Financial Markets in Europe, and the Asia Securities Industry and Financial Markets Assoc. ("Global FX Division"), at 11.

[16] BIS, Greenwich Associates, Oliver Wyman analysis.

[17] Formed in 1978 under the sponsorship of the Federal Reserve Bank of New York, the FXC is an industry group that produces best practice recommendations for the foreign exchange industry, addressing topics such as management of risk in operations and trading.

[18] 7 U.S.C. 1a(47)(F)(i).

[19] 7 U.S.C. 1a(47)(F)(ii) (referring, in turn, to 7 U.S.C. 2(c)(2)).

[20] *See* comment by 3M, Cargill Inc. *et al.*, at 2.

[21] *See, e.g.,* comment by Global FX Division, at 12–14.

ample authority to craft appropriate regulations governing systemically important financial market utilities and payment, clearing, and settlement activities under Title VIII of Dodd-Frank Act. These commenters also cite the effective functioning of the foreign exchange market during the financial crisis of 2008.

In contrast to these views, commenters who oppose an exemption for foreign exchange swaps and forwards are primarily concerned that the exemption would create a large regulatory loophole, citing the large size of this market, as well as the lack of a fundamental economic difference, in their view, between foreign exchange swaps and forwards and other derivative products.[22] In light of the recent financial crisis, these commenters argue that such loopholes can play a significant role in undermining financial stability by preserving an opaque, unregulated and under-capitalized market. Opponents also express concerns that an exemption could be used to mask complex transactions in an effort to avoid subjecting them to clearing and trading requirements.

B. Statutory Factors

As discussed above, in considering whether to exempt foreign exchange swaps and forwards from the definition of the term "swap," the Secretary must consider five factors. Treasury is continuing to consider each of these statutory factors and invites comment on the analysis of each of these factors, as follows.

(i) Systemic Risk, Transparency, Financial Stability

Treasury has considered several factors to assess whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States. Treasury believes that, given the reduced counterparty credit risk profile of this market, the challenges of implementing central clearing within this market significantly outweigh the marginal benefits that central clearing and exchange trading would provide.

Regulating foreign exchange swaps and forwards under the CEA would require insertion of a CCP into an already well-functioning and highly interconnected settlement process, which could result in unnecessary operational and settlement challenges. Other derivative transactions, such as interest rate swaps and credit default swaps, create settlement obligations that equal only the change in the market price of the notional value of the underlying instrument—not the full principal amounts—and, thus, result in much smaller daily payment obligations for those markets. While the existing CLS and other PVP settlement systems protect against the risk of principal loss in the foreign exchange swaps and forwards market, central clearing would further protect participants against the economic loss of profit on a transaction. However, combining these two functions in a market that involves settlement of the full principal amounts of the contracts would require massive capital backing in a very large number of currencies, representing a much greater commitment for a potential CCP than for any other derivatives market.

To date, no CCP has developed a practical solution to guarantee the extraordinarily large volumes of transactions in foreign exchange swaps and forwards, including provision of or coordination with the settlement services that are essential to the foreign exchange swaps and forwards market. Introducing a central clearing facility without settlement capabilities would not improve market functioning instead, requiring central clearing would raise unnecessary operational challenges by introducing additional steps between trade execution and settlement. iven that any risks created through the increased complexity would be magnified by the number of currencies involved, among other factors, Treasury believes that requiring the use of a CCP for clearing foreign exchange swaps and forwards is not warranted, particularly because existing settlement arrangements currently function well and address the main source of risk, settlement risk.

In response to the October 2010 Notice, end-users of foreign exchange swaps and forwards have expressed significant concern that requiring centralized clearing would substantially increase the costs of hedging foreign exchange risks. Commenters argue that additional costs associated with collateral, margin, and capital requirements required by the CCP would potentially reduce their incentives to manage foreign exchange risks.[23] Such additional costs borne by non-financial end-users could lead to lower cash flows or earnings, which would divert financial resources from investment and discourage international trade, thereby limiting the growth of U.S. businesses.[24] Several commenters also suggest that requiring centralized clearing of foreign exchange swaps and forwards could lead non-financial end-users to move production facilities overseas in order to establish "natural hedges" through the consistent use of local currencies and force them to reconsider the use of CLS in light of the additional costs associated with central clearing.[25]

As noted above, the market for foreign exchange transactions is one of the most transparent and liquid global trading markets. Pricing is readily available through multiple sources and a large portion of foreign exchange trades currently are executed through electronic trading platforms.[26]

In light of these and similar factors raised by the commenters, Treasury believes that mandating centralized clearing and exchange trading under the CEA for foreign exchange swaps and foreign exchange forwards actually would introduce significant operational challenges and potentially disruptive effects in this market which would outweigh any marginal benefits for transparent trading or reducing risk in these instruments.

