LEGISLATIVE PROPOSALS REGARDING DERIVATIVES

HEARING

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SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT

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LEGISLATIVE PROPOSALS REGARDING DERIVATIVES

Wednesday, February 14, 2018

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
SECURITIES, AND INVESTMENT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:19 p.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Present: Representatives Huizenga, Hultgren, Wagner, Poliquin, Hill, Mooney, Davidson, Budd, Hollingsworth, Maloney, Sherman, Lynch, Scott, Himes, Foster, Sinema, Vargas, Gottheimer, and Gonzalez.

Also present: Representatives Lucas and Luetkemeyer.

Chairman HUIZENGA. The committee will come to order. And without objection the Chair is authorized to declare a recess to the committee at any time.

This hearing is entitled, "Legislative Proposals Regarding Derivatives."

I now recognize myself for 4 minutes to give an opening statement.

Derivatives are financial instruments or contracts with prices or terms of payments derived directly from the value or performance of another asset or commodity. They are primarily used to manage risk. While derivatives have long been used to manage risks related to the pricing of goods such as produce and livestock, they have become increasingly more complex over time.

Nowadays corporations including industrial and financial firms use derivatives to hedge their exposure to risks such as the changes in prices of commodities or fluctuations in currencies, interest rates, or underlying equity securities.

As of June 2017, the notional amount of outstanding over-the-counter (OTC) derivatives contracts were $542 trillion with a gross market value of $13 trillion.

The Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission, CFTC are the regulators charged with supervising the trading of derivatives. The regulation of the derivatives market changed drastically in response to the 2008 financial crisis.

Title VII of the Dodd-Frank Act restructured the derivatives market to more closely resemble the market for listed securities and listed futures tradings. The reforms included mandatory clearing for certain swaps and increased data disclosures meant to promote greater market liquidity and transparency. However, despite these well-intentioned reforms Title VII of the Dodd-Frank Act has resulted in a fragmented regulatory scheme of the derivatives market.

Perhaps the largest criticism of Title VII is, one outlined in the recent Treasury report on Capital Markets, the lack of clarity provided to the SEC and the CFTC on how they should propose and issue their rules. Title VII bifurcated the regulatory jurisdiction over swaps. The CFTC oversees interest rate swaps, indexed credit default swaps, foreign exchange swaps, certain types of equity swaps, and other commodity swaps.

The SEC oversees the security-based swap market. While the CFTC has finalized their swaps rule, the SEC has yet to finalize their regulations for registration and regulation of security-based swaps, dealers trade reporting, mandatory central clearing of standardized security-based swaps, and trade execution requirements.

This incomplete and disjointed regulatory structure has resulted in discrepancies between the SEC and the CFTC's interpretations of Title VII, making it difficult for market participants to comply with these inconsistent regulations.

One of the proposals before us today would require that the CFTC and SEC harmonize their over-the-counter swaps rules to provide necessary clarity to the market.

It is encouraging to hear SEC Chairman Clayton say that the SEC and the CFTC are already moving in this direction. In a recent speech he said, quote, "we are seeking to harmonize our ultimate securities-based swap rules with the CFTC where appropriate, to increase effectiveness as well as reduce complexity and cost. This requires deliberate and constructive, and current engagement with our CFTC brethren which I am pleased to report is well underway," close quote.

The other proposals before us today fix many of the market irregularities that exist in today's derivatives markets. I would like to thank my friend and chairman of our Financial Institutions Subcommittee, Representative Luetkemeyer for introducing a bill that would require the appropriate Federal banking agencies to recognize initial margin in the firm's leverage ratio calculation.

The other proposals include drafts to help provide relief for derivatives end-users, clarify the relief from mandatory clearing availability to centralized Treasury units of non-financial affiliates, and exempt swap transactions between affiliated entities from the swaps rules, clarify the definition of financial entity, excluding hedging swaps from the swap dealer *de minimis* threshold, provide clarity regarding the *de minimis* exception, annual thresholds for swap dealers and security-based swap dealers, clarify the definition of financial end-user as it applies to parent and holding companies, and exclude non-U.S. regulated funds from the definition of, quote, "a United States person."

As we address these current legislative proposals, it is important to note that derivates are a vital part of the healthy functioning of our global economy. Companies of all sizes in Michigan and across the United States use derivatives to better manage the risks that they face every day. Derivatives help to ensure that prices are stable and that customers are not subject to immense market fluctuations.

We must work to ensure that the derivatives market is appropriately regulated and is working efficiently to benefit Main Street investors.

And with that I will yield to the gentlelady from New York for her 5 minutes for an opening statement.

Mrs. MALONEY. I thank the Chairman for holding this important hearing and welcome all of our guests today, particularly my former colleague and friend Ken Bentsen, always a pleasure to see you.

This hearing will examine 11 different derivatives bills. While I have never believed that Dodd-Frank was perfect, I think it is important to remember why Dodd-Frank created a regulatory regime for derivatives in the first place.

Derivatives played a central role in the financial crisis. They turned losses on sub-prime mortgages in the U.S. into a global financial crisis, allowed financial institutions to take on excessive risks, and created dangerous connections between financial institutions that spread and amplified risk across the entire financial system.

It was derivatives that brought down AIG, a 90-year-old company that was one of the largest financial institutions in the world. Taxpayers were forced to spend $180 billion to bail out and restructure AIG which failed because of risky, unregulated gambling on credit default swaps.

This is why Fed Chairman Ben Bernanke testified and I quote, "making derivatives safer is very important, part of solving Too Big to Fail and preventing another financial crisis."

Dodd-Frank created a comprehensive regulatory regime for derivatives so that they would never bring down the financial system again.

Under Title VII of Dodd-Frank, over-the-counter derivatives are now regulated by the CFTC and the SEC. Standardized derivatives have to go through central clearinghouses, trade on transparent exchanges, and be reported to regulators.

Financial institutions have to hold appropriate capital against their derivatives, and have to post collateral on their derivatives every single day. This is all contributive to a derivatives market that is vastly safer than it was before the crisis. But Congress did recognize that lots of companies use derivatives to hedge their day-to-day risks and not to take speculative bets. That is why Dodd-Frank specifically exempted these companies which are known as end-users of derivatives from many of the new regulations in the bill.

When sufficient evidence was presented to this committee that end-users were being inadvertently swept up in the regulatory regime intended for big banks and hedge funds, this committee acted on a bipartisan basis to tweak the law to protect end-users. That bill ultimately was signed into law. I remember it well because it was attached to the Terrorism Risk Insurance Act, a bill that was very important for New York City, the area I represent.

Congress also acted on a bipartisan basis to clarify when certain derivates trades between affiliates of the same company could be exempt from some of the Dodd-Frank rules. And Congress made these changes because we wanted to ensure that derivatives remained available for the end-user companies that rely on derivatives to hedge their day-to-day risks. But these were technical fixes that were identified immediately after Dodd-Frank passed and were intended to help legitimate commercial end-users.

Any additional changes to Dodd-Frank's derivatives rules needs to satisfy, in my opinion, a high burden of proof for me to support rolling back rules on the derivatives market just because they are inconvenient for some institutions. There needs to be a real, concrete problem that is both significant and unintended in order for me to support further changes to Dodd-Frank's derivatives rules.

I look forward to hearing and learning today from the testimony of the board here today and from my colleagues.

I yield my remaining time to my esteemed colleague from the great State of California, Mr. Sherman.

Mr. SHERMAN. Thank you.

Dodd-Frank was written in this room. It did not come down to us from Mount Sinai. I am open to changes and at the same time we need a secure financial system.

As the Chairman points out the purpose of derivatives is to allow an investor or other end-user to shift risk. Most of the time we shift risk, we call that an insurance contract. We need to make sure that whenever derivatives are issued, wherever someone is assuming risk that they can handle that risk and that there is no possibility of a bail-out, or even worse yet a telephone call from Wall Street saying we had better bail out the issuer of that derivative or the entire economy goes down.

AIG was in the insurance business and all of their subsidiaries seemed to have weathered the crisis except for the only one that was not regulated as an insurance company. That entity assumed risk, didn't have adequate reserves, and I yield back.

Chairman HUIZENGA. The gentlelady's time has expired.

And at this point the Chair now recognizes the gentleman from Illinois Mr. Hultgren, the Vice Chairman of the subcommittee.

Mr. HULTGREN. Thanks, Chairman Huizenga. Thanks for holding this important hearing. It is not often that we get the opportunity for an in-depth discussion of derivatives issues despite our committee maintaining some jurisdiction over derivatives.

It is important for us to identify opportunities to provide relief from Dodd-Frank and Basel regulatory framework, if it means lowering cost for companies simply interested in managing their market risks.

As a former member of the House Agriculture Committee under Chairman Lucas, we used to have more regular opportunities to deal with these issues, but I do know how important it is for companies in my district and especially in Chicago to be able to effectively manage their market risk.

We shouldn't have regulator impediments that discourage legitimate hedging strategies. We want our markets to function in a way that allow for opportunities to lower overall costs.

I am very encouraged by a number of legislative proposals under consideration today, I am a co-sponsor of Chairman Luetkemeyer's bill calling for a narrow but practical change in the supplementary leverage ratio.

I have also received positive feedback from my constituents on a number of draft bills under consideration, such as relief from the credit valuation adjustment, amending the definition of financial entity, and relief from mandatory clearing for centralized Treasury units that I hope to learn more about today.

Thanks, Chairman. And I yield back.

Chairman HUIZENGA. The gentleman yields back.

I would like to address also the participation in the subcommittee hearing today and without objection any member from the Financial Services Committee is permitted to participate in today's subcommittee hearing.

Misters Luetkemeyer and Lucas are members of the Financial Services Committee and we appreciate their interest in this important topic.

Today we welcome the testimony of Kenneth Bentsen, Jr., President and CEO of the Securities Industry and Financial Markets Association, also known as SIFMA; Thomas Deas, who is Chairman of the National Association of Corporate Treasurers on behalf of the Coalition for Derivatives End-Users; Mr. Andy Green, Managing Director of Economic Policy for the Center for American Progress; and Scott O'Malia, Chief Executive Officer, International Swaps and Derivatives Association, ISDA.

We appreciate your time and attention to this. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Without objection, each of your written testimonies will be made part of the permanent record as well.

So with that, Mr. Bentsen, you are recognized for 5 minutes.

STATEMENT OF HON. KENNETH BENTSEN, JR.

Mr. BENTSEN. Thank you, Chairman Huizenga and Ranking Member Maloney and members of the committee. I appreciate the opportunity to testify on Title VII of Dodd-Frank.

As was pointed out, Title VII created a new regulatory regime for derivatives or swaps. SIFMA believes the key pillars of this regime, transparency requirements, central clearing, and capital and margin requirements are beneficial to the market and should remain in place.

But we are concerned that some of the regulations go beyond what is necessary to achieve Title VII's core objectives and may even conflict with other regulations. It is important for policymakers to evaluate these issues including Congress.

I would like to offer SIFMA's view on four pieces of legislation being considered by the committee.

First, inter-affiliate transactions are for centralized risk management between affiliated counterparties within a firm as they serve their clients. Inter-affiliate transactions don't raise system risk concerns because they don't create new exposure outside the corporate group or increase interconnectedness between third parties.

We are concerned that U.S. banking regulators have incorrectly and uniquely imposed initial margin requirements in such transactions, whereas the CFTC and other jurisdictions have not. Some SIFMA members report that they are locking up more margin for risk reducing inter-affiliate transactions than they are collecting from third parties. These requirements discourage prudent risk management strategies and make it more challenging to provide hedging solutions for end-user customers.

This also locks up capital that firms could allocate to invest in the broader economy. We believe that a logical solution would be to exempt inter-affiliate swaps from initial margin, mandatory clearing, and mandatory trading requirements so long as they are part of a centralized risk management program and remain subject to variation margin and trade reporting requirements.

SIFMA currently supports legislative measures to fix the treatment of inter-affiliate swaps. We believe that any such measure should apply consistently across all U.S. regulators.

Second, Title VII's distinction between swaps and security-based swaps did not accurately reflect market practice and the jurisdictional split between the CFTC and the SEC has posed challenges.

Despite efforts by the agencies to coordinate and harmonize the requirements, important differences remain. Some areas where more work is needed include reducing conflicts with other legal regimes. For example, the SEC has adopted certification and legal opinion requirements relating to the SEC's access to a non-U.S. dealer's books and records which create conflicts with foreign laws that the CFTC has sought to avoid.

Second, following consistent international standards for margin and reporting requirements which helps promote a level playing field and efficient coordination among regulators. And third, recognizing instances where satisfying another regulator's requirements would achieve a comparable outcome while avoiding overlapping regulations.

The SEC and CFTC should look for more opportunities to leverage each other's rules for dual registrants.

We support recent efforts to consider additional harmonization, such as indicated in the recent speeches by Chairmen Clayton and Giancarlo, and look forward to contributing to this dialog.

We also encourage coordination between market regulators and banking regulators especially on capital and margin.

Third, completely risk-insensitive leverage capital measures such as the supplemental leverage ratio are becoming binding capital restraints for many banking organizations. As a result, the amount of required capital is increasingly unrelated to the level of risk taken. This could lead to insufficient or excess capital levels depending on the prevailing economic conditions.

One particular problematic area is the SLR's (supplementary leverage ratio) treatment of centrally cleared derivatives. When a firm clears derivatives for a client, the firm guarantees the client's obligations to the clearinghouse, collects initial margin from the client to securities obligation, and segregates that margin. Although this initial margin largely offsets exposure to the client and the clearing firm, the clearing firm cannot use the margin to fund its business. The SLR does not recognize an offset for the initial margin.

Because the SLR requires clearing firms to hold capital against client exposures far in excess of the risk, it discourages client clearing. This incentive runs counter to Dodd-Frank's mandate to promote clearing.

SIFMA supports H.R. 4659 as it would deduct client provided initial margin on cleared derivatives from the leverage exposure for the clearing firm and it requires amendments to the capital rules to reflect this change. This is one of several changes policymakers should consider with respect to the SLR.

Last, Title VII exempts a person from being deemed a swap dealer if the person engages in only a *de minimis* quantity of swaps connected to its dealing activity.

When the CFTC and the SEC initially adopted rules implementing these provisions, they did not have data to sufficiently inform the process. They therefore set their *de minimis* thresholds conservatively with automatic reductions over a period of time absent a rulemaking.

We have concerns that decreasing the *de minimis* threshold would reduce the number of market participants willing to deal in swaps within commercial end-users. Such an outcome would reduce liquidity and concentrate swaps with larger institutions.

We believe that the changes to the *de minimis* threshold must be supported by robust data and we support the CFTC's recent order providing for additional time to make informed decisions on this issue.

Thank you for the opportunity to present our views. And I look forward to your questions.

[The prepared statement of Mr. Bentsen can be found on page 36 of the appendix.]

Chairman HUIZENGA. We can tell Mr. Bentsen is an expert witness. He is turning back time and the Chairman can't even jam it all in, in the time allotted, so way to go.

With that, Mr. Deas, you are recognized for 5 minutes.

STATEMENT OF THOMAS DEAS

Mr. DEAS. Good afternoon, Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee, I am Tom Deas, Chairman of the National Association of Corporate Treasurers, which is a member of the Coalition for Derivatives End-Users. Our coalition represents hundreds of end-user companies across the country that employ derivatives to manage day-to-day business risks.

I would like to thank you all for doing so much to protect Main Street companies from undue burdens of financial regulations. We support the transparency that the Dodd-Frank Act attempts to achieve in the derivatives market. We also believe it is sound policy and consistent with the law to exempt end-users from provisions intended to reduce the inherent riskiness of swap dealers' activities, but which can increase end-users' cost and make our risk management activities prohibitively expensive.

As you consider potential changes to Dodd-Frank and its implementing regulations, I want to assure you that end-users comprising less than 10 percent of the derivatives market are offsetting business risk, and not creating new financial ones.

We support legislative changes to address, first, bill No. 2 on the agenda related to capital charges. A bipartisan consensus has clarified that commercial end-users are exempted from having to post cash to margin their derivatives positions. However, U.S. prudential banking regulators are requiring swap counter-parties they regulate to hold extra capital against end-users on margin trades.

This effectively negates the exemption with an equivalent economic cost that end-users must bear. This credit valuation adjustment not only adds costs that can make hedging business risk too expensive but places American companies at a competitive disadvantage compared to their European and other foreign rivals whose regulators have exempted their end-users from this burden in recognition that their derivatives are reducing overall economic risk.

Next, bill No. 3 on the agenda, the financial entity definition. The coalition believes that end-users employing derivatives to reduce their business risk should not be unduly burdened with regulations intended for those running open books of positions such as swap dealers.

The unifying characteristic for the end-user exemption should be the exact matching of a derivative with an underlying business exposure, not whether the end-user is engaged in certain activities which might be considered financial in nature.

Take a real estate company which owns and manages factory buildings and supporting infrastructure and leases them to manufacturers. If this company is organized as a real estate fund it is characterized as financial. And under the current rules, it cannot hedge its business exposures in the derivatives market without being subject to the full range of regulations applied to financial counterparties.

We support proposals that would follow European, Canadian, and other foreign regulators that have set thresholds for financial activity below which companies would be treated as commercial end-users.

Now finally, relating to bills No. 4 and 5 on the agenda, on inter-affiliate exemption and centralized Treasury units, end-user treasurers have long widely used the accepted risk reduction techniques of netting exposures within our corporate group so we can reduce derivatives outstanding with banks.

We use centralized Treasury units (CTUs) as the hub for netting out opposite-way inter-affiliate derivative transactions to achieve this reduction in outstanding hedges. These CTUs allow us to centralize control and compliance supervision across often far-flung corporate groups. However, the commercial end-user exemption needs legislative clarification to ensure it applies to CTUs and the inter-affiliate derivatives centralized through them so they are not subject to mandatory clearing and the requirement to post margin for these internal notional derivative positions.

In conclusion, end-users employ the OTC derivatives market for the efficient transmittal of risk from where they incur it to where they can match and offset it with a swap dealer. Undue regulatory costs along the way, including those placed on our financial intermediaries are ultimately borne by the end-user.

In our world of finite limits and financial constraints, these unintended economic burdens on end-users represent a direct dollar for dollar subtraction from funds that we would otherwise use to expand our plants, to build inventory, to support higher sales, to conduct research and development, and ultimately to sustain and we hope grow jobs.

I noted in my written testimony, specifics of these concerns along with suggested remedies and will do my best to answer questions you may have.

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

[The prepared statement of Mr. Deas can be found on page 43 of the appendix.]

Chairman HUIZENGA. Thank you for your testimony.

With that, Mr. Green, you are recognized for 5 minutes.

STATEMENT OF ANDY GREEN

Mr. GREEN. Thank you, Chairman Huizenga, and Ranking Member Maloney, for the opportunity to testify in this important topic.

The derivatives market is a vital avenue for financial and non-financial companies to prudently hedge the risks they face. Today's roughly $550 trillion swaps market may not directly impact the day-to-day lives of the average American, but a severe disruption in the market can have knock-on effects impacting the real economy.

The unregulated swaps market was at the heart of the 2007, 2008 financial crisis, which cost 8.7 million Americans their jobs, 10 million families their homes, and helped eliminate 49 percent of the average middle-class family's wealth compared to 2001 levels.

Thanks in part to the unregulated swaps market, financial distress in one company quickly reverberated throughout the financial system. AIG is the only most commonly discussed example, but every other major Wall Street dealer bank faced major threats from margin calls and the risk of knock-on losses arising from swaps.

Nor was the 2008 financial crisis the first time swaps markets created major challenges. Long-Term Capital management, Enron, Amaranth, Gibson Greeting Cards, Proctor and Gamble, Orange County, all got themselves in trouble in one way or another from the OTC swaps market, negatively impacting investors, market participants, financial stability, and taxpayers.

In the wake of their devastation brought by the financial crisis, Title VII of Dodd-Frank sought to bring stability, transparency, and competition to the swaps market. Nearly 8 years since Dodd-Frank was signed into law, with the exception of the SEC, the swaps regime is operational and working. And it is benefiting the real economy.

In just one study, the Bank of England found in the U.S. total execution costs for day-to-days were reduced by about $7 million to $13 million a day for SEF-mandated swaps.

With reform showing positive results in the large investment and operations and compliance systems already made by firms, any legislative proposal should have to overcome a heavy burden in favor of maintaining what is working.

Financial regulatory changes also need to be considered as a whole. For example, FSOC's designation process which helps to reduce the risks that non-bank financial firms create knock-on effects across markets.

The Office of Financial Research monitors and investigates the risks across the financial system. And other regulatory protections such as bank capital, liquidity, and the Volcker Rule which properly distribute risk and focus firms' activities on the real economy appear under threat. To the extent that these tools are dialed back, it places even more strain on any weaknesses that may emerge in the derivatives markets.

Unfortunately, the bills presented today all appear to press in the wrong direction. A persistent theme in them is to extend the scope of commercial end-user treatment to entities and activities that are financial in nature. This violates the basic bargain, that strong regulatory protections cover the market which is dominated by financial firms, and that special treatment can be accorded the relatively small number of commercial entities.

To draw an analogy to public health, a small number of people can avoid being immunized and still remain protected by the broader use of a vaccine, but if that group becomes too large, everyone is put at risk, especially those people who actually cannot be immunized.

To the extent that any of the bills today embody specific concerns by market participants, far more needs to be done to study specifically identified challenges.

To facilitate accurate analyses and broad-based consensus on these questions, far more market and institutional data, including at the subsidiary level, must be made available to, and usable by the public.

Last, policymakers should avoid falling victim to the argument that reducing regulation will enhance competition and benefit end-users or the real economy. Financial markets have a tendency toward rent-seeking behavior which comes at the expense of the real economy.

Regulatory standards are required to ensure transparency and competition which benefit those that utilize those markets, small and medium-size enterprises, family farmers, manufacturers. Energy and commodity companies are far better served by a simple, robustly regulated market where prices are transparent and competition is meaningful.

I have addressed the special proposals today in my written comments and in the interest of time will stop here. I look forward to taking your questions. Thank you.

[The prepared statement of Mr. Green can be found on page 50 of the appendix.]

Chairman HUIZENGA. Thank you.

And with that Mr. O'Malia you are recognized for 5 minutes,

STATEMENT OF SCOTT O'MALIA

Mr. O'MALIA. Chairman Huizenga, Ranking Member Maloney, and members of the committee on behalf of the International Swaps and Derivatives Association and its 900 member firms, I would like to thank the committee for holding this timely hearing to discuss potential adjustments to the regulatory regime of the derivatives market.

I am pleased to offer my written testimony where I have addressed in great detail my observations regarding the progress that has been made to implement Dodd-Frank, the important initiatives taken by ISDA and its membership to develop mutualized solutions to optimize implementation of the rules, and then more specific recommendations on the legislation before this subcommittee.

The implementation of Dodd-Frank and the related margin in capital rules have made the financial market more transparent, more resilient and have reduced systemic risk.

Over the past 7 years, ISDA and our members have made significant progress in implementing the regulatory agenda. Today trade data on derivatives is now required to be reported to SDRs and fully accessible to regulators. Nearly 88 percent of interest rate derivatives and 80 percent of CDS Index notional trade in 2017 is centrally cleared. More than half of all interest rate derivatives in the U.S. were traded on an electronic platform in 2017.

Globally significant banks have added $1.77 trillion in Tier 1 capital to their balance sheets since 2009 and further increases are contemplated.

Nearly $1 trillion of collateral has been posted by counterparties with the 20 largest market participants to back the risk of the non-cleared swaps and we are only halfway through that process.

It is important to stress that we are in no way advocating for a roll-back of this progress. However, with any regulatory reform of this size and this scope we are bound to find areas where anticipated outcomes and the actual results don't align, creating redundancies, higher costs or areas for improvement. And we believe these improvements could be made to the current regulatory regime by focusing on three broad areas.

First, harmonizing regulatory requirements; second, reducing operational complexity and cost; and third, providing regulatory relief to market participants, small market participants and end-users.

Let me begin by discussing the need for greater regulatory alignment.

As we all know, both the CFTC and the SEC have oversight over parts of the swap market. Ideally we would have an effective identical requirement for the market segments the two agencies oversee. However, such an outcome has proven to be difficult to achieve in practice. As a result, ISDA recommends that the CFTC and the SEC develop a more holistic solution, a safe harbor approach to address these issues.

Under such an approach, market participants in compliance with the CFTC rule sets for swaps including business conduct, capital and margin would be granted a safe harbor from the same rules sets issued by the SEC and vice versa. To be clear, in either case the derivative activity would be thoroughly regulated.

Most importantly, the safe harbor approach does not contemplate the relinquishment of the agencies' respective authorities or jurisdiction. Both commissions would retain anti-fraud and anti-manipulation enforcement authority and the respective Congressional committees would retain their legislative and regulatory oversight.

One final word on this matter, while it has taken significant work between the U.S. and Europe to find a solution to recognize one another's clearing and trading rules, it would be quite remarkable if we were able to achieve a determination with a foreign government but not within our own.

Turning now to a second area where greater global regulatory harmonization is needed and that is the treatment of inter-affiliate transactions under the margin rule.

My former colleague, Chairman Gary Gensler, explicitly recognized the benefits of such transactions when providing an exception from the clearing requirements. This position enjoyed bipartisan support on the commission. His successor, Tim Massad, further memorialized the CFTC position by providing an exemption from the initial margin requirements which are consistent with policies in the EU and Japan.

Now the rules promulgated by the U.S. prudential regulators however do not provide such an exemption and disadvantage certain firms doing business in the U.S. and abroad. The legislation being discussed today would remedy this disparity.

Moving on to my second theme is reducing operational complexity and cost. I can think of no better example than the treatment of margin under the supplemental leverage ratio requirements. In its current form the leverage ratio acts to dis-incentivize central clearing adding to cost of banks to provide this service. This perverse impact has been highlighted by numerous policymakers over the past several years.

This is not a partisan issue. CFTC chairmen under two separate administrations have raised these concerns. It runs counter to the objectives of the G20 as implemented by Congress in Dodd-Frank and to encourage centralized clearing.

Now the final broad area which I will discuss is providing relief to small market participants and end-users.

ISDA believes that Congress can have an immediate impact on this. We applaud the committee's focus to address the un-level playing field created the Credit Value Adjustment providing a technical fix to the exemption of centralized Treasury units and ending the uncertainty over the CFTC's swap dealer *de minimis* threshold.

As noted earlier, ISDA and its members support a safe and efficient market and we have worked hard to implement the regulatory reforms to increase transparency and mitigate systemic risk.

ISDA looks forward to working with Congress, the U.S., and international regulators to develop solutions to further strengthen, simplify, and harmonize the regulatory framework.

Thank you very much.

[The prepared statement of Mr. O'Malia can be found on page 78 of the appendix.]

Chairman HUIZENGA. Thank you.

At this time I would like to recognize myself for 5 minutes.

Real quickly and this wasn't in the oral testimony but in written testimony. We saw Mr. Green compare the different rules from different agencies as different types of transportation modes having different types of safety rules. It seems to me that it might be the same highway but we now have the State police setting truck speeds and safety rules, and while the county sheriff is setting vehicle speeds, private vehicles speeds on those same highways and roadways.

Mr. Bentsen and Mr. Deas, and maybe Mr. Deas first, how are these end-users generally different from other participants in the OTC derivatives markets and did the derivatives activity by end-users contribute to this financial crisis that we had seen previously?

Mr. DEAS. Thank you, Mr. Chairman. The fundamental difference between end-users and the other participants in the market is that to qualify as an end-user you must be matching a derivative exactly as to timing, amount, currency, whatever the characteristics may be with an underlying business exposure.

So the exposure of the day-to-day business risk and the derivative are matched and they offset each other exactly. Whereas swap dealers are maintaining an open book, at times that book doesn't balance and positions going one way may exceed those going another way, and so, that they incur through that imbalance a risk, and it is proper we think that there be appropriate capital and other charges related to those risks.

End-users comprise less than 10 percent of the derivatives market and did not contribute to systemic risk.

Mr. BENTSEN. I guess I would just add, this is a little bit of a dilemma inherent in the U.S. regulatory framework that this committee and its predecessor committees have dealt with over the years where you have products that are providing the same function but are differentiated by legal definition, and you run into a situation of functional regulation which is the U.S. framework that we have in place.

In our mind it doesn't make a lot of sense for regulators to have differing regulation for the same product just because of the legal definition. It actually seems, in our mind, to run counter to what has been at the top of the house at the U.S. in multiple administrations, in the agreements that are worked out amongst the G20 and the Pittsburgh Principals of having harmonization across jurisdictions, particularly in what is a global marketplace.

So I think those different enforcement schemes are not necessarily the best approach.

Chairman HUIZENGA. So ultimately you believe the inconsistencies have affected compliance and—

Mr. BENTSEN. It creates fragmentation—

Chairman HUIZENGA. Fragmentation—

Mr. BENTSEN. Yes, it creates fragmentation in what is a global market and it affects everything from execution, price, and availability.

Chairman HUIZENGA. And not in a beneficial way I think is—

Mr. BENTSEN. No, we have seen that some of our buy-side members have done surveys where they have seen cost and execution go up, the number of entities who are willing to provide clearing services go down. And then even in the cross-border realm where we have seen fragmentation in markets which reduces liquidity, which we don't think is a good thing.

Chairman HUIZENGA. Ultimately do you believe the CFTC should be granted the authority to issue the fees on derivatives? That is something that has been proposed in the budget by the White House, and I am curious how it would affect market participants and liquidity in the marketplace, maybe have you address that, Mr. O'Malia? Mr. O'Malia, if you want to go first?

Mr. O'MALIA. Thank you. This proposal has come up time and time again in different forms and in different administrations. And each time it has been rejected because it adds to the cost of risk management. We don't support the fees that are proposed in the budget.

Chairman HUIZENGA. Neither does Mr. Giancarlo.

I don't know if Mr. Bentsen—

Mr. BENTSEN. I think Scott makes a fair point. I think what is in—and Chairman Giancarlo did come out against this the other day. And there's the question of how you would let—in some cases you could have a fee that exceeds the spread on the product, and so, you have to take that into consideration as well.

Chairman HUIZENGA. With that I will yield back my time and recognize the gentlelady who has freshly returned from the floor as we are debating some Financial Services bills down there.

The gentlelady from New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you. Thank you. Thank you. I thank the gentleman for recognizing me.

First of all I would like to ask Mr. Green. As I mentioned in my opening statement I think that there should be a very high burden of proof for any bill that makes additional changes to Dodd-Frank's derivatives rules.

There needs to be a real concrete problem that is both significant and unintended before I am willing to support legislative change for derivatives rules.

In your view, Mr. Green, do any of these bills meet this high standard of proof or any or the problems that the bills are addressing significant enough to warrant legislative action?

Mr. GREEN. Thank you. No, they do not on both questions.

Mrs. MALONEY. Mr. Green, as you know, Dodd-Frank excluded legitimate commercial end-users from many of the derivatives rules that were intended for banks and hedge funds. One of these bills would extend the end-user exemption to commodity pools and even to private funds. Are these legitimate commercial end-users or are they more like financial institutions? And do you think it is appropriate to treat these entities like end-users?

Mr. GREEN. Thank you. Absolutely not. Despite the name "commodity pool," this is not some place that drained the water in their backyard pool and has filled it now with corn and wheat. These are basically mutual funds or private funds that are offered to investors or other market participants for the purpose of investing and I use that term with a little bit of quotes because the commodities markets and the comodities derivatives markets are different from normal SEC investment markets.

They are for the purpose of investment they are financial activities, they are not owning commodities or engage in those types of activities. It is really quite inappropriate to extend end-user treatment to them. And I would even argue that the real estate funds we have seen from the financial crisis, and in other cases, that real estate can be a major source of speculative bubbles and that prudent risk management of a financial nature is essential when you are engaged in these types of financial activities.

Mrs. MALONEY. Mr. Green, one of these bills would reduce the capital requirement for banks that are trading derivatives with end-users. How would giving relief to banks on their derivatives trade help end-users?

Mr. GREEN. I don't believe that it would, and I believe the evidence of what we have seen with respect to capital and the approaches to capital overall suggest that it does not historically.

It is important to remember that it is frequently understood that capital is something that people talk about as being held by a company. It is a form of funding. It is there so that firms can withstand losses and be flexible with response to changing market conditions.

In this particular bill you are referencing, it is very essential that fair value risks are of credit, as they change, are appropriately included within capital. And we are ready, we are looking at banks overall, very, very much at the bare minimum in terms of a socially responsible level in equity capital buffer, any steps taken to reduce that would be very unwise.

Mrs. MALONEY. Do you think banks would pass on this relief to end-users in the form of lower trading costs?