(ii) Regulatory Scheme Comparable to That of the CEA

Treasury has considered several factors to assess whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps.

Since the introduction of floating exchange rates in the early 1970s, central banks and regulators have undertaken strong and coordinated oversight measures for the foreign

[22] *See, e.g.,* comment by Council for Institutional Investors, at 1–2.

[23] *See, e.g.,* comment by National Assoc. of Manufacturers, at 4.

[24] *See, e.g.,* comment by 3M, Cargill Inc. *et al.,* at 6.

[25] *See, e.g.,* comment by Coalition for Derivatives End-Users, at 16–17.

[26] Furthermore, Treasury understands that plans are being made for the creation of at least one global foreign exchange trading repository pursuant to section 21 of the CEA (7 U.S.C. 24a, as added by section 728 of the Dodd-Frank Act), which will dramatically expand reporting coverage for swaps, including foreign exchange swaps and forwards, regardless of whether the Secretary issues a determination that these transactions should not be regulated as "swaps" under the CEA. 75 FR 76,574 (Dec. 8, 2010). (In its proposed rule regarding swap data recordkeeping and reporting requirements, the CFTC explains that, for the purposes of reporting requirements, foreign exchange swaps and forwards would be included within the category of "currency swap." *Id.* at 76,586. The CFTC also has proposed rules relating to the registration and regulation of swap data repositories that would adopt new part 49 of the CFTC's regulations, 17 CFR Part 49. *See* CFTC, Notice of Proposed Rulemaking: Swap Data Repositories, 75 FR 80898 (Dec. 23, 2010)).

exchange market because of the critical role this market plays in the conduct of countries' monetary policy. More specifically, in 1996, the Bank for International Settlements ("BIS") launched a globally coordinated strategy on behalf of the G10 central banks, calling for specific actions by individual banks, industry groups and central banks to address and reduce risk in the foreign exchange market. This strategy has resulted in specific actions undertaken to address settlement risk, mitigate counterparty credit risk and develop global supervisory guidelines on managing foreign exchange risk. Largely as a result of these measures, many market observers note that the foreign exchange market was one of the few parts of the financial market that functioned effectively throughout the financial crisis.[27]

One of the key goals of this work was to expand the use of PVP settlement systems. Such systems largely eliminate settlement risk, which is the predominant risk in a foreign exchange swap or forward. As noted, PVP settlement ensures that the final transfer of one currency occurs only if a final transfer of the other currency or currencies takes place, thereby virtually eliminating settlement risk. In order to support such PVP arrangements, central banks undertook significant actions by extending operating hours, providing cross-border access to central bank accounts and enhancing the legal certainty around such settlement arrangements.

The creation of CLS was the most successful outcome of this work. As noted earlier, CLS is the predominant PVP settlement system, settling the majority of all global foreign exchange transactions in 17 currencies, through 60 settlement member banks and approximately 9,000 third party users.[28]

A comparable regulatory scheme applies to the settlement system conducted through CLS. While the Federal Reserve is the primary regulator for CLS, a CLS Oversight Committee[29] consisting of 22 central banks was established to provide coordinated oversight of CLS by all central banks whose currencies are settled through its system. As a result of this group's efforts, each participating central bank now maintains accounts for CLS and has created a window period during which real-time gross settlement systems are open to accommodate the funding necessary for the settlement of payment instructions. This group has also developed a set of risk management tests that CLS must apply to each instruction it submits for settlement to mitigate the associated credit, market and liquidity risks.