Mr. GREEN. No. I don't believe the evidence is that would be the case. I believe the trading costs are lowered when you have competition, and real transparency in the market and that is why those types of parts the reforms are essential and need to be advanced further.

Mrs. MALONEY. Or would this simply make trading derivatives more profitable for banks?

Mr. GREEN. It would certainly be more profitable. It would certainly make it more profitable, but really what it does is it creates more of a risk that is being borne by the taxpayer and the resolution regime that would have to step in if the equity was not there to absorb the risks of losses.

It is important to remember that capital and even margin only cover a small portion of the estimated risks that are created by these exposures. When models fail and other problems emerge, we need a sufficient buffer to be able to withstand what happens in the markets. And those benefits would not go on to the end-users.

Mrs. MALONEY. Thank you very much. My time has expired. Thank you.

Chairman HUIZENGA. The gentlelady yields back.

With that, the Chair recognizes the Vice Chairman, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thanks, Chairman. Thank you all, so much for being here. I want to address my first question to Mr. O'Malia if that is all right. It is a multi-part question.

Is it practical for the credit valuation adjustment (CVA) to apply to derivatives transactions with end-users that are designed for hedging purposes? And do you believe U.S. bank regulators were attempting to address an issue or was this simply an oversight? And why would the EU's implementation of the Basel framework exclude hedging transactions with end-users from the CVA calculation?

Mr. O'MALIA. Thank you very much. The capital rules are really developed as global rules and through the Basel committee, they are trying to establish a consistent regulatory framework. That is very important because as was noted earlier, these are global markets and so you are dealing with global banks with end-users that can trade in different areas and access liquidity. And it is very important that we align those rules in a very comprehensive and consistent fashion.

As you quite rightly pointed out, the European Commission did not impose a CVA charge, chose not to do that. Right now, we are trying to assess what the new Basel requirements would do to impact U.S. traders. And it is very important we do the economic analysis. I don't think the data will hide the fact that this is more expensive for end-users if you have these in place. And then you have to reconcile the international standards and balance and what that does for you as competitiveness.

Mr. HULTGREN. I wonder if you could maybe detail even a little bit more some of the unintended consequences of the current CVA treatment. For example, does the current CVA treatment disincentivize hedging by institutions, instituting a punitive capital framework on banks for engaging in hedging transactions with end-users, and are U.S. banks and end-users at a disadvantage to their European competitors?

Mr. O'MALIA. I believe they are. And there are several of these capital rules whether it is the leverage ratio that adds cost while you are including initial market (IM) for cleared risk, that doesn't take that into consideration. There are a number of different capital rules that are just going to increase the cost to end-users in these positions making it more expensive to either access capital and/or access clearing which is clearly a mandate and a goal of Dodd-Frank.

Mr. HULTGREN. Yes. Thanks, Mr. O'Malia.

Mr. Deas, if I could address to you, your testimony underscores what I think is a widely recognized concern when a company falls under Dodd-Frank's definition of financial entity, it is automatically precluded from qualifying for or otherwise electing any of the exceptions or exemptions for uncleared derivatives. Do you know the justification for why the law was written this way if any?

Mr. DEAS. Congressman, no. We feel that the relevant distinction should be an end-user should be using derivatives to hedge underlying business risk rather than maintaining an open book as a swap dealer would do. If that entity as in my example a real estate fund that owns factories and leases those to manufacturing companies, we would think that that should be exempt from these extra requirements, and failure to exempt such entities would ultimately result in costs being passed on to manufacturers.

Mr. HULTGREN. Yes. Do you believe the draft bill under consideration today named Derivative 03 would address this issue and bring parity for these companies deemed as financial entities that use derivatives for hedging?

Mr. DEAS. Our coalition does support the bill scheduled as agenda item 3 and that it would not only do that, but it would bring the U.S. in line with Europe, Canada, Singapore, Australia, and other of our foreign competitors.

Mr. HULTGREN. Thanks.

Mr. Bentsen, my last minute here, CFTC Commissioner Quintenz recently spoke at the conference in D.C. hosted by the Mercatus Center and the Institute for Financial Markets where he focused on the need for updating the *de minimis* exemption for swap dealers and security-based swap dealers, noting and I quote, "the threshold's reduction to $3 billion would create a 'black hole,' sucking in community banks and end-users who pose zero systemic risk. At the center of that 'black hole' lies an enormous set of costs."

Do you believe that legislation proposing to exclude all hedging from the swap dealer *de minimis* threshold would provide relief to those dealers concerned with exceeding the threshold?

Mr. BENTSEN. That is a good question. First of all, to your first point and what the Commissioner was talking about is a concern that if you—and as I said in my testimony, we really need more data to see who is subject to the *de minimis* threshold.

All the larger banks are obviously well beyond the threshold and whatever you are going to set it at. But there are a lot smaller dealers who are not subject to it, and our concern is that many of those smaller dealers, while they pose no systemic risk, might not be willing to stay in the business if they are going to be subject to that compliance to serve their clients so this is traded away to others.

You will create more concentration in the market and you will take more players out of the market. We think that the commission needs to be very cautious in their approach here. They now are getting more data since these rules have come into place. Let us look at the data and see what it says.

Mr. HULTGREN. Thanks.

My time has expired. I yield back. Thanks, chairman.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from California is recognized for 5 minutes.

Mr. SHERMAN. Mr. Bentsen, welcome back. As market participants work to comply with U.S. derivative rules, do you have any suggestions for how U.S. regulators like the SEC, the CFTC can achieve their regulatory objectives in situations where there are conflicts with international data privacy, blocking, secrecy laws, and other jurisdictions?

Mr. BENTSEN. It is a very good question. It is something that, obviously, national regulators have not only their legal mandate that the Congress provides, puts forth for them but when you are dealing with global markets you have to deal with other national laws and cross border.

In the case of the data reporting, the ability to look at books and records is a problem that both the SEC and CFTC are confronting. The CFTC, I think, is trying to be more accommodative where they conflict with the national law, privacy laws that are in place. The SEC, I think, is still struggling with that and we think that they need to do more work in that area.

And it is something that I think the U.S. needs to be very cognizant of because this can cut both ways. We have been through this process of trying to get equivalency regimes put in place for trading and clearing, where we have had foreign regulators who want to have access to books and record and the like in the U.S.

And we have had to work through the process. I think any time we are negotiating and trying to accomplish our goals in negotiating with a foreign entity, we need to consider the two-way street approach. And I think this is only going to get more complicated as we go through the Brexit regime.

Mr. SHERMAN. One reference from outside this room is the exchange of information provisions that we have in our tax treaties where we also have regulators, in this case tax authorities, looking at the same regulation.

Mr. Deas, you are here for the end-users. A certain amount of capital is posted at various times with the exchanges. Question is whether this is adequate enough for you to assure me that none of these end-users that you represent are ever going to come to Congress and say, they didn't post enough capital so they are now liable to us, we sue them, they are bankrupt, you will have to bail us out. Is there enough capital being posted so that none of your members will ever say such and such a derivative issuer went under and Uncle Sam has got to write a check?

Mr. DEAS. Congressman, thank you for that question. Just to address an answer Mr. Green just gave, I can't tell you that the vaccination regime we have guarantees that nobody will get sick. What I can tell you is that end-users comprise less than 10 percent of the derivatives market by notional amount outstanding and during the financial crisis, represented a far lower percentage than that of defaulting parties.

Mr. SHERMAN. But we may be in a circumstance where we need, if we just required higher capital, we might be OK, but because we didn't, Uncle Sam has to write a check.

Mr. DEAS. Sir—

Mr. SHERMAN. Before the entire economy falls apart.

Mr. DEAS. End-users seek to do their derivative transactions in the majority with Fed-member banks or other regulated financial institutions of that type and in our case, the Federal Reserve does stress tests and conducts other examinations.

Mr. SHERMAN. The higher standards that there are imposed on those you are buying derivatives from, the less likely it is that they will default, the less likely that either you or I will be holding the bag.

Mr. DEAS. We believe that there is an adequate capital cushion to guard against these kinds of outlier events.

Mr. SHERMAN. OK.

Let me just ask Mr. Green, this is insurance, I have got a comprehensive auto insurance. If my car is stolen, I give the pink slip which is what we call the title to the insurance company and they write me a check for 20 grand.

If instead we structured that as a credit de-car swap and we would say under certain circumstances I give them the pink slip and they give me $20,000 worth of U.S. treasuries, that would just be the trade of one piece of paper for another piece of paper. I guess it would not be regulated as insurance.

Why and I realize this is national or international so you might need a national regulator but why don't we regulate this like insurance?

Chairman HUIZENGA. Quickly answer.

Mr. SHERMAN. Very quick answer.

Mr. GREEN. You make some very important conceptual points. We have not historically done that, but there are some very strong arguments why particularly certain parts of the market ought to be treated like that, particularly credit markets and certain parts of Dodd-Frank do start to push in that direction such as prohibiting a firm from betting against a securitization product that they issue. I think there is a lot of conceptual backing to the argument you are making and ought to be supported further.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentlelady from Missouri is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Chairman Huizenga.

And thanks to all of our witnesses for being here today; many of you are repeat customers.

The 2017 Treasury report on capital markets contains recommendations for the CFTC and the SEC to undertake a joint effort to review their respective rulemakings in order to eliminate redundancies.

Mr. Bentsen, in your testimony, you also note and I quote, "the regulatory distinctions between swaps and security-based swaps as defined under Title VII did not accurately reflect market practice and the resulting jurisdictional split between the CFTC and SEC has posed challenges for market participation."

Mr. Bentsen, can you please briefly explain how the different regulatory timelines and approaches under both the SEC and CFTC have created these inconsistencies and redundancies?

Mr. BENTSEN. I think what we are finding is, a lot of it is in my testimony but the treatment of rules in terms of how you define a U.S. person and, a lot of the rules the SEC has not finished yet so they are still in the promulgation period.

Mrs. WAGNER. Yes.

Mr. BENTSEN. But it moved and not clearly been moving in the same direction. We think where we are now is an opportunity with the Treasury recommendations, with the two new leaders of the two commissions to try and create either harmonization or as one of the other witnesses testified, a safe harbor approach or a substituted compliance approach between the two regimes.

Mrs. WAGNER. Thank you.

Mr. O'Malia, you also talked about duplicative requirements in your testimony and for a need to level that playing field. For some market participants who must adhere to both sets of rules, how do these different approaches for many of the similar activities and products create compliance concerns and additional costs?

Mr. O'MALIA. The operational challenges of implementing dual sets of regulation and we have examples on a global level, in particular the data rules, each jurisdiction requires a different data reporting regime. I think we have to look at this in a very practical approach and then also look at it in what results do you want to achieve.

Now, the CFTC and the SEC have largely well-aligned swap dealer definitions and rules. They are being implemented on a different timeframe, so the results you are going to get if you deal with the safe harbor approach, basically saying to the extent you have complied fully with the CFTC rules for swap dealer registration and meet all those, you are compliant with the SEC or vice versa if you chose to start with the SEC.

Now, the two agencies could work together to figure this thing out.

Mrs. WAGNER. How about a holistic approach, what about that?

Mr. O'MALIA. We would like a safe harbor approach. You comply with one or the other. And there are examples of this that we achieved at the CFTC back in 2013 with FERC (Federal Energy Regulatory Commission). We were not the FERC tariff rate-setter, but yet we had jurisdiction over some of those commodity markets. We deferred to the FERC to make those decisions.

These are workable solutions. We also worked with other SROs to defer some of that regulatory oversight. It is imminently possible and available to us. It is letting the chairman sort this out given the strong direction from the committee and others to get those results and then I think you will have an operational solution.

Mrs. WAGNER. I appreciate your elaborating especially on the regulatory safe harbor testimony that you have given.

Mr. Bentsen, since the U.S. and EU have been able to determine regulatory equivalence in terms of clearing and trade execution rules, does it make sense for the SEC and CFTC to do the same within the U.S. regulatory framework?

Mr. BENTSEN. Yes, I think so. Yes, absolutely, I think that we have functional regulation in the U.S. that sometimes is defined by legal definition but we are talking about similar products. I think that we should certainly domestically try and have similar coordination that we are trying to do cross border.

Mrs. WAGNER. Many requirements in the Title VII of Dodd-Frank tasked the SEC and CFTC with virtually identical rulemakings. One would think that requirements for swaps and security-based swaps would be very similar if not identical. Has this been the case, Mr. Bentsen?

Mr. BENTSEN. I think as we have gone through the rulemaking process, we have seen that there have been differences in interpretation of Title VII between the two regulators. I don't want to say that it is necessarily one regulator versus another. And to be fair, they have come at it from their legacy focus.

The CFTC was much a futures regulator; the SEC obviously a securities regulator. But as we have had some experience now, 7, 8 years of experience, this is really something where we should be able to converge or just, as Scott said, employ a safe harbor approach.

Mrs. WAGNER. I appreciate that. My time has expired. I have some other questions, Mr. Chairman, I will submit for the record. I thank the witnesses and I yield back.

Chairman HUIZENGA. The gentlelady's time has expired.

The gentleman from Massachusetts, Mr. Lynch, is recognized for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the witnesses for your help on this matter. First of all, this grouping the bills, the 11 bills that are presented, they are not actually bills, they don't have bill numbers. But I guess they call them proposals, taken in the aggregate would wipe out much of the taxpayer protections that were put in place by Dodd-Frank after the crisis back in 2008.

In particular, one of the bills before us today H.R. blank number 6, I guess at least that is in the memo, creates a large exemption for swaps between quote, "affiliated entities." They would be exempt from CFTC and SEC regulations. We have addressed before, during Dodd-Frank, and subsequent to that.

We have previously considered this matter with input from both Treasury and the FDIC (Federal Deposit Insurance Corporation). And we have some pertinent communications specifically from Vice Chairman Tom Hoenig of the FDIC. And I think it is instructive that he says inter-affiliate margin ensures that there is sufficient capital and liquidity to the financial firm in the market should any unit of a consolidated bank company find itself in a position where it cannot serve end-users or where its failure becomes a threat to the broader economy and the taxpayer.

Chairman Hoenig then pointed out that affiliates are incentivized to transfer their risks through uncleared swaps to U.S. banks who have valuable subsidies including importantly the implicit presumption that they will be bailed out by the U.S. taxpayer.

If the banks don't collect margin from their affiliates on these trades, the bank effectively takes on the affiliate's risks which are subsidized by the taxpayer. Mr. Hoenig also wrote that requiring JPMorgan's affiliate operating in London to post margin to JPMorgan's U.S. bank, that would have helped keep the $2 billion London Whale losses outside of the federally insured bank. I think it is a great example in what we are talking about here today.

The bill would also eliminate the CFTC's initial margin requirement for swaps with foreign affiliates that are not subject to comparable regulatory regime, exposing us to considerable risk.

Mr. Green, are we seeing here a case of a purported exception actually swallowing the rule? If an affiliate is described too broadly, couldn't companies simply funnel their derivative trades through a so-called affiliate to evade U.S. requirements?

Mr. GREEN. Yes, I agree with that. I think this is an area that is extremely dangerous. It is extremely broad, some estimates are at the inter-affiliate swaps are half the swaps that are out there. The large financial firms have thousands of affiliates, the most important affiliates are a smaller number of that.

But given the interactions between resolution and also cross border where a lot of the conversation about inconsistency in CTFC versus SEC regulation that was just noted a couple of minutes ago, are actually about the extent to which foreign affiliates that are foreign affiliates of U.S. firms where the risk will come back to the U.S. are subject to the basic protections that we set in place for the U.S. taxpayer.

If you start to undermine those, you have major, major challenges. Now, as Commissioner O'Malia has noted, Chairman Gensler and others have noted, there are distinct differences that require these swaps to be tailored slightly and we can discuss and debate particularities but the bill that is presented today is a broad base exemption that is not acceptable.

Mr. LYNCH. Right. What does this bill do to the requirements for posting margin with foreign affiliates that are not subject to overseas regulatory regimes, that are comparable to our own? You touched on that a little bit but I am just concerned that aren't we just creating a loophole to allow foreign-funnelled trades to have an advantage over U.S. banks that don't operate through a foreign affiliate?

Mr. GREEN. Absolutely. This is, any time where you are getting into a description like you mentioned, I think that is a very real risk. This is the Export U.S. Financial Service Jobs Abroad Act. This is import foreign risk into the U.S. because the U.S. taxpayer, for a variety of reasons, has been the one that has had to step up and make sure that U.S. financial institutions are there when need be.

And a far more appropriate approach is to ensure a broad, consistent using substitute compliance comparability regime so that there are good regulatory approaches around the world and where there are not, we need to make sure that the U.S. regulatory regime is the floor and then no one can evade it with a large exemption like the one that is being proposed in the bill today.

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

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from Maine is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much.

And thank you, gentlemen, for all being here today.

One of the roles of Government as I see it is to make sure that we create laws and rules are made such that our families are helped in such they live better lives with more opportunities and more freedom. That is why I have been a very big proponent and continue to about reducing or limiting the regulatory environment that is redundant and unnecessary and harmful.

Second of all, I have been a big supporter of our tax reform package which is being quite successful as far as stimulating economic growth and job creation here in this country and my State of Maine.

The State of Maine, gentlemen, has world-class fisheries and agriculture and also wood products. We have tremendous resources, natural resources with our sustainable forests and what have you. I am really concerned about some of the folks on the other side of the aisle today saying something to this and I will paraphrase, I hope I get it right that they are concerned about any adjustments to Dodd-Frank when it comes to derivatives because they believe that doing so will represent or cause potentially systemic risk to our economy.

Now, what would be helpful to me, Mr. Deas, if I am pronouncing it correctly.

Mr. DEAS. Deas, sir.

Mr. POLIQUIN. Deas, thank you sir, could you use a specific example of an end-user, say, a potato farmer in Aroosta county, how such an end-user might us such a derivative, such a financial instrument to help that farm conduct his business to lower its risk so it can grow, be more successful and also offer more price stability to the consumer. And explain to us clearly, sir, how that does not represent a systemic risk to the U.S. economy.

Mr. DEAS. Yes, sir. I am privileged to have served 18 years in the treasury and corporate finance function at Scott Paper Company which as you know—

Mr. POLIQUIN. When I was a kid growing up in Central Maine, Scott Paper was a great employer right across the river in Winslow, Maine and we appreciated those jobs. My best buddy across the street, his dad was a machinist at Scott Paper, thank you for that job.

Mr. DEAS. Thank you, sir. And it was my privilege to finance the construction of those operations. And I can tell you for example at the Winslow mill where there are, quite a bit of energy is consumed in the transformation of wood pulp into paper, those energy exposures to the extent they are variable represent a risk to the business and to the extent that Scott Paper Company's treasury were able to hedge those energy purchases forward in the over-the-counter derivatives market matching up exactly the exposure of when we are buying the energy against the derivative, it helped stabilize the business, maintain level cost base and ultimately support those jobs in Winslow.

Mr. POLIQUIN. That in your opinion, sir, represented no potential systemic risk to the U.S. economy?

Mr. DEAS. We think it is risk-reducing and the Europeans have taken the same view and exempted their end-user companies from many of these regulations we are advocating be adopted in the U.S.

Mr. POLIQUIN. Mr. Bentsen, do you have a further experience that could shed light on this issue where the end-user is representing no risk to the U.S. economy?

Mr. BENTSEN. I think Mr. Deas has laid it out well. The end-user is effectively buying the product to mitigate their risk or to hedge their risk activity. They are really in a different function than in a financial risk.

Mr. POLIQUIN. Explain to us if a paper company like Scott might not have the ability to hedge its risk, how that might be more risky to the economy and to the families that depend on those jobs.

Mr. BENTSEN. And, again, Mr. Deas is probably better to speak to this fact, to talk about having to mitigate your risk to fluctuations and the cost of fuel or feedstock for your plants or fluctuations for a global company, fluctuation in currency prices.

Mr. POLIQUIN. How might there be some confusion, gentlemen, either one of you, between this issue that we are talking about in the use of derivatives in other parts of the economy that could have and did in some parts cause problems in 2008.

Mr. BENTSEN. I think, first of all, we have to step back and look at where we are today compared to where we were in 2007–2008. We have a very robust new architectural regime that has been put in place for the derivatives markets in the U.S. and across the globe. And much of what we are talking about today is how do we, in what is truly a global marketplace, how do we make sure that the plumbing is the same across the organization. We don't create fragmentation or diminish liquidity in different market sectors so companies like Scott Paper or a global company can function globally as well.

Here we are talking about do we have the calibration right after 7 years of imposing a dramatic series of rules, many of which the industry supports. But the time is now to see what works, what does not work and are we accomplishing the policy goals.

Mr. POLIQUIN. Thank you, gentlemen, very much. Appreciate your time.

Thank you, Mr. Chairman.

Chairman HUIZENGA. The gentleman's time has expired.

The Chair at this time recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. This is a very interesting and very important hearing dealing with a very important matter. But first, I want to thank Mr. Luetkemeyer for, again, partnering with me on some common sense legislation. And I want to devote that to our legislation that Mr. Luetkemeyer working with H.R. 4659 of which I am the Democratic lead on.

It forces banking regulators to recognize the exposure-reducing nature of client margin for cleared derivatives. Now, first of all, I have recognized the importance of client margins and I believe that client margin should be excluded from what we refer to as supplemental leverage ratio calculations, but more importantly, if we were to include client margin in supplemental leverage ratio calculation, it would put our clearinghouses at a very distinct disadvantage.

And a major thing we wanted to do in Dodd-Frank was bring transparency to this over-the-counter market that previously operated in the shadows of our financial system. But we made a decision as a Nation to expand the use of central clearing.

That is why I struggle to understand why anyone could not be supportive of putting together regulations that incentivize more companies to clear derivatives. That is what our bill, Mr. Luetkemeyer and I, our bill 4659 does. It makes clearing more attractive to our country's biggest institutions.

Mr. Bentsen, you and Mr. O'Malia, I would like for you to comment and explain, am I going wrong? Am I right? And does not our bill help in this matter?

Mr. BENTSEN. Mr. Scott, I think you are right on point. This is counterintuitive and goes against what really was official policy of trying to drive more product that could be driven to central clearing and now you are being penalized for doing this. It is one of the problems in the construct of the SLR and we think needs to be approached. We think you all are right on target.

Mr. SCOTT. Now, let me ask you this and Mr. O'Malia you comment, too, because this could get into record questions I always try to be able to not just look down the road but look down the road and around corners to see what might be coming. And I think as we get further in this bill, a question might be raised that what we are trying to do with 4659, somebody could say what Mr. Scott and Mr. Luetkemeyer are doing could make our financial system riskier.

Do you, anybody agree with that we want to make sure that what we are doing is making our system stronger. I don't want anybody arguing later on as we get to moving this bill that there is any risk involved. Would you all comment on that? Anybody, Mr. O'Malia?

Mr. O'MALIA. Sir, ISDA supports the legislation and the lead—

Mr. SCOTT. Pardon me. Repeat that again.

Mr. O'MALIA. ISDA supports the legislation.

Mr. SCOTT. Thank you, sir.

Mr. O'MALIA. We are pleased to support it because we think it is prudent and recognizes that clearing has put IM aside and that is a very important risk-reducing measure. And to add an SLR component on it or not to recognize the fact that you have got risk-reducing IM associated with it just makes it more costly.

Mr. SCOTT. Thank you very much.

Mr. Chairman, I think I would be derelict in my duty if I not mention that I am the ranking democrat on the derivatives committee in agriculture and when my staff alerted me that we would be having an 11-bill legislative hearing on derivatives, I absolutely thought right then that they would give our little subcommittee in agriculture that I am head of where Dodd-Frank exclusively gave our subcommittee on commodities markets interchange and on derivatives a little bit of a warning and say can you work with us on that.

And I see my former chairman Mr. Lucas there and I know he would be proud of me for getting respect for our agriculture committee on this, and perhaps you might pass that along to the chairman. We hope that it wasn't a disrespect but we work hard there, Austin Scott and I and we would have loved to have a little part in this.

Thank you, sir.

Chairman HUIZENGA. The gentleman's time has expired but it is my understanding that there has been communication between our committee and the agricultural committee and Dodd-Frank as you pointed out did put CFTC in charge of certain aspects but it also created bifurcated authority under which the SEC is also a part of that.

That is the reason—

Mr. SCOTT. I don't argue any exclusivity. I just as the ranking member, I certainly was not informed and thought I would bring that out. I look forward to going forward, however.

Chairman HUIZENGA. Fair enough.

All right. With that, the Chair recognizes the gentleman from Ohio, Mr. Davidson, for 5 minutes.

Mr. DAVIDSON. Thank you, chairman.

I really thank our witnesses and as Mr. Scott alluded about the intersection with agriculture, that will highlight one of the many reasons the topic of derivatives is so important to Ohio's 8th district, agriculture being very critical to our district but manufacturing companies like AK Steel, retail companies like Speedway in Enon, Ohio who are purchasing fuel and so many others, in the insurance markets, derivatives are a massive part of global trade.

They are a massive part of risk management. And before coming to Congress, I spent the past 15 years starting and growing manufacturing companies. I know firsthand the effect Basel III has had and those international standards on the regulatory overreach that has been happening across our whole economy, particularly with the need for small companies to access capital that they need to grow.

But in 2014, European regulators exempted risk-weighted assets held by European banks from the Basel imposed capital variation adjustment requirement also known as CVA. This exemption has provided a business advantage to European banks, European customers, and European end-users at the expense of American businesses, banks, and end-users.

Mr. Deas, you addressed this exact concern in your opening testimony and I wonder in regards to the U.S. markets, what consequences you have seen as a result of the European exemption.

Mr. DEAS. Congressman, thank you for that question. I am also privileged to represent U.S. treasurers at the international group of treasury associations and our colleagues in Europe calculated that that difference was about 5 basis points on an average swap. If you take—I don't have my calculator with all the zeros in it—but if you take the $500 trillion number that the Chairman mentioned of derivatives and take 10 percent as the estimate for end-users and then take 5 basis points of that, that is real money.

And we would propose to be exempted from that and keep us in line with our European competitors.

Mr. DAVIDSON. That is terrific. I think anyone would have a hard time calling that crumbs but I have been surprised by the use of the term lately. Do you believe this exemption only has hurt U.S. financial institutions or does it go through the rest of the economy and affect end-users?

Mr. DEAS. Absolutely, I can tell you that we prefer to trade in general. I am speaking now on behalf of corporate treasurers with member banks regulated by the prudential banking regulators as our swap counterparties and I can tell you that they have to cover their cost and to the extent they have to hold aside capital for transactions with us, they absolutely price that in. And we ultimately bear the cost as end-users and that is passed on to our customers.

Mr. DAVIDSON. Thank you for that.

Mr. Bentsen, in their capital markets report last year, the Treasury Department expressed U.S. derivatives market participants were at a disadvantage when compared to their international counterparts. Does the EU CVA exemption play a role in fostering this competitive disadvantage and have other nations taken any action in response to this?

Mr. BENTSEN. I think it was $25 billion maybe but I think the EU CVA decision was a diversion from what Basel was trying to get to having a uniform approach but it also underscored problems in the Basel approach to CVA and more inherently. And it was a problem for the U.S. I know it was a problem for the—the Canadians had raised concerns about it as well and other jurisdictions also.

Basel as I understand it is now I think starting to take a look at going back and looking at CVA. It is not helpful to have diversions within jurisdictions on global marketplaces, number one, but even before that is the calculation, the right calculation. We hope that this can be resolved and we can get back to a uniform standard globally.

Mr. DAVIDSON. In the interim, do you feel that the CVA requirements for U.S. over-the-counter derivatives could be exempted so that the U.S. would be in that level playing field?

Mr. BENTSEN. Yes. That is an issue I know that Mr. Deas' group has weighed in more than ours. It is an issue that needs to be resolved for sure one way or the other.

Mr. DAVIDSON. Mr. Deas, do you feel like Congress providing that exemption would level the playing field?

Mr. DEAS. Yes, sir. That would be important and so we fully support, the coalition does, bill No. 2 on the agenda that would achieve that for us.

Mr. DAVIDSON. Would the net effect of such an exemption be felt in sectors such as agriculture and really across the U.S. economy?

Mr. DEAS. Absolutely. I was privileged to serve as treasurer of FMC Corporation which is a leading supplier of agricultural chemicals and I can tell you that to the extent that that company is hedging its risks with bank counterparties in the derivatives market, it bears the cost of the CVA charge they have to incur.

Mr. DAVIDSON. Thank you.

My time has expired. Mr. Chairman, I yield.

Chairman HUIZENGA. Not seeing anybody on the other side of the aisle, gentleman from North Carolina, Mr. Budd, is recognized for 5 minutes.

Mr. BUDD. Thank you, Mr. Chairman.

Again, thank you to our witnesses for your being here today.

We have some exciting proposals that would impact the derivatives market and we have actual legislation like Mr. Luetkemeyer's bill here 4659 which if enacted would rightfully ensure that the SLR recognizes the exposure of reducing nature if initial client margin in cleared derivative transactions.

My questions have to do with proposal No. 1 which would direct the SEC and CFTC to harmonize rules overseeing the over-the-counter swaps. The different regulatory timelines and approaches under SEC and CFTC create inconsistencies and sometimes redundancies which we can fix with this proposal.

My first question is, and this is an open question, for some market participants who have to adhere to both sets of rules, how do these different approaches for many similar activities and products create compliance concerns and additional costs?

Again, for any of you.

We can start with you, Mr. Bentsen, if you like.

Mr. BENTSEN. Again, as I pointed out, we are still getting the SEC rules so they are lagging a little behind so firms have been focusing more on their compliance with the CFTC rules. But as we're seeing where the SEC has been headed, it is raising the concerns that you would have conflicting compliance regimes that you would have to apply for different products.

We do know as I pointed out how you define U.S. person and, again, both agencies maybe have some things that are good, some things that are not so good. The idea of while we are still in this process of creating, mandating harmonization, driving harmonization would be a good thing.

Mr. BUDD. Mr. Deas or anyone else?

Mr. O'MALIA. If I may, the significant implication of just filing and complying with the swap data or the swap dealer rules themselves is massive. It is thousands of pages, a lot of compliance back and forth working with the staff and the agencies to develop the right compliance regimes.

In fact, I don't think the CFTC has officially and finalized the swap dealer checklist yet for anybody to be in an official—they are on their temporary registration. It is a massive challenge today and to double that with different rules with the SEC, different rules from the CFTC, different guidance you may receive from the staff will just make that operation that much more difficult.

I think a safe harbor when you complied eventually with the SEC or the CFTC rules, either one, then you have met that mandate. Then, you think about some of the capital requirements and other requirements that will pass on as a result of that. From a practical standpoint, it is an operational challenge of enormous consequence.

Mr. BUDD. Thank you. Mr. Green?

Mr. GREEN. Just a couple of thoughts. One is, these are very different markets. Credit default swaps look to bonds, foreign exchange look to currencies, commodities, very different from interest rates, et cetera, and total return swaps are in the equities market. There are legitimate differences that can and should emerge based on these different markets. Everybody wants as much similarity as possible. I do think we are seeing that. But one of, the U.S. person definition, frankly, the SEC has taken a weaker approach, in part due to massive lobbying to try to dial back jurisdiction toward being only the U.S., whereas the CFTC took an approach as mandated in Dodd-Frank that said if the risk is going to come back to the U.S., we are going to capture that. So I think there are tensions and things going on that we need to think about.

Mr. BUDD. Thank you, Mr. Green. I want to go ahead and jump to the second question while we have some time. Besides this proposal which I support, are there any other approaches to this body we should consider, such as a regulatory safe harbor?

Mr. BENTSEN. Yes, a safe harbor would be a good idea. And I think the other thing to keep in mind is where we are today versus where we were a year ago, or certainly 8 years ago, a lot has already been done. I would caution mandating starting all over again. Let us start with the framework that we are in, and let us figure out how we can make it work, and a safe harbor is a good example of that.

Mr. O'MALIA. I think to Mr. Green's point, if you do believe that the SEC should have different rules, a safe harbor works nicely. Because then it respects the SEC's differences to whatever extent there are, and then you can say, if you have complied with one, you have complied with the other. A safe harbor also protects this committee's jurisdiction. And when you think about, as Mr. Green pointed out, the difficulty around products, the difficulty around jurisdictions, there is no way to neatly divide this up, and to protect everybody's current jurisdiction, as Mr. Scott pointed out, it is important that agriculture have its oversight. This is the easiest way in our opinion to make sure that everybody still controls their piece of the pie.

Mr. BUDD. Thank you for that, and I want to go ahead and yield back since I am out of time.