In addition, Treasury notes that the established regulatory scheme also actively encourages the use of CSAs and master netting agreements to reduce counterparty credit exposures. Similar to changes made to enable the use of PVP settlement arrangements, central banks and governments worked to strengthen the legal foundations of bilateral and multilateral netting. Master netting agreements mitigate credit risk by enabling closeout netting in the event of a default or bankruptcy. CSAs can also be negotiated as a supplement to master agreements to further reduce and mitigate exposures to counterparties by collateralizing transactions.

(iii) Adequacy of Supervision

Treasury also has assessed the extent to which bank regulators supervise participants in the foreign exchange market, including by imposing capital and margin requirements.

The predominant participants in the foreign exchange swaps and forwards market are banks which have long been subject to prudential supervision. In fact, nearly all trading within the foreign exchange market involves bank counterparties. Roughly 95 percent of foreign exchange trading occurs between banks acting in the capacity of either principal or agent. Compared to non-bank entities, banks have distinct advantages to provide the liquidity and funding necessary to conduct foreign exchange swaps and forwards, which involve the exchange of principal, rather than variable cash flows. In conjunction with providing the liquidity and funding needs to conduct these transactions, banks are uniquely qualified to have access to CLS to settle transactions on a real-time basis, and thereby meet the payment and short-term funding needs of the end users. Prudential supervisors regularly monitor the activities, exposures, internal controls and risk management systems of these banks.[30] In order to meet safety-and-soundness requirements, banks have implemented monitoring systems, limits, internal controls, hedging techniques, and similar risk-management measures. Counterparty credit risk management is a fundamental issue for banking supervisors and is extensively addressed in bank supervisory guidelines as well as under the Basel Accords. In addition, CLS itself is subject to comprehensive oversight by 22 central banks whose currencies are settled through its system.

As an example of the continuing supervisory efforts in this market, the Federal Reserve will conduct an assessment of current risk management practices, in conjunction with other jurisdictions, in order to better inform the development of supervisory guidance covering the use of CLS, CSAs, and other systems and controls. Treasury understands that this process might ultimately highlight the need for any additional supervisory or regulatory action, including potential actions under Title VIII of the Dodd-Frank Act. This review will inform BCBS and CPSS updates to bank supervisory guidelines on managing foreign exchange settlement risk.

In addition to the supervisory measures discussed above, the OTC Derivatives Supervisors Group, which includes market and banking regulators from the .S., France, Germany, apan, Switzerland and the . ., has been securing commitments from market participants since 2005 to strengthen market infrastructure, risk management practices, and transparency in the OTC derivatives market. This group is currently engaged with foreign exchange industry groups and market participants, such as the FXC, to secure and monitor new commitments that advance risk management in this market.

(iv) Adequacy of Payment and Settlement Systems

Treasury also has assessed the extent of adequate payment and settlement systems for foreign exchange swaps and forwards. With respect to this factor, as noted, the G10 strategy successfully resulted in the establishment of PVP settlement systems to virtually eliminate the settlement risk associated with foreign exchange swaps and forwards, with CLS being the primary example of this work. Central banks undertook significant actions to support these robust PVP settlement arrangements. As a result, roughly 75 percent of notional foreign exchange is either settled through CLS or otherwise settled without risk, including trades that are settled between affiliates of the same corporation or across a single bank's

[27] *See, e.g.,* comment by Global FX Division, at 11–12.

[28] *See, e.g., http://www.cls-group.com.*

[29] Federal Reserve Board, "Protocol for Cooperative Oversight Arrangement for CLS," Nov. 25, 2008, *available at http://www.federalreserve.gov/paymentsystems/cls_protocol.html.*

[30] *See, e.g.,* supervisory and examination standards for wholesale payments systems developed by the Federal Financial Institutions Examination Council, available at *http://ithandbook.ffiec.gov/it-booklets/ wholesale-payment-systems/ wholesale-payment-systems-risk-management .aspx.*

books for its clients. In the foreign exchange swaps and forwards market in particular, CLS estimates that it settles more than 50 percent of foreign exchange swap and forward transactions that are subject to settlement risk. Furthermore, CLS has announced a multi-year strategic objective to expand settlement services to include additional currencies, increase volume capacity, and add additional settlement times. Treasury understands that the Federal Reserve and the CLS Oversight Committee are currently reviewing these plans, as well as encouraging the expansion of other PVP settlement services.