Chairman HUIZENGA. The gentleman's time has expired. And with that, we welcome our guest, the gentleman from Oklahoma, Mr. Lucas for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman, and I appreciate the opportunity to join this subcommittee today. Not necessarily being a member of the subcommittee, but a member of the full committee, and as was noted by my colleague off the Ag committee and fellow member here, Mr. Scott, an old Ag committee chairman, and ranking member at the time Dodd-Frank was put together, I am very sensitive about this issue, and in fact it is a topic that matters to my farmers, my ranchers, all my end-users in the district who use these derivative products to hedge their positions in the market.

And I would note, as has been discussed by a variety of members, I am also particularly pleased to note the two proposals under consideration today, and very happy to be one of the original cosponsors of Mr. Luetkemeyer's bill 4659 to support the initial, offsetting the initial margin for SLR calculations, and the second of this proposal regarding margin requirements for inter-affiliated transactions which mirrors my amendments to the CFTC reauthorization bill that was passed out of the full House last year.

But first, turning to Mr. O'Malia and the SLR issue, this issue is not immediately obvious to people that don't interact a lot with derivatives markets. But could you briefly explain the rules that ensure that posted customer margin cannot be used to fund a bank's own operation? Let us get to the core of the issue here.

Mr. O'MALIA. Yes, that is an important point, because that just shows that the IM or the initial margin is reserved and protected, not on the bank's balance sheet. It is with a clearinghouse, for example, or it could be possibly with a U.S. Federal Reserve account where they have put the cash as well. These are in very safe and secure spots and are truly reserved for risk reduction, they are also the property of the customer.

Mr. LUCAS. One more time, let us make it very clear. So there is no real threat that money can be misappropriated by a bank when it is placed in one of these accounts.

Mr. O'MALIA. Correct. In the secured third-party accounts, there is—

Mr. LUCAS. Because that is one of the concerns of my colleagues is that this money that is in secured third-party accounts might be manipulated by the banking institution. But that is not going to happen. Let us assume this bill were to be passed into law and CFTC Chairman Giancarlo has estimated that enacting this simple change would reduce leverage exposure by a mere 0.22 percent nationwide. That is about a quarter of a percentage point nationwide. Do you have any sense as to how much clearing activity would be increased by such a bill?

Mr. O'MALIA. We do not, sir, offhand.

Mr. LUCAS. But it is a fair statement to say there would indeed be an increase.

Mr. O'MALIA. It certainly reduces the cost of not paying two insurance protection items. One, IM, which is significant, and then the other is any charge you have had to pay for dealing with a bank that it will charge you an SLR.

Mr. LUCAS. With, as Mr. Giancarlo noted, an increase of 22 hundredths of a percentage point nationwide in exposure. That is a pretty cost-effective balance out, I would think.

Mr. Bentsen, turning to the inter-affiliate margin requirements, could you give us some reasons why affiliates might want to enter into these transactions? We are a body where you need to reinforce the important points.

Mr. BENTSEN. Banks will enter into inter-affiliate transactions when they have got an outbound transaction and then they will do swaps to better manage and mitigate their risks as an organization. And so they are not taking on more risk, they have already collected margin where they need to. It is really in effect collecting margin again. And that ends up trapping, and to your point that you were just making with respect to central clearing and the SLR, that ends up trapping assets which are not actually available to the bank in that instance as well. In fact, the prudential regulators, who are different from the CFTC, different from Japan and Europe and other Basel entities, the prudential regulators do not count this margin in the bank's resolution plans. It is not viewed as available for single point of entry in the resolution plans.

In effect, it is not really adding value from a safety and soundness or a systemic aspect, but it is trapping capital that could be allocated elsewhere.

Mr. LUCAS. Which is a cost to the economy as a whole when you put that weight out there.

Mr. Chairman, in a final observation, I would simply note to my colleagues, a handful of us only anymore it seems like were here for the Dodd-Frank process and all the things we went through in that bill. I would note to my colleagues that the document that dealt with derivatives that came out of the Ag committee was done in a very bipartisan way, 8, 9 years ago. And the work that was done in this committee was done in a relatively bipartisan way. It is when we got to conference that the bill that came out of there was not a bipartisan document. I always note to my friend, when the primary authors of legislation retire shortly after it is signed into law, that is an indication. Yield back, Mr. Chairman.

Chairman HUIZENGA. That is an interesting observation. With that, we would like to welcome our other guest, Chairman of Financial Institutions, Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Chairman Huizenga, I appreciate the opportunity to be in your committee this afternoon and listen to some of the testimony and the questions. As I have been listening here, they have been discussing H.R. 4659, and have thoroughly discussed it in my mind, a lot of the ins and outs, and I don't know that I have got a whole lot of questions left here. But let me just thank Congressman Scott for his hard work on the bill, I know Congressman Lucas who just asked some questions did a very good job of framing some of the concerns that we had, that we tried to address with supplemental ratio, leverage ratios here.

Let me just ask a couple of quick questions here with regards to, I am a firm believer that banks need to hold adequate capital to protect themselves and their customers and the financial system.

That is one thing that both Republicans and Democrats agreed upon coming out of the financial crisis as Chairman Lucas just indicated. With respect to supplemental leverage ratio, do you believe the current treatment of client margin is appropriate?

Mr. O'Malia?

Mr. O'MALIA. We do.

Mr. LUETKEMEYER. Very good. Do you want to elaborate more than just yes?

Mr. O'MALIA. Yes. This has gone back years and years that so many things around client protection of margin and, goes back all the way to the early futures markets, and we built those solutions on those, and those have been robust, they have not changed, they are protective. They are resilient, we have found with different FCM failures that there is a way to protect the client margin here. And it is very important as we think about what we are going to do with raising the standards around CCPs (central counterparty clearinghouses) going forward, because the resolution and recovery tools around CCPs we think can be increased, you have better protection around protecting IM and customer margin that has been given to a CCP. We want to make sure that the waterfall events do protect that customer money going forward. It is the foundation of this very safe system.

Mr. LUETKEMEYER. Perfect. With respect to the impact of H.R. 4659, the CFTC has calculated that an offset for initial client margin will result in a less than 1 percent decrease in overall capital reserves. Do you agree with the financial—do you agree that the financial system could withstand a capital reduction to less than a penny on a dollar in exchange for both significantly reduced costs on agricultural producers and encouraging more clearing in the derivatives market?

Mr. O'MALIA. We do, we do believe that it could withstand that and the system will be safe.

Mr. LUETKEMEYER. Anybody else?

Mr. GREEN. The supplementary leverage ratio is based on the idea that we want a risk-neutral way of evaluating the capital, the equity that is in the system. And the more you start adjusting things based on the, how people view the riskiness or the usability, et cetera, of a particular asset, the less value it is overall of being risk-blind. And it is important I think to remember that this is, the supplementary leverage ratio is calculating, tending to calculate a broader overall exposure. The margin, or even the capital against the swap is only a portion of the overall risk that could come back to the firm. The firm stands in with a full guarantee to the counterparty. And so the SLR attempts to calculate that. And as folks like Sheila Bair and other respected regulators, Tom Hoenig at the FDIC have noted that it is the simplicity of the leverage ratio that gives us its value. We ought to try to retain that as much as possible.

Mr. LUETKEMEYER. Mr. Bentsen, are you going to come in on that?

Mr. BENTSEN. Sure. First of all, again, it contravenes official policy going back to the Obama Administration to drive more of the swap business to central clearing. And not just Chairman Giancarlo but Chairman Massad had come out and said that this should be changed. The second thing is, the SLR which is gold-plated in the U.S., we have had a leverage ratio In the U.S. since the Great Depression. We took it from 3 percent to 5 percent and 6 percent. And it has become the binding constraint on top of what is an extremely robust capital regime that has been put in place since the financial crisis, which can exceed to high double digits for many firms. The idea of making this one change that is counter-intuitive to what the policy is to drive, really, the benefits or the cost in this instance far outweigh the benefits as to what policy has been.

Mr. LUETKEMEYER. You have a comment you are going to make, sir?

Mr. DEAS. Sir, just speaking as a corporate treasurer, I can tell you that if ultimately the initial margin and capital through CBA and other requirements are intended to offset risk, and yet if initial margin is not calculated in the determination of risk for capital purposes, it seems to be out of sync with the economic realities, and ultimately, that will get us off-track.

Mr. LUETKEMEYER. Appreciate your comments, I see I am out of time. I yield back. Thank you, Mr. Chairman, for your diligence today.

Chairman HUIZENGA. No problem, gentleman's time has expired. With that, Mr. Hollingsworth from Indiana is recognized for 5 minutes.

Mr. HOLLINGSWORTH. If nobody has told you yet, Happy Valentine's Day. I actually live in the very southern part of my district in Indiana, and I live just literally two or three miles from the Kentucky border. And sometimes, I run into businesses based in Indiana that say, I have a location in Kentucky and a location in Indiana. And I am literally required to do something in Indiana and I am barred from doing that same thing in Kentucky. And they are trying to work across those two jurisdictions. Now, that is a really small problem for a lot of small businesses, but it could be a really big problem, and I think it was addressed in the Treasury report, for large multinationals trying to comply with U.S. rules, but might find themselves in a situation where non-U.S. jurisdictions bar them from certain activities.

So this is coming to Mr. Bentsen and Mr. O'Malia. I wanted to really address this. I think both of you alluded to this in your testimony earlier, but I want to draw your attention to pages 133 and 135 of the Treasury report, quote, "market participants have raised concerns with aspects of the SEC's cross border rules and have highlighted those that conflict with privacy, blocking and secrecy laws in non-U.S. jurisdictions."

A company is here, trying to comply with rules here but maybe see cross currents of rules elsewhere preventing them from full compliance here. And I think this has a long history of us trying to work these things out; task force getting together, signing MOUs, forbearance, et cetera.

I guess I really wanted to get at what do you think that those trying to comply with U.S. derivatives rules, what suggestions of how U.S. regulators including the SEC and the CFTC should work to help ensure there is harmony between these two or ensure there are opportunities for cross national companies to be able to operate in both jurisdictions, meet the rules of both jurisdictions?

Are there any suggestions you have for the SEC or CFTC on how we could best work through that process as quickly as possible to ensure that these companies that want to do the right thing can quickly do the right thing for both the jurisdictions they operate in?

Mr. BENTSEN. I guess I will start. I think this is an issue that it is hard to believe why this can't be worked out. And I think if you read the other parts of the Treasury report particularly the first Treasury report, it makes a very important point that is indicative of the U.S. financial markets because we have a very open market system here where we have both U.S. and non-U.S. domiciled firms that invest in our markets and provide capital credit and liquidity to our markets to the betterment of the country as a whole.

And one of things it points out is that non-U.S. domiciled financial institutions provide a tremendous amount of credit and capital to the U.S. markets including to areas like Indiana in the agricultural space and elsewhere. That is important and we should value that.

The problem is where we have rules that conflict and we have this inbound also from other jurisdictions sometimes in the U.S., rules that conflict with a domestic rule that could preclude an entity from actually providing the services in the U.S. and that would create a cost to the system here.

To us it seems in the case where a European-based swap dealer cannot comply with the rule as defined by the SEC and, therefore, can't be a registered swap dealer does not seem to—there has got to be a way to work through that.

Mr. HOLLINGSWORTH. It doesn't benefit us, right?

Mr. BENTSEN. It doesn't benefit us.

Mr. HOLLINGSWORTH. For those that might say, we want to keep foreign firms out, that is not true of the financial services industry, it is not true generally. Everybody participates.

Mr. BENTSEN. It would be a disadvantage to the U.S.

Mr. HOLLINGSWORTH. That's exactly right. Well said.

Mr. O'MALIA. There a number of examples and I know each of the chairmen of the respective agencies have worked very hard to build the international bridges I would have to say that the relationship among this Administration and internationally has been quite strong. Time has passed since some of the earlier rules, the exporting of U.S. regulation has dissipated a little bit and the conversation has probably moved on.

But there are always going to be these little issues where there is a misunderstanding or you just simply can't deliver the rules. There are plenty of data rules globally that privacy functions prevent entities from reporting. Asia in particular has a number of these things.

To Ken's point, you certainly don't want to put the U.S. at a disadvantage in terms of attracting capital or business.

Mr. HOLLINGSWORTH. Yes. I am a big believer that frankly the more participants we have, more varied participants that we have, the better and stronger, more resilient the ecosystem is overall. That resiliency is a more emergent quality than a dictated quality.

We need to welcome foreign firms operating here. Rising tide lifts all boats but we have to figure out a way to get through some of these gaps and make sure that across jurisdictions they can comply with both sides at the same time to better empower them which ultimately empower Americans better and that is what I am really excited about.

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

Chairman HUIZENGA. The gentleman yields back.

I would like to thank our witnesses for their testimony today. I think this was very illuminating and helpful as we are having this. Without objection, I would like to submit the following statements for the record. First, the statement from Richard Baker, President and CEO of Managed Funds Association and without objection and a letter of support from FIA, Commodity Markets Council, CME Group and the Intercontinental Exchange and without objection.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Once again, I appreciate your time and expertise in this very complicated space and we look forward to continuing this conversation. With that, this hearing is adjourned.

[Whereupon, at 4:03 p.m., the subcommittee was adjourned.]

A P P E N D I X

February 14, 2018

sifma
Invested in America

Written Testimony of Kenneth E. Bentsen, Jr.

President & CEO, SIFMA

before the U.S. House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets, Securities, and Investment

Hearing entitled "Legislative Proposals Regarding Derivatives"

February 14, 2018

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee, my name is Ken Bentsen and I am President and CEO of the Securities Industry and Financial Markets Association (SIFMA).[1] SIFMA welcomes this opportunity to testify regarding this Subcommittee's review of the post-crisis regulatory regime for derivatives and consideration of targeted legislative improvements.

As you know, Title VII of the Dodd-Frank Act created, and U.S. regulators have now mostly implemented, a new regulatory regime for derivative products commonly referred to as swaps. SIFMA believes that many of the key pillars of this regime – enhanced transparency requirements, central clearing for standardized swaps, and capital and margin requirements designed to address the risks of non-cleared swaps – should remain in place.

We are concerned, however, that some of the regulations adopted as part of these reforms go beyond what is necessary to achieve core risk mitigation and transparency objectives and may even be in conflict with or redundant to other regulations on the books. These new regulations impose undue costs on beneficial risk management activities by financial institutions and their end-user customers, including manufacturers and the agricultural industry. They also foster unnecessary regulatory complexity and uncertainty. Targeted fixes to these regulations can help promote U.S. competitiveness, job creation and economic growth, without undermining the increased safety and stability brought about by the reforms.

SIFMA and its members are pleased to see that policymakers across the globe are now evaluating these issues as they take stock of recent derivatives reforms. Specifically, we are supportive of recent efforts by the President and the Department of the Treasury to review the full scope of financial regulations covering capital markets participants, products, and activities and make recommendations for changes[2] – many of which SIFMA agrees with. The Commodity Futures Trading Commission (CFTC), for its part, has undertaken a similar initiative, known as "Project KISS,"[3] with the goal of reducing unnecessary regulatory burdens on the markets and participants the CFTC oversees to make them simpler, less burdensome and less of a drag on the American economy. SIFMA provided many detailed recommendations in response to this initiative, and we look forward to working with CFTC Chairman Giancarlo and the rest of the CFTC moving forward on this initiative. And as the Securities and Exchange Commission (SEC) nears

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] See: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[3] 82 FR 23765 (May 24, 2017) (Project KISS), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-10622a.pdf.

completion of its Title VII regime, SIFMA is hopeful that the agency will be informed by the recommendations and output stemming from these review efforts, and will seek to engage in a beneficial dialogue as they work to finalize their rules.

SIFMA believes that Congress also has an important role to play in evaluating how to improve derivatives regulation. Indeed, there are areas of reform that would require statutory modification as the regulators lack the proper authority. In the remainder of my testimony, I will focus on a few specific areas where the Subcommittee's important work in this area, including the legislative proposals under consideration today, can make significant contributions by making our regulations more risk-sensitive, less complex, and clearer.

Treatment of Transactions Between Affiliates

A key goal of the Dodd-Frank Act was to reduce the risk of financial contagion by reducing interconnectedness in the swaps markets. One of the primary ways that multinational companies, both financial institutions and commercial companies, can help accomplish this goal is through centralized, group-wide risk management strategies. By using swaps between commonly owned and managed affiliates to efficiently allocate and net risks within the corporate group, these strategies reduce interconnectedness by reducing the need to trade with third parties.

Rather than encouraging these beneficial, risk-reducing transactions, certain regulations impose significant, additional costs on firms executing them. In particular, U.S. bank regulators require the firms they regulate to collect an additional amount of collateral (called "initial margin") from their affiliates above and beyond the current credit exposure posed by those affiliates, which is already covered by mark-to-market or "variation" margin. The covered banks must then segregate this initial margin instead of using it to fund their lending activities or as a liquidity cushion they can use for other aspects of their businesses.

Some of the SIFMA members subject to these inter-affiliate initial margin requirements report that they are locking up as much, and sometimes more, collateral for these risk-reducing inter-affiliate transactions than they are collecting from third parties. Such risk-insensitive margin requirements discourage prudent risk management strategies and make it more challenging for the affected firms to provide cost-effective hedging solutions for end-user customers. They also reduce the resources these firms otherwise could loan out or invest in the broader economy.

Additionally, because only the U.S. bank regulators have imposed initial margin requirements on inter-affiliate swaps – not the CFTC or foreign regulators – the requirements create an un-level playing field and unnecessary regulatory complexity. The requirements also undermine decisions by the CFTC to extend relief to inter-affiliate swaps from the Dodd-Frank Act's mandatory clearing and mandatory trading requirements. The CFTC extended this relief because it recognized the risk management benefits of inter-affiliate swaps, although it adopted certain conditions to the relief that have proved problematic in some cross-border contexts.

We believe that an appropriate and targeted solution to these issues would be to exempt inter-affiliate swaps from initial margin, mandatory clearing, and mandatory trading requirements, so long as they are part of a centralized risk management program and remain subject to variation margin and trade reporting requirements. This approach would bring the banking regulators' margin rules in line with the CFTC's and help streamline existing CFTC exemptions. The banking regulators would retain a full suite of traditional bank regulatory tools to address any unique considerations raised when a federally-insured bank enters into inter-affiliate swaps.

SIFMA accordingly supports legislative measures to fix the current application of Title VII requirements to inter-affiliate transactions. We believe that any such measure should apply across the CFTC, SEC and U.S. banking regulators, who should be required to amend existing rules, as necessary, to be consistent with the new legislative framework and prevented from adopting any future rule, regulation or interpretation that is inconsistent with that framework.

Agency Review and Harmonization of Rules Relating to the Regulation of Over-the-Counter Swaps Markets

The regulatory distinction between "swaps" and "security-based swaps" as defined by Title VII did not accurately reflect market practice, and the resulting jurisdictional split between the CFTC and SEC has posed challenges for market participants. Despite some efforts by the agencies to coordinate and harmonize their Title VII requirements, important differences in these requirements remain.

SIFMA has long encouraged the CFTC and SEC to identify additional opportunities to simplify, harmonize and streamline their respective Title VII requirements, where appropriate. We are especially focused on areas where both agencies have an opportunity to build on lessons learned from experience with the CFTC's Title VII rules during the five years since they took effect at the end of 2012. These include:

- Reducing conflicts with other legal regimes, especially where different U.S. regulators' rules overlap, or U.S. rules apply extraterritorially. For example, the SEC has adopted ambiguous certification and legal opinion requirements relating to the SEC's access to a non-U.S. dealer's books and records, which create conflicts with foreign laws that the CFTC has sought to avoid. These conflicts would put U.S. investors at a disadvantage when they seek to access foreign markets because they would prevent non-U.S. dealers from trading with U.S. investors, lest those dealers become subject to conflicting requirements. The SEC should follow the CFTC's approach to avoiding or mitigating these conflicts.
- Following consistent international standards in areas such as margin and reporting requirements, which help promote a level playing field and efficient coordination among regulators. In contrast, the SEC's proposed margin rules include

idiosyncratic approaches to calculation and segregation of initial margin, which if adopted would make it difficult for SEC registrants to trade with other firms effectively. Also, the SEC's reporting rules take different approaches than rules adopted by the CFTC and foreign regulators to what data is required, who must report it, and when it must be reported, which will inhibit use of existing reporting systems and prevent regulators from effectively aggregating each other's data. To the extent characteristics of the SEC's markets or regulatory mandates justify differences in these areas, those differences should be more narrowly tailored.

- Recognizing instances where satisfying another domestic or foreign regulator's requirements would achieve a comparable regulatory outcome while avoiding the complexity and uncertainty associated with overlapping regulations. In particular, the SEC and CFTC should look for more opportunities to leverage each other's rules, especially for dual registrants.

We are supportive of recent efforts of the agencies to coordinate and consider where harmonization is appropriate, as indicated in recent speeches by the Chairmen, and look forward to contributing to this important dialogue. We hope that these efforts consider the principles that I have summarized above. We also would encourage additional coordination between the markets regulators and the U.S. banking regulators, especially in relation to capital and margin requirements.

Regulatory Capital Requirements

Regulatory capital requirements should be based on the principle that taking greater risk requires greater capital. Completely risk-insensitive leverage capital measures, such as the supplemental leverage ratio (SLR), are becoming the binding capital measures for many banking organizations, and the standardized risk-based capital requirements do not permit sufficient use of more risk-sensitive methodologies. As a result, the amount of required capital is increasingly unrelated to the level of risk taken. This defeats the principle of correlation between risk and capital and could lead to insufficient or excess capital levels, depending on prevailing economic conditions. These trends are exacerbated by excessively conservative and unrealistic assumptions built into the requirements, which creates a one-way ratchet toward higher amounts of capital and liquidity without adequate consideration of the effects on lending, market liquidity and the ability of end-users to hedge their risks.

One particularly problematic area is the SLR's treatment of centrally cleared derivatives. When a firm acts as an intermediary between a derivatives clearinghouse and a client, the firm guarantees the client's obligations to the clearinghouse, collects initial margin from the client to secure the client's obligations, and segregates that margin from its own assets (often by posting the margin to the clearinghouse). Although this initial margin largely offsets the clearing firm's exposure to the client and the clearing firm cannot use the margin to fund its business, the SLR requires the clearing firm to treat the full client exposure as a source of leverage without recognizing an offset for the initial margin.

Because the SLR's approach to client clearing requires clearing firms to hold capital against these exposures far in excess of the risks they face, it discourage client clearing activity. This incentive runs directly counter to the Dodd-Frank Act's mandates to promote central clearing. SIFMA accordingly supports H.R. 4659, as it would deduct any client-provided initial margin on centrally cleared derivatives from the amount of leverage exposure for the firm clearing the swap, and requires the banking regulators to amend their leverage-based capital rules to reflect this change.

There are also several other areas where leverage-based capital rules require firms to hold capital far in excess of their risks and discourage beneficial activity. For example, several post-crisis rules now require banks to hold significant amounts of high-quality, liquid assets as a cushion against future liquidity strains. But the leverage ratio treats these assets as though they were just as risky as any other asset held by a bank. To address this issue, we also recommend excluding from total leverage exposure all cash and cash equivalents, such as cash on deposit with central banks, U.S. Treasuries and government agency securities, and foreign sovereign debt that qualifies for a 0% risk weight under the risk-based capital rules.

Establishment of *De Minimis* Exception Annual Thresholds for Swap Dealers and Security-Based Swap Dealers

The Dodd-Frank Act exempts a person from being deemed a swap dealer or security-based swap dealer if the person engages in only a *de minimis* quantity of swaps or security-based swaps connected to its dealing activity. When the CFTC and SEC initially adopted rules implementing these provisions, they did not yet have much data they could use to quantity participation in the swap and security-based swap markets. They therefore set their *de minimis* thresholds relatively conservatively, with automatic reductions after a period of time absent a rulemaking to change the threshold or its methodology. For example, the CFTC's threshold is currently set at $8 billion, with an automatic reduction to $3 billion to occur absent CFTC action.

Over time, a potential decrease in the *de minimis* threshold has been a source of significant uncertainty for smaller firms, especially regional banks and dealers that facilitate access of smaller commercial end users to swaps. SIFMA has previously raised concerns[4] that decreasing the *de minimis* threshold would lead to a reduction in the number of swap market participants willing to engage in swap dealing activity with commercial end users for fear of going above the threshold and triggering the swap dealer registration requirement. Such an outcome would lead to reduced liquidity and a greater concentration of swaps transactions with larger financial institutions. In fact,

[4] See comments from SIFMA and the International Swaps and Derivatives Association, Inc. in response to CFTC staff's "Swap Dealer De Minimis Exception Preliminary Report" (submitted Jan. 19, 2016), available at: https://www.sifma.org/resources/submissions/sifma-and-isda-submit-comments-to-the-cftc-on-the-swap-dealer-de-minimis-exception-preliminary-report/.

a 2016 CFTC staff report on this issue stated that lowering the swap dealer registration threshold to $3 billion would provide "insignificant additional regulatory coverage" for dealing activity in interest rate swaps and index credit default swaps as compared to the $8 billion level.[5] The Department of the Treasury recently recommend that the CFTC should maintain the swap dealer *de minimis* registration threshold at $8 billion, and establish that any future changes be subject to formal rulemaking and a public comment process.[6]

We believe that any determination to modify the *de minimis* threshold must be supported by reliable, complete and robust data to avoid uncertainty and disruption in the swap markets. We support the CFTC's recent order[7] providing for additional time to consider data and make informed decisions moving forward regarding the appropriate level for the *de minimis* threshold.

In addition to setting their *de minimis* thresholds at an appropriate level, it is also critical for the CFTC and SEC to tailor what types of transactions count toward those thresholds. In particular, we are concerned about the extent to which the agencies currently require firms to count non-U.S. transactions, even transactions entered into by affiliates subject to comparable foreign regulation. We believe it is imperative that the agencies appropriately tailor the scope of transactions that lead to swap dealer or security-based swap dealer registration in the cross-border context.[8]

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

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[5] Swap Dealer De Minimis Exception Final Staff Report (Aug. 15, 2016) at 21, available at: http://www.cftc.gov/idc/groups/public/@swaps/documents/file/dfreport_sddeminis081516.pdf.

[6] Department of the Treasury Report, "A Financial System that Creates Economic Opportunities: Capital Markets" (Oct. 2017) at 139, available at: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[7] 82 FR 50309 (Oct. 31, 2017) (Order Establishing a New De Minimis Threshold Phase-in Termination Date).

[8] See comments from SIFMA in response to the CFTC's Project KISS initiative regarding swap dealer registration requirements (submitted Sep. 29, 2017), available at: https://www.sifma.org/resources/submissions/response-to-cftc-project-kiss-initiative-in-regards-to-swap-dealer-registration/. "*Title VII should not apply extraterritorially to U.S. firms' foreign branches or affiliates where existing regulation already protects against significant risk flowing back to the United States. As such, [swap dealer ("SD")] registration should not apply to a U.S. firm's non-U.S. affiliate on the basis of trading with non-U.S. counterparties if the U.S. firm's non-U.S. affiliate is regulated in a G20 jurisdiction or otherwise subject to Basel-compliant capital standards, regardless of whether the affiliate is guaranteed by its U.S. parent. Further, non-U.S. swap counterparties should not be required to register as SDs as a result of doing business with a U.S. firm's foreign branch or affiliate (guaranteed or not), and rather allow for existing prudential regulation to address any risks faced by U.S. firms trading abroad. By appropriately excluding such transactions from registration calculations, the Commission would promote U.S. competitiveness abroad and facilitate continued access of U.S. firms to foreign liquidity providers, trading platforms and centralized counterparties ("CCPs").*"

Written Testimony before the
U.S. House of Representatives, Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing Entitled "Legislative Proposals Regarding Derivatives"

Thomas C. Deas, Jr.
Chairman, National Association of Corporate Treasurers, and
Representative, Coalition for Derivatives End-Users

February 14, 2018

Chairman Huizenga, Ranking Member Maloney and distinguished Members of the Subcommittee, it is an honor to appear before you today at this important hearing on ways to improve the U.S. regulatory regime for over-the-counter ("OTC") derivatives.

By way of background, I am the current chairman 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. I also represent the NACT on the steering committee of the Coalition for Derivatives End-Users (the "Coalition"), which is comprised of over 300 end-user companies and trade associations. The Coalition's member companies employ OTC derivatives to manage commercial and operational risks in their day-to-day business activities, principally through the dedicated efforts of their corporate treasurers. I am testifying today on behalf of the Coalition.

The end-user community is appreciative of this Subcommittee's historical and continued support in providing end-users with relief from some of the costliest regulations promulgated under financial reforms, including, specifically, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1]. In spite of your efforts and those of agencies that have worked with the Coalition on sensible regulations, Main Street businesses remain burdened by a number of Dodd-Frank rules. For example, U.S. prudential regulators,[2] acting in accordance with their Dodd-Frank mandates, have continued to issue rules that have resulted in increased costs for end-users' risk mitigation activities. The cumulative effects of these burdens and costs have threatened the ability of American businesses to affordably protect against risks associated with their day-to-day commercial operations.

While the Commodity Futures Trading Commission ("CFTC"), the Securities and Exchange Commission, and the prudential regulators have implemented important reforms to better protect commercial end-users and the OTC derivatives markets generally, the implementation of many of these new, well-intended measures have adversely impacted American business investment,

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[1] See Pub. L. 111-203, 124 Stat. 1376 (2010).

[2] Depending on the context, the term "U.S. prudential regulators" generally refers to the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Farm Credit Administration or the Federal Housing Finance Agency.

acquisitions, research and development and job creation. Hence, the Coalition is very pleased that this Subcommittee today is examining legislation to provide relief to end-users. And I would like to express the Coalition's support for a number of these bills.

As I will explain later in my testimony, the Coalition expressly supports the following four legislative proposals: (i) the proposal creating an end-user exemption from the credit valuation adjustment ("CVA"); (ii) the proposal ensuring end-user fairness in the Dodd-Frank "financial entity" definition; (iii) the proposal exempting internal risk management practices between affiliates from myriad Dodd-Frank swap requirements; and (iv) the proposal fixing the statutory centralized treasury unit ("CTU") relief.

First, however, allow me to provide context on how end-users use OTC derivatives and what role end-users play in OTC derivatives markets, and how targeted regulatory relief can help end-users continue to drive the economy and create good jobs here in the United States.

I. End-Users and Today's OTC Derivatives Markets

End-users are fundamentally different from most other participants in the OTC derivatives markets in that they only employ derivatives to reduce risks arising from their business operations. I think a simple example will help explain this point. Consider a U.S.-based agricultural chemicals manufacturer that sells products in Brazil. One of the company's customers in Brazil needs to purchase crop-protection chemicals at planting time, but can only pay six months in the future, at harvest time. During this six-month period, the Brazilian farmer faces both commodity price risk and currency risk. The U.S. chemicals manufacturer arranges a trade with the Brazilian farmer, whereby the farmer agrees to pay in bushels of soybeans at harvest time, six months forward, and the U.S. manufacturer agrees to provide the chemicals that the farmer needs to apply at planting time. Through that trade, the farmer has transferred the commodity price risk to the U.S. chemicals manufacturer, which can enter into a customized OTC commodity derivative, which locks in the U.S. dollar price six months in the future, thereby hedging its risk in the derivatives market.

By reducing the overall volatility of its business results, the OTC derivative executed by the U.S. chemicals manufacturer contributes to the stability and predictability of its business. Additionally, it supports U.S. exports, manufacturing, research and development, and ultimately employment of U.S. workers. However, that U.S. chemicals manufacturer cannot sustain this beneficial transaction without being able to offset the manufacturer's risks by trading with a bank counterparty, which provides liquidity. And the U.S. chemicals manufacturer also cannot provide that service in Brazil if the transaction pricing for its offsetting trade with the bank is too high.

OTC derivatives activity reduces business risk for thousands of end-user companies like the one in my Brazil example. From an end-user company's point of view, the OTC derivatives market should allow the efficient transmittal of risk from where it is incurred to where it can be matched and offset. Undue regulatory costs along the way, including those placed on its financial intermediaries, are ultimately borne by the end-user. This hedging activity does not create meaningful system risk and did not roil markets during the 2008 financial crisis. For perspective, end-users comprise less than 10 percent of the notional amount of the OTC derivatives market.

Now that I have provided some context regarding why end users employ OTC derivatives, I would like to turn to addressing how we believe certain OTC derivatives legislative proposals under consideration by the Subcommittee would likely address two underlying policy concerns affecting end-users. First, the Coalition expressly supports two proposals since they would likely help maintain the competitiveness of U.S. businesses when they do business overseas. Second, the Coalition expressly supports two other proposals since they would likely reduce the costs and burdens of existing Dodd-Frank regulations, which have had unintended, adverse consequences on end-users.