(v) Possible Use of Exemption to Evade Requirements

Treasury has considered several factors to assess whether the use of an exemption for foreign exchange swaps and foreign exchange forwards could be used to evade otherwise applicable regulatory requirements. Treasury believes that the unique characteristics of foreign exchange swaps and foreign exchange forwards, as defined by the CEA, make it difficult for these products to be structured to replicate currency or interest rate swaps to evade regulatory requirements under the CEA.

Unlike other types of swaps, foreign exchange swaps and forwards are distinct because, as defined by the CEA, these transactions must (1) involve the exchange of the principal amounts of the two currencies exchanged, as opposed to an additional set of cash flows based upon some floating reference rate (e.g. LIBOR), and (2) be settled on a physical basis.[31]

A "swap" regulated under the CEA, such as a currency swap, interest rate swap, or other derivative, generally involves a periodic exchange of a floating amount of cash flows between the counterparties based on some notional amount, whereas a foreign exchange swap (which would be exempt from the definition of "swap" under this determination) involves a simple exchange of principal at one point in time and a reversal of that exchange at some later date. For example, a user of a currency swap could seek funding advantages by obtaining financing in a foreign currency and swapping those cash flows back to the user's locally denominated currency. This would then entail paying or receiving a series of floating interest rate payments (*i.e.,* based on prevailing interest rates) over the life of the transaction. This ability to receive periodic payments during the term of a transaction is a significant feature of "swaps" that will be regulated under the CEA, which is absent from a foreign exchange swap or foreign exchange forward.

While there is a possibility that foreign exchange swaps could be used by some market participants to speculate on the short term path of interest rates, Treasury believes that the operational challenges and transaction costs associated with transforming these instruments to replicate currency or interest rate swaps significantly reduce the likelihood that market participants would actually do so in order to evade regulatory requirements under the CEA.

To begin with, the transactions costs associated with replicating currency swaps through the use of foreign exchange swaps would likely be significant because a market participant would need to regularly roll over its foreign exchange swap position as it seeks to replicate a currency swap. For example, a participant would need to consider the costs associated with the series of separate bid-ask spreads accompanying each of the foreign exchange swap transactions, as well as the costs of monitoring those positions. Moreover, whether a participant would structure foreign exchange swap transactions in order to replicate other, non-exempt swaps that are subject to central clearing requirements would be highly dependent on the costs associated the operational or systems arrangements necessary to execute the foreign exchange swap transactions, relative to the costs imposed by CCPs to clear the other, non-exempt swap transactions (such as margin costs), which could vary among market participants.

Importantly, a determination to exempt foreign exchange swaps and forwards from regulation as "swaps" under the CEA would not affect the application of other provisions that will prevent evasion by market participants and improve market transparency. Opponents of an exemption argue that such a determination would create a large regulatory loophole that exacerbates systemic risk. owever, all foreign exchange swaps and forwards would remain subject to the CFTC's new trade-reporting requirements, enhanced anti-evasion authority, and strengthened business-conduct standards for swaps dealers and major swap participants.[32] Notably, the creation of global foreign exchange trade repositories, plans for one of which already are underway, will dramatically expand reporting to regulators and the market more broadly. This additional reporting will also provide regulators with information that can be used to detect attempts by market participants to use foreign exchange swaps or forwards to replicate other derivatives in order to evade regulatory requirements. Lastly, the Dodd-Frank Act amends the CEA and other laws to provide other measures to enhance oversight of key players in the swaps market, which will further reduce the risk that foreign exchange swaps and forwards could be used to evade regulatory requirements.

III. Procedural Analysis

A. Executive Order 12866 and Executive Order 13563

Executive Orders 13563 and 12866 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximi e net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasi es the importance of quantifying both costs and benefits, of reducing costs, of harmoni ing rules, and of promoting flexibility. This rule has been designated a "significant regulatory action" although not economically significant, under section 3(f) of Executive Order 12866. Accordingly, the rule has been reviewed by the Office of Management and Budget.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) generally requires agencies to prepare a regulatory flexibility analysis unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. It is hereby certified that this determination would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that entities that engage in foreign exchange swaps and forwards, as defined by the CEA and as described in this proposed determination, tend to be large entities. Accordingly, a regulatory flexibility analysis is not required. Notwithstanding this certification,

[31] In this regard, Treasury notes that, in other swaps transactions, the parties may, by agreement, physically settle their obligations.