II. Maintaining the Competitiveness of U.S. Businesses When They Do Business Overseas

Recognizing that the OTC derivatives markets are truly global, end-users should have a consistent, predictable and level regulatory playing field in which they do not suffer any relative disadvantages when compared to their foreign competition. Foreign regulators of many of our trading partners have granted exemptions to end-users that are not available under U.S. law, placing American end-users at an economic disadvantage compared to their foreign competitors. Moreover, financial end-users that use derivatives the same way as non-financial end-users(i.e., to manage business risks) should enjoy the same exemptions from clearing and margin requirements. The Coalition believes that the following two legislative proposals under consideration by the Subcommittee would directly address these policy issues:

- Proposal creating an end-user exemption from the CVA charge; and
- Proposal ensuring end-user fairness in the Dodd-Frank "financial entity" definition.

Proposal Creating an End-User Exemption from the Credit Valuation Adjustment

European policymakers have implemented capital charges on OTC derivatives positions significantly more favorable to their end-users than U.S. prudential regulators. The European approach recognizes that end-users' hedging activities are in fact reducing risks, and accordingly, exempts end-user derivatives transactions from the CVA capital charge.[3] In contrast, the CVA capital charge rules promulgated in the United States require U.S. banking institutions to calculate and hold capital to mitigate counterparty credit risk on all uncleared OTC derivatives transactions.[4] Since commercial end-users that transact OTC derivatives with U.S. banking institutions are not required to clear their transactions, all of those transactions are subject to the CVA charge. U.S. banking institutions pass along the costs associated with the CVA charge to their end-user counterparties in the form of higher transaction pricing. As a result, end-users pay more for their swaps executed with U.S. banking institutions.

[3] EU Capital Requirements Regulation, Article 382(4).

[4] The CVA capital charge requires a banking organization to retain additional capital to protect against potential mark-to-market losses in situations where their OTC derivatives counterparties' creditworthiness deteriorates. U.S. prudential regulators were given the statutory authority to promulgate CVA capital charge rules under the Basel III regulatory framework. Although the CVA is not discussed in Dodd-Frank, the underlying statutory authority of 12 U.S.C §§ 5371(b)(2) and 5365(b)(1) provides prudential regulators with the authority to promulgate risk-based standards, like the CVA under 12 C.F.R. §§ 217.132(e) and 324.132(e) (2016).

The lack of a CVA exemption in the United States significantly reduces the benefits of the statutory exemptions from clearing and margin requirements, which were granted by Congress under Dodd-Frank. An exemption would put U.S. businesses on equal footing with their non-U.S. counterparts. For those reasons, the Coalition supports a legislative proposal that explicitly requires U.S. prudential regulators to establish an exemption from the CVA capital charge for U.S. banking institutions' OTC derivative hedging transactions with commercial end-users.

Proposal Ensuring End-User Fairness in the Dodd-Frank "Financial Entity" Definition

The Coalition believes that all end-users employing derivatives to manage business risk should be treated equally. Under Dodd-Frank, Congress established status-based exceptions and exemptions from several requirements, including mandatory clearing, mandatory trading, and the requirements under the CFTC's and U.S. prudential regulators' final uncleared margin rules. That is, eligibility for an exemption or exception from a particular Dodd-Frank requirement turned primarily on an entity's status as a financial entity. Falling under Dodd-Frank's definition of "financial entity" means that an entity is automatically precluded from qualifying for or otherwise electing any of exceptions or exemptions. Essentially, Dodd-Frank treats entity status—financial versus non-financial—as a proxy for the potential riskiness an entity poses to the U.S. financial system irrespective of the types of activities in which the entity engages (i.e., speculative versus hedging activities). As a result, less risky end-users are captured within the broad "financial entity" definition (such as special-purpose vehicles and other similar structures) and must clear their OTC derivatives at clearinghouses, trade their OTC derivatives on regulated exchanges and exchange margin on their uncleared OTC derivatives transactions, notwithstanding the fact that those transactions were entered to hedge or mitigate legitimate commercial risks.

Consider a real estate company, which owns and manages factory buildings and supporting infrastructure, and leases them to manufacturers. To the extent the company is organized as a real estate fund, it is characterized under current rules as financial and cannot hedge its business exposures in the derivatives markets without being subject to the full range of regulations applied to financial counterparties. The unifying characteristic for the end-user exemption should be maintaining a book that matches a derivative with an underlying business exposure, not whether the end-user is engaged in certain activities which might be financial in nature.

Foreign policy makers and regulators in Europe, Canada and other jurisdictions have taken a different view.[5] These jurisdictions have determined that eligibility to claim exemptions and exceptions from OTC derivatives rules should be based on an entity's activity-levels within their markets. In most cases, these jurisdictions focus on the types and size of an entity's activities in determining the entity's riskiness to their financial markets and, in turn, the entity's eligibility to elect exemptions and exceptions from certain requirements. To that end, these jurisdictions have established *de minimis* tests to determine an entity's eligibility.

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[5] See European Market Infrastructure Regulation (EU) No. 648/2012 (Dec. 12, 2012). See also Canadian Securities Administrators, National Instrument 94-1010 (Jan. 19, 2017). See also Monetary Authority of Singapore, Securities and Futures (Clearing of Derivatives Contracts) Regulations 2015, ch. 289.

In order to level the playing field for American businesses, the Coalition fully supports legislative proposals that would narrow Dodd-Frank's broad definition of "financial entity" by including a *de minimis* threshold. This approach would be consistent with the approaches taken by foreign jurisdictions and would more appropriately measure an entity's riskiness based on actual OTC derivatives activity. This approach was also expressly supported by CFTC Chairman J. Christopher Giancarlo[6] and supported in principle by the U.S. Department of the Treasury in its Capital Markets Report.[7] Last year, Chairman Giancarlo testified before the House Agriculture Committee that the definition "is perhaps [one of a couple of] areas where the rules have been overly broad and overly restrictive."[8] Treasury's Capital Markets Report further expressed support for a legislative amendment to the Commodity Exchange Act ("CEA") clarifying the scope of the "financial entity" definition and allowing non-prudentially regulated entities that are financial in nature to become eligible for an exception to the clearing requirement that is appropriately conditioned on, among other things, the size and nature of swaps activities.[9]

III. REMOVING THE COSTS AND BURDENS OF WELL-INTENDED REGULATORY MEASURES WITH UNINTENDED, ADVERSE CONSEQUENCES

After more than seven years of Dodd-Frank implementation, the comprehensive harmful impacts that the full suite of Dodd-Frank regulations have had on end-users' opportunities to manage, effectively and cost-efficiently, their exposures to volatile market risks and access the capital markets are well-known to corporate treasurers. The Coalition believes that two of the legislative proposals currently under consideration by the Subcommittee will mitigate harmful impacts. In particular, those two proposals would:

- Exempt internal risk management practices between affiliates from myriad Dodd-Frank swap requirements; and
- Fix the statutory centralized treasury unit relief.

Proposal Exempting Internal Risk Management Practices Between Affiliates from Myriad Dodd-Frank Swap Requirements

Currently, Dodd-Frank provisions added to the CEA and CFTC regulations that were promulgated under those provisions indiscriminately apply many requirements to inter-affiliate derivatives transactions as if those transactions were executed between unaffiliated, third-parties. While the CFTC has issued final rules and staff no-action letters to provide relief from various Dodd-Frank requirements in recognition of the fact that inter-affiliate derivatives transactions are not

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[6] See Congressional Testimony Transcript, CFTC Chairman J. Christopher Giancarlo before the Committee on Agriculture, House of Representatives, EXAMINING THE 2017 AGENDA FOR THE CFTC, 115th Congress, First Session, Oct. 11, 2017, Serial No. 115–12, ("Giancarlo's House Agriculture Testimony"), available at https://agriculture.house.gov/uploadedfiles/115-12_-_27184.pdf.

[7] See U.S. Dept. of the Treasury Report, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES – CAPITAL MARKETS, pp. 141-142, available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf ("Treasury's Capital Markets Report").

[8] See Giancarlo's House Agriculture Testimony at p.40.

[9] Id. at 142.

speculative and do not raise the systemic risk concerns that Dodd-Frank is intended to address, the CFTC's rules and staff no-action letters have created uncertainty and impose complex conditions on end-users' internal risk management practices.

Rather than having each affiliate separately execute swaps, it is a common for derivatives end-users to engage in the risk-reducing best practice of operating a single market-facing entity within a corporate group in order to centralize hedging expertise. The end-user company employing this practice gains the benefit of reducing the exposure it needs to hedge with a financial counterparty by netting out opposite-way trades within its corporate group. This model allows for risks to be managed across a corporate group, with the appropriate specialized expertise and operations, in the appropriate entity, jurisdiction, or time zone subject to overall direct corporate control and compliance supervision.

The Coalition believes that the legislative proposal under consideration today would more permanently clarify that these internal, risk-reducing transactions are not subject to regulatory burdens that were designed to be applied only to certain market-facing swaps. The proposal would ensure that commercial end-users can net inter-affiliate derivatives and thereby enter into fewer external swap transactions with third-party financial counterparties, allowing them to use these inter-affiliate transactions to manage their commercial risks without unnecessary and costly burdens being imposed on such transactions. Moreover, initial margin requirements for inter-affiliate trades of end-users' counterparties, and the related collateral segregation requirements for such entities, impose additional cost burdens that directly increase transaction prices for commercial end-users. Ensuring that inter-affiliate transactions for both end-users and their counterparties are exempt from economically inefficient regulation would help to reduce costs and would not contribute to the systemic risk that Dodd-Frank was intended to address.

Proposal Fixing the Statutory Centralized Treasury Unit Relief

CTUs are centralized corporate departments of Coalition companies that aggregate and manage the enterprise-wide treasury needs of a derivatives end-user. Rather than each subsidiary engaging in its own derivatives hedging transactions, CTUs serve as a singular unit to oversee the financial needs of the organization, creating costs savings and making for a more efficient and financially sound enterprise. In 2014, CFTC staff first provided relief to CTUs from the CFTC's mandatory clearing requirements through the issuance of a no-action letter.[10] A year later, Congress sought to provide identical relief to CTUs by enacting a statutory exemption for CTUs.[11] Congress' statutory exemption, however, included slightly different language, which created certain interpretive gaps. These gaps now threaten the cost-saving efficiencies and risk management practices that end-users have established through their corporate structures.

The Coalition supports the legislative proposal under consideration by the Subcommittee that would harmonize the language in Congress' statutory exemption with CFTC staff's relief in order to remove uncertainty for both end-users and market regulators. In our view, this proposal would

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[10] See CFTC No-Action Letter 14-144 (Nov. 26, 2014), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/14-144.pdf.

[11] 7 U.S.C. § 2(h)(7)(D).

address the clear, unintended consequences resulting from Congress' well-intended statutory exemption.

IV. Conclusion

The Coalition appreciates the Subcommittee's interest in considering measures to improve the U.S. OTC derivatives regulatory framework and stands ready to help move these important bills forward. The Coalition believes that legislative efforts to address the specific concerns with Dodd-Frank that I highlighted today will reduce burdens and costs placed on American Main Street businesses and will improve America's global competitiveness.

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

Hearing on "Legislative Proposals Regarding Derivatives"

Protecting Financial Stability and Enhancing Competitiveness in the Derivatives Markets

Testimony before the U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Securities and Investment

Andy Green
Managing Director, Economic Policy
Center for American Progress

Wednesday, February 14, 2018

Thank you, Chairman Huizenga and Ranking Member Maloney, for the opportunity to testify on this important topic. I am the Managing Director for Economic Policy at the Center for American Progress, where I help oversee the work of our Economic Policy team. Today, I will discuss the important reforms made to the derivatives market by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, outline views on some of the derivatives-related legislative proposals before the Subcommittee today, and suggest fruitful areas for the Subcommittee to consider going forward.

Background on Derivatives and Past Market Failures

The derivatives market is a vital avenue for financial and nonfinancial companies to prudently hedge the risks they face—including foreign exchange, interest rate, and credit risks. One portion of the derivatives market, namely futures and options contracts in which a buyer and seller agree to transact (or the buyer has the option to transact) at a certain price on a future date, have long been regulated and traded on public exchanges. However, a large segment of the derivatives market, consisting primarily of swaps—contracts in which counterparties agree to swap different cashflows that may reference specific indexes or interest rates—were unregulated prior to the financial crisis. These derivatives, referred to as over-the-counter (OTC) derivatives were truly left in the shadows of our financial system.

Today, the OTC derivatives market stands at roughly $550 trillion, in terms of the notional amount of outstanding contracts.[1] This massive market may not directly impact the day to day life of the average American, but a severe disruption in the market can have knock on effects impacting the real economy. As former Chairman of the Commodity Futures Trading Commission (CFTC), Gary Gensler, stated so aptly, "So many people...in the United States who never had any connection to derivatives or exotic financial contracts had their lives hurt by the risks taken by financial actors."[2] We must get the regulation and oversight of these markets right. Prior to financial crisis, we did not. And the economy, workers, and families suffered the ills of that mistake. When derivatives markets are functioning well, however, consumers experience the benefits of better prices, as financial and nonfinancial companies across the economy are able to better manage the risks they face.

The unregulated OTC derivatives market was at the heart of the 2007-2008 financial crisis, which cost 8.7 million Americans their jobs, 10 million families their homes, and eliminated 49

[1] Bank for International Settlements, "Statistical release OTC derivatives statistics at end- June 2017" (2017) https://www.bis.org/publ/otc_hy1711.pdf

[2] Chairman Gary Gensler, "OTC Derivatives Reform," testimony before the Chatham House, London, March 18, 2010, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-35

percent of the average middle-class family's wealth compared with 2001 levels.[3] OTC derivatives tied counterparties across the financial sector together in complex webs of risk, largely out of sight of regulators. Christopher Cox, the chairman of the Securities and Exchange Commission (SEC) during the financial crisis, referred to the market as a "regulatory blackhole."[4] Then-president of the Federal Reserve Bank of New York Tim Geithner expressed similar concerns in 2006 regarding the market, including challenges in the firms' infrastructure and operational management of these contracts.[5] This market was a clear source of systemic risk. The buildup of financial sector interconnectedness meant that material financial distress at one or a handful of financial companies could quickly reverberate throughout the financial system.

For example, American International Group Inc. (AIG) had a substantial portfolio of credit default swaps (CDS) it had written against collateralized debt obligations stuffed with subprime mortgages.[6] The CDS were insurance products at their core and AIG was essentially insuring others against the risk that the subprime mortgage market would bottom out. When the subprime mortgage market did indeed crash, AIG had to payout the CDS contracts.[7] Because these derivatives were not regulated like a traditional insurance product or in any other responsible way, AIG didn't have adequate capital or reserves to cover the losses—bringing the global insurance company to the brink of failure. AIG's failure would have caused significant losses for the company's derivatives counterparties, as the default swaps were being used by AIG's

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[3] Annalyn Kurtz, "U.S. soon to recover all jobs lost in crisis," CNN Money, June 4, 2014, available at http://money.cnn.com/2014/06/04/news/economy/jobs-report-recovery/; Carmel Martin, Andy Green and Brendan Duke, eds., "Raising Wages and Rebuilding Wealth: A Roadmap for Middle-Class Economic Security" (Washington: Center for American Progress, 2016), available at https://www.americanprogress.org/issues/economy/reports/2016/09/08/143585/raising-wages-and-rebuilding-wealth/; National Center for Policy Analysis, "The 2008 Housing Crisis Displaced More Americans than the 1930s Dust Bowl," May 11, 2015, available at http://www.ncpa.org/sub/dpd/index.php?Article_ID=25643.

[4] Chairman Christopher Cox, "Speech by SEC Chairman: Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System," October 8, 2008, available at https://www.sec.gov/news/speech/2008/spch100808cc.htm.

[5] Timothy F. Geithner, President of the Federal Reserve Bank of New York, "Implications of Growth in Credit Derivatives for Financial Stability," Remarks at the New York University Stern School of Business Third Credit Risk Conference, New York City, May 16, 2006, available at https://www.newyorkfed.org/newsevents/speeches/2006/gei060516.

[6] Alistair Barr, "AIG execs say super senior CDO portfolio in 'run off,'" MarketWatch, May 9, 2008, available at http://www.marketwatch.com/story/aig-execs-say-super-senior-cdo-portfolio-in-run-off.