[32] In addition, Treasury notes that section 753 of the Dodd-Frank Act amends section 6(c) of the CEA to provide, in relevant part, that "it shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity." 7 U.S.C. 9, 15.

Treasury invites comments on the impact on small entities.

IV. Proposed Determination

For the reasons set forth in sections I and II, which are incorporated into and made part of this section IV, the Secretary proposes to issue a determination, as follows:

(a) Authority and purpose. This determination is issued under section 1a(47)(E) and 1b of the Act in order to implement the provisions of the Act relating to the treatment of foreign exchange swaps and foreign exchange forwards as swaps under the Act.

(b) Findings and exemption—(1) *Considerations.* The Secretary has considered—

(i) Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States, and finds that the required trading and clearing of these instruments would introduce new challenges and could result in negative consequences, without improving transparency;

(ii) Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by this Act for other classes of swaps, and finds that the regulatory scheme for foreign exchange swaps and foreign exchange forwards applicable in the U.S., as well as the regulatory schemes in other jurisdictions, have required specific actions that address settlement risk, mitigate counterparty credit risk, and manage other risks associated with foreign exchange swaps and forwards;

(iii) The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements, and finds that regulators are adequately supervising these participants, in part by requiring the implementation of risk-management and operational processes, including the use of payment-versus-payment settlement arrangements for settling transactions and the adoption of credit support annexes with counterparties;

(iv) The extent of adequate payment and settlement systems, and finds that these systems are adequate for foreign exchange swaps and foreign exchange forwards, particularly because a specialized settlement system, which is subject to Federal oversight, has proven capabilities to settle the majority of all global foreign exchange transactions in multiple currencies; and

(v) The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements, and finds that foreign exchange swaps and foreign exchange forwards, as defined under the Act, are distinguished from other derivatives, widely used by supervised banks for bona fide funding transactions, and not likely to be used to evade otherwise applicable regulatory requirements because of operational and transactions costs associated with potentially transforming these instruments into other derivatives that are subject to regulatory requirements under the Act.

(2) Exemption. Upon consideration of each of the factors set forth in section 1b of the Act, the Secretary finds that—

(i) Foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the Act; and

(ii) Foreign exchange swaps and foreign exchange forwards are not structured to evade the requirements of the Dodd-Frank Act, in violation of any rule promulgated by the Commission, pursuant to section 721(c) of the Dodd-Frank Act (15 U.S.C. 8321)— and, accordingly, hereby determines that any foreign exchange swap or foreign exchange forward hereby is exempt from the definition of the term "swap" under the Act.

(c) *Scope*—As provided in sections 1a(47)(E) and 1b(c) of the Act—

(1) *Reporting.* Notwithstanding this determination, all foreign exchange swaps and foreign exchange forwards shall be reported to a either a swap data repository or, if there is no swap data repository that would accept such swaps or forwards, to the Commission, pursuant to section 4r of the Act (7 U.S.C. 6r) within such time period as the Commission may by rule or regulation prescribe.

(2) *Business standards.* Notwithstanding this determination, any party to a foreign exchange swap or forward that is a swap dealer or major swap participant (as such terms are defined under the Act or under section 721(c) of the Dodd-Frank Act (15 U.S.C. 8321)) shall conform to the business conduct standards contained in section 4s(h) of the Act (7 U.S.C. 6s(h)).

(3) *Effect of determination.* This determination shall not exempt any foreign exchange swap or foreign exchange forward traded on a designated contract market or swap execution facility from any applicable antimanipulation provision of the Act.

(d) Definitions. For the purposes of this determination, the following definitions apply:

(1) *Act* means the Commodity Exchange Act.

(2) *Commission* means the Commodity Futures Trading Commission.

(3) *Dodd-Frank Act* means the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(4) *Foreign exchange forward* shall have the same meaning as in section 1a(24) of the Act.