[7] Robert McDonald and Anna Paulson, "AIG in Hindsight" (Chicago: Federal Reserve Bank of Chicago, 2014), available at https://www.chicagofed.org/~/media/publications/working-papers/2014/wp2014-07-pdf.pdf;

counterparties to hedge against a subprime market downturn.[8] The Federal Reserve bailed out AIG's in part because its failure would cause failure or distress at other financial institutions across the financial sector.[9]

AIG was by no means the only example of the dangerous webs of risk created by unregulated derivatives during the crisis. Lehman Brothers' disorderly failure, which was felt across the global financial system in September of 2008, was exacerbated due to the company's extensive OTC derivatives portfolio. The company had around 930,000 OTC derivatives contracts at the time of its failure.[10] Moreover, the systemic importance of Bear Stearns, Merrill Lynch, and countless other financial institutions that were bailed out during the crisis was increased by their OTC derivatives portfolios.[11]

The significant risks posed by unregulated derivatives markets were not necessarily new in 2007-2008. In 1998, the highly leveraged hedge fund, Long Term Capital Management (LTCM), leveraged roughly $4 billion of net assets into $125 billion in gross assets. Beyond LTCM's leveraged balance sheet, it also used OTC derivatives to increase its total leverage exposure to $1 trillion.[12] When the hedge fund's bets went sour, the Federal Reserve Bank of New York stepped in to help facilitate a private bailout of the firm because many large Wall Street banks were LTCM's counterparties.[13] Speculative derivatives losses also led to the downfall of another sizeable hedge fund, Amaranth Advisors. Amaranth lost $6 billion on unregulated energy

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[8] Serena Ng and Carrick Mollenkamp, "Goldman Fueled AIG Gambles," The Wall Street Journal, December 12, 2009, available at http://www.wsj.com/articles/SB10001424052748704201404574590453176996032.
[9] Federal Reserve Bank of New York, "Actions Related to AIG" available at https://www.newyorkfed.org/aboutthefed/aig.
[10] Michael Greenberger, "The Role of Derivatives in the Financial Crisis," Testimony before the Financial Crisis and Inquiry Commission, June 30, 2010, available at https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0630-Greenberger.pdf.
[11] Board of Governors of the Federal Reserve System, "Bear Stearns, JPMorgan Chase, And Maiden Lane LLC," available at https://www.federalreserve.gov/regreform/reform-bearstearns.htm (last accessed February 2018); Gretchen Morgenson, "How the Thundering Herd Faltered and Fell," *The New York Times,* November 8, 2008, available at http://www.nytimes.com/2008/11/09/business/09magic.html.
[12] Michael Fleming and Weiling Liu, "Near Failure of Long-Term Capital Management," Federal Reserve Bank of Richmond, November 22, 2013, available at https://www.federalreservehistory.org/essays/ltcm_near_failure.
[13] Roger Lowenstein, "Long-Term Capital Management: It's a short-term memory," The New York Times, September 7, 2008, available at http://www.nytimes.com/2008/09/07/business/worldbusiness/07iht-07ltcm.15941880.html.

derivatives when its bets in the natural gas market went south.[14] Additionally, unregulated energy derivatives were at the center of Enron's collapse. The company looked more like a financial institution than a utility company by the time of its demise.[15] Enron used OTC derivatives to hide debt, to hide losses, and to speculate.[16] When its smoke and mirrors risk-shifting and highly-leveraged speculation came crashing down, the $63 billion energy giant filed for bankruptcy—at that time the largest bankruptcy filing in U.S. history.[17] Unfortunately following these episodes, which revealed the dangers of unregulated derivative markets, no material improvements were made to the regulatory regime—paving the way for the central role played by the OTC derivatives market in 2007-2008.

In addition to increasing the interconnectedness of the financial sector, OTC derivatives enabled financial companies to conceal their leverage prior to the 2007-2008 crisis. These unregulated markets did not have adequate capital or margin requirements for derivatives held by banks, or any capital/margin requirements for non-bank dealers, which would have restricted the leverage employed by institutions using these financial instruments. On-balance-sheet leverage, funding assets through various forms of borrowing, was restricted—albeit inadequately—at the firm-level by capital requirements. Similarly, regulated derivatives markets, through exchange trading and clearing, required counterparties to put up capital at the transaction-level known as margin, to protect against counterparty default. Not having adequate capital or margin requirements in place in the OTC derivatives markets enabled firms to take on excessive leverage, without adequate buffers to protect against price movements against their positions.

[14] United States Senate Permanent Subcommittee on Investigations, "Excessive Speculation in the Natural Gas Market," Staff Report, June 2007, available at https://www.hsgac.senate.gov/download/report-psi-staff-report-excessive-speculation-in-the-natural-gas-market-6/25/07; Jenny Anderson, "Betting the House and Losing Big," *The New York Times*, September 23, 2006, available at http://www.nytimes.com/2006/09/23/business/23hedge.html?mtrref=www.google.com.

[15] Michael Schroeder, "Enron's Dealing in Derivatives Helps Shift Spotlight to a Gap in Oversight," The Wall Street Journal, January 28, 2002, available at https://www.wsj.com/articles/SB1012168575563404120; Frank Partnoy, "Testimony of Frank Partnoy before the Unites States Senate Committee on Governmental Affairs," January 24, 2002, available at https://www.hsgac.senate.gov/download/?id=e61872aa-e5b1-4f41-a184-d4ebab8faa46.

[16] Ibid.

[17] The Associate Press, "Enron Will Emerge From Bankruptcy Protection," The New York Times, July 16, 2004, available at http://www.nytimes.com/2004/07/16/business/enron-will-emerge-from-bankruptcy-protection.html.

In addition to the systemic risk arising from the unrestricted leverage and interconnectedness of the OTC market, certain OTC derivatives products were used speculatively and magnified risk, instead of hedging it. The bipartisan report of the Senate Permanent Subcommittee on Investigations, among others, chronicled how credit default swaps enabled the creation of synthetic (otherwise non-existent) exposures to subprime mortgages, which in turn dramatically expanded the financial sector's exposure to those assets.[18] These products did not serve to manage or hedge against risks, but simply enabled speculative activities and increased the buildup of excessive risk in the financial system.

Following the 2007-2008 financial crisis, policymakers understood the need to bring the OTC derivatives market out of the shadows to regulate and oversee the complex maze of interconnections that had built up over time.

Title VII Reforms Enhance Market Stability and Competitiveness

In the wake of the devastation wrought by the financial crisis, Congress and the Obama administration took action to reform the financial regulatory regime in the U.S. and passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Title VII of Dodd-Frank addressed the significant flaws in the unregulated OTC derivatives market that proved so costly during the crisis. The bill mandated a series of regulatory improvements to the swaps markets, including: (i) registration requirements for swap dealers and major swap participants; (ii) requirements that standardized OTC derivatives be centrally cleared through clearinghouses; (ii) requirements that trading of standardized OTC derivatives take place on exchange-like platforms; (iii) new capital requirements for swap dealers and major swap participants and margin requirements for uncleared swaps; (iv) data reporting and recordkeeping requirements; (v) governance requirements and protections against conflicts of interest for the users of these products; and (vi) position limits to limit speculative activities; among others. The bill directed the CFTC for most swaps and the SEC for security-based swaps to promulgate implementing

[18] HSGAC Subcommittee on Investigations, "Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis," Press release April 13, 2011, available at https://www.hsgac.senate.gov/subcommittees/investigations/media/senate-investigations-subcommittee-releases-levin-coburn-report-on-the-financial-crisis.

rules and also strengthened enforcement tools at both agencies. It also clarified, mandated, and strengthened robust cross-border coverage, owing to the fact that risks in swaps can easily flow back to the United States.

The goal of these reforms was to bring stability, transparency, and competition to this previously-unregulated segment of the derivatives market. In several respects, these policy ideas were not novel—variations of many of them had worked for decades (or longer) in the regulated segment of the market. The registration, reporting, and recordkeeping requirements all were meant to provide regulators and market participants with greater insight into the day-today functioning and structure of the OTC derivatives market. The central clearing mandate was included to address the dizzyingly complex, and systemically risky, interconnections created by the web of OTC derivatives transactions across the financial sector—ensuring that a dedicated third party assumed, managed, and reduced the resulting counterparty risks. The goal of exchange-like trading mechanisms was to improve the liquidity, pre-trade transparency, and costs for end-users, as the old off-exchange trading processes were cumbersome and opaque. Capital and margin requirements were a must to improve the resiliency of these markets to face the systemic risks they create. Governance requirements better protected end-users from abuses. And position limits help further these goals by restricting the negative impact that excessive speculative activities can have on real economy users of physical commodities.

Nearly eight years have passed since Dodd-Frank passed Congress and was signed into law by President Obama. Beyond sounding well-meaning in theory, have these changes in practice addressed the pre-crisis ills of this market? We can answer that question with a resounding yes: significant progress has been made. Central clearing of OTC transactions has increased significantly since the crisis. In 2007, roughly 15% of derivatives overseen by the CFTC were centrally cleared.[19] Today, the dollar volume of cleared swaps is north of 80%.[20] Research in the CDS market shows that the increase in the use of central clearing has reduced counterparty credit

[19] Chairman Timothy G. Massad, Testimony before the U.S. Senate Comittee on Agriculture, Nutrition & Forestry, May 14, 2014, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22.
[20] U.S Commodity Futures Trading Commission, "Swaps Reports Archive," available at http://www.cftc.gov/MarketReports/SwapsReports/Archive/index.htm, December 29-January26 dollar volume of IRS and CDS (cleared/total).

risk, and has improved liquidity in the market.[21] Moreover, the use of exchange-like entities known as swaps execution facilities (SEFs) has improved pre-trade transparency for end-users and increased competition in the market. End-users can compare prices in real-time and analyze competing bid/offers from multiple dealers. The Bank of England analyzed the impact of SEFs on the OTC derivatives market and found that in the U.S., "total execution costs for end-users are reduced by about $7-$13 million a day" for SEF mandated swaps.[22]

While the CFTC and the prudential regulators have largely completed implementing their parts of the Title VII regime, the SEC has, unfortunately, little to show for its efforts to implement its securities-based swaps mandate. By deferring the effectiveness of its rules until all of them are completed, the SEC has remained frozen on even its most foundational steps.[23]

Evaluating the Subcommittee's Legislative Proposals

As outlined above, failures of the unregulated derivatives markets had enormous negative impacts on financial stability, which in 2008 contributed enormously to a financial crisis that devastated U.S. economic growth and ordinary household economic performance. Moreover, the sensible reforms put in place following the crisis have, by all available evidence, begun to succeed as intended to reduce the risks to the U.S. economy and taxpayers from failures in the derivatives markets, as well as lower costs for the users of those financial markets by increasing transparency and enhancing competition. Firms have already made investments in updating their business operations and compliance systems. As such, any legislative proposal should have to overcome a heavy burden in favor of maintaining what is working.

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[21] Yee Cheng Loon and Zhaodong Zhong, "Does Dodd-Frank Affect OTC Transaction Costs and Liquidity? Evidence from Real-Time CDS Trade Reports," *Journal of Financial Economics (JFE),* Forthcoming (2015), available at http://bit.ly/2E9n5t4.

[22] Evangelos Benos, Richard Payne and Michalis Vasios, "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act" Working Paper 580 (Bank of England, 2015), available at https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2016/centralized-trading-transparency-and-interest-rate-swap-market-liquidity.pdf?la=en&hash=F19D254DDF6F4AFED1D47842B65BE72170253391.

[23] U.S Securities and Exchange Commission, "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," available at https://www.sec.gov/spotlight/dodd-frank.shtml# (last accessed February 2018).

In addition, financial regulatory reform proposals need to be considered on the whole. Derivatives reforms designed to enhance stability across the derivatives markets are importantly complemented by the designation process put in place under the Financial Stability Oversight Council (FSOC), which looks at the risks present in nonbank financial firms that could, if not properly regulated, create knock-on effects even across otherwise well-regulated systems. Similarly, the Office of Financial Research (OFR) was deployed to look across the financial system to identify the build-up of unexpected and problematic risks. Today, however, FSOC appears to be in the process of undoing much of its designation process, while OFR in 2017 suffered a 25 percent budget cut from 2016 and remains under funding and other pressures.[24] It is unclear what the Federal Reserve Board, under its new leadership, and other regulators will do on other important reforms, such as higher capital, stronger liquidity, and the Volcker Rule's requirements that banking organizations focus on serving clients and the real economy. But the overall direction as outlined by the Treasury Department's series of reports points towards highly troubling levels of deregulation. Those are wrong on their own, but they also matter to how the derivatives markets function, as those markets magnify and transmit risks across financial institutions and markets. To the extent that institution-based oversight is being dialed back, it places even more strain on any weaknesses that may emerge in the derivatives markets. Policymakers must keep as a top priority ensuring that derivatives markets have sufficient firewalls to stop a future financial conflagration from spreading.

The series of bills presented for consideration in today's hearing all appear to press in the wrong direction. The degree of severity depends upon the bill. But all of them slice, dice, or otherwise poke holes – sometimes large holes – in the firewalls placed in the derivatives markets by post-2008 reforms.

A persistent theme in the bills is to extend the scope of commercial end-user treatment to entities and activities that are financial in nature. As discussed in greater detail below, this violates the basic bargain that strong regulatory protections are put in place across the market, which is

[24] Gregg Gelzinis, "The Trump Administration Is Quietly Slashing Financial Stability Funding," (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/news/2017/12/07/443709/trump-administration-quietly-slashing-financial-stability-funding/.

dominated by financial firms, and that special treatment can be accorded the relatively small number of commercial entities.[25] To draw an analogy to public health, a small number of people can avoid being immunized and still remain protected by the broader use of a vaccine, but if that group becomes too large, everyone is put at risk – especially those people who actually cannot be immunized.

To the extent that any of the bills embody specific concerns by market participants, far more needs to be done to study these specifically identified challenges. To facilitate ensure accurate analyses and broad-based consensus on these questions, far more market and institutional data must be made available to, and usable by, the public. Right now, even regulators struggle to digest the mountains of inconsistent and messy data coming in from swap data repositories. Data challenges exemplify the importance of new institutional resources like OFR, which has been helping the chronically underfunded CFTC to improve swaps data and more broadly had been working internationally to establish new data standards like the Legal Entity Identifier (LEI) as well as swaps-specific identifiers like a unique product identifier and a unique transaction identifier. These efforts are key to identifying and potentially stopping both major market disruptions and abuses. For example, the inability of market participants and regulators to understand exactly which firms were responsible for which trades created a significant risk that exacerbated the 2008 financial crisis. [26] Further, the failure to have LEIs in our trading system makes it extremely difficult for regulators to identify and police potential abuses.[27] These efforts are essential for proper modern financial system oversight.

[25] It is worth noting that the special treatment accorded to commercial end-users, such as using uncleared swaps or not posting margin, largely involves extensions of credit by the swap dealer to the end-user. Given the impacts that high levels of corporate indebtedness can have on investors and financial stability, whether these extensions of credit are properly collateralized from a risk perspective, recognized from credit rating and debt covenants perspective, and collectively examined from a systemic risk perspective are themselves questions worth examining more closely, especially in a rising interest rate environment.

[26] Tyler Gellasch, Executive Director, Healthy Markets Association before the House Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment, "Implementation and Cybersecurity Protocols of the Consolidated Audit Trail", Nov. 30, 2017, available at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-tgellasch-20171130.pdf.

[27] Ibid.

Similarly, markets need more information about the swaps exposures and activities, especially at the subsidiary level, of the largest institutional participants in the markets. The SEC has been engaged in a "Disclosure Effectiveness Review" and has also invited comment on updating its guide setting standards on financial institution disclosure. Enhancing disclosure will both better protect investors in financial institutions and others active in the derivatives markets, but also improve the ability for policymakers, academics, and the public to evaluate the successes and areas for improvement in the derivatives markets.

Lastly, policymakers should avoid falling victim to the argument that reducing regulation will enhance competition and benefit ultimate end-users and the real economy. Financial markets have a strong frequent tendency towards rent-seeking behavior which comes at the expense of the real economy. Regulatory standards are required to ensure transparency and competition that will benefit those in the real economy that would utilize those markets, irrespective of financial stability purposes. Small and mid-sized businesses, family farmers, and others in the real economy are far better served by a simple, robustly regulated market where prices are transparent and competition is meaningful.

Below are specific comments on the proposals.

H.R. 4659, To require the appropriate Federal banking agencies to recognize the exposure-reducing nature of client margin for cleared derivatives.

This bill directs the federal prudential banking regulators to revise leverage capital requirements by deducting initial margin provided by a client against a centrally-cleared derivative from the denominator of the leverage ratio. If enacted, H.R. 4659 would chip away at the Supplementary Leverage Ratio (SLR), an important post-crisis capital requirement that applies