(5) *Foreign exchange swap* shall have the same meaning as in section 1a(25) of the Act.

(6) *Swap* shall have the same meaning as in section 1a(47) of the Act.

Dated: April 29, 2011.

Alastair Fitzpayne,

Deputy Chief of Staff and Executive Secretary.

[FR Doc. 2011–10927 Filed 5–4–11; 8:45 am]

BILLING CODE 4810–25–P

DEPARTMENT OF THE TREASURY

Fiscal Service

Financial Management Service; Proposed Collection of Information: List of Data (A) and List of Data (B)

AGENCY: Financial Management Service, Fiscal Service, Treasury.

ACTION: Notice and Request for comments.

SUMMARY: The Financial Management Service, as part of its continuing effort to reduce paperwork and respondent burden, invites the general public and other Federal agencies to take this opportunity to comment on a continuing information collection. By this notice, the Financial Management Service solicits comments concerning the form "List of Data (A) and List of Data (B)."

DATES: Written comments should be received on or before July 5, 2011.

ADDRESSES: Direct all written comments to Financial Management Service, 3700 East West ighway, Records and Information Management Branch, Room 135, yattsville, Maryland 20782.

FOR FURTHER INFORMATION CONTACT: Requests for additional information or copies of form(s) and instructions should be directed to Rose Miller, Manager, Surety Bond Branch, 3700 East West ighway, Room 632F, yattsville, MD 20782, (202) 874–1427.

SUPPLEMENTAL INFORMATION: Pursuant to the Paperwork Reduction Act of 1995, (44 U.S.C. 3506(c)(2)(A)), the Financial Management Service solicits comments on the collection of information described below:

Title: List of Data (A) and List of Data (B) *OMB Number:* 1510–0047.

Q.4. There has been an increase in litigation against banks related to foreign currency trading activities. Pension funds and State attorneys general allege that certain banks executed trades at one price, but charged a higher price to the funds. Whistleblowers have also come forward alleging improper practices related to foreign currency trading by banks. An October 2009 report by Russell Investments noted that there is "no regulator charged with defending the rights and interests of clients when converting currency." What work has Treasury done to monitor and investigate allegations of improper practices regarding currency trading? What is the current state of the regulatory framework that addresses this area? What options, if any, has the Department explored for enhancing transparency? What, if any, legislation might be required in this area to better protect clients from improper practices in this area?

A.4. The Treasury Department does not comment on pending litigation and investigations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) further strengthens the oversight and transparency of all foreign currency derivatives markets, including foreign exchange swaps and forwards. It subjects participants in the derivatives markets to heightened business conduct standards and provides the CFTC and banking regulators with additional oversight of market participants and with strong anti-evasion powers to ensure that they do not structure products or take other steps to evade the Commodity Exchange Act's requirements. The DFA's trade reporting requirements will significantly enhance the transparency and oversight of derivatives markets, including for foreign currency derivatives.

Q.5. Title VII of the Dodd-Frank Act, largely overseen by the SEC and CFTC, will require firms to keep additional capital for over-the-counter trades, so that they will be able to pay up, if the trade moves against them. At the same time, the Volcker Rule, which is overseen by banking regulators, as well as the SEC and CFTC, also imposes capital requirements. These provisions require regulators to impose additional capital charges for any proprietary trading by the nonbank financial companies supervised by the board [((a)(2)) and ((f)(4))], and explicitly authorizes regulators to impose additional capital charges on banking entities, for even permitted activities such as market-making. [((d)(3))] And, of course, the Treasury Department and the banking regulators are working with their international counterparts to effectively implement new Basel requirements on capital. What work is the Treasury Department doing, whether independently or in coordination with the prudential regulators, the SEC, or CFTC, to help enhance the capital requirements for trading positions, as directed by not just the derivatives title, but also by the Volcker Rule?

A.5. Although the Treasury Department is not directly responsible for writing the regulations to implement either the derivatives provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act or the Volcker Rule, we are working closely with the agencies responsible for issuing the regulations to implement the Volcker Rule to coordinate the rulemakings so that they are as consistent and comparable as possible across supervisory jurisdictions.

Q.6. Historically OTC derivatives have been taxed under the conventional realization method of accounting for stock, bonds, and other securities, while exchange traded funds have been subject to Section 1256 of the Internal Revenue Code, which generally requires that contracts within its scope be marked-to-market on an annual basis, and provides that gains or losses are considered capital gains/losses with 60 percent long-term and 40 percent short term. Section 1601 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 1256 of the IRC. On December 7, 2010, the Treasury/IRS business plan provided for the development of "guidance on the application of [Section] 1256 to certain derivatives contracts." What tax issues is the Department considering with respect to derivatives contracts? When does the Department expect that it will issue guidance in this area? If the Secretary of the Treasury exempted foreign exchange swaps and forwards from the definition of "swap" under the Commodity Exchange Act, would the definition under Section 1256 of the IRC, as amended by Dodd-Frank, remain applicable?

A.6. Section 1256 of the Internal Revenue Code generally requires that "section 1256 contracts" be marked-to-market annually. A section 1256 contract is a regulated futures contract, a foreign currency contract, a dealer securities futures contract, or certain options listed on a qualified board or exchange (QBE). Gain or loss from a foreign currency contract is generally treated as ordinary income and subject to tax at regular income tax rates; a regulated futures contract, dealer securities futures contract, and a listed option generates 60 percent long-term and 40 percent short-term capital gain or loss, assuming the contract is a capital asset in the hands of the taxpayer.

In recent years, an increasing number of contracts have been moving to QBEs and/or centralized clearinghouses, raising the question as to whether such contracts are section 1256 contracts. The Dodd-Frank Wall Street Reform and Consumer Protection Act added section 1256(b)(2) to the Internal Revenue Code, which generally limits the scope of section 1256 to those contracts that have historically been section 1256 contracts. Thus, section 1256(b)(2) specifies that over-the-counter swaps and similar financial instruments are not section 1256 contracts. The exemption of foreign exchange swaps and forwards from the Commodity Exchange Act does not affect the section 1256 tax analysis.

Guidance under section 1256 is on the 2010–2011 Priority Guidance Plan published by the Treasury Department and the IRS. That guidance will address issues related to the Dodd-Frank Wall Street Reform and Consumer Protection Act amendment to section 1256, including the scope of section 1256(b)(2). The section 1256 guidance project is expected to be published this summer.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM MARY J. MILLER

Q.1. On April 12, the banking regulators released their proposal on "Margin and Capital Requirements for Covered Swap Entities." The proposal requires dealer banks and significant counterparties to post two way initial margin and to hold that margin at third party custodian banks. This margin would be limited to immediately available cash funds and high-quality, highly liquid U.S. Government and agency obligations. Re-hypothecation of such amounts would be prohibited. What are the costs associated with tying up margin in segregated accounts at custodian banks? Have you quantified the impact this requirement will have on liquidity?

A.1. As you note, the banking regulators released a notice of proposed rulemaking on "Margin and Capital Requirements for Covered Swap Entities" on April 12. Those proposed rules are currently open for public comment. Among the questions on which the banking regulators have solicited comments is what costs the proposed rules would impose and what impact they would have on liquidity. Comments are due by June 24, 2011. These are clearly important questions, and we look forward to reviewing the comments the banking regulators receive in response to these and the many other questions they have asked.

Q.2. The margin and capital requirements proposal takes a risk-based approach by distinguishing between four separate types of derivatives counterparties. The proposal extends the definition of financial end user to include any government of any foreign country or any political subdivision, agency, or instrumentality thereof in the world. How would margin and capital requirements apply to the dealings of the foreign subsidiary of a U.S. financial institution that enters into a swap? What about a U.S. financial institution that enters into a swap with a foreign government? Would the foreign subsidiary of a U.S. institution that enters into a swap with a foreign government be required to post margin in U.S. Treasuries?

A.2. As noted in response to the prior question, the banking regulators released a notice of proposed rulemaking on "Margin and Capital Requirements for Covered Swap Entities" on April 12 and have requested comments from the public by June 24, 2011. The proposed rules also have specifically solicited comment on whether the proposed rules appropriately limit the margin rules consistent with the territorial scope of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and how the rules could affect the structure, management, and competitiveness of U.S. entities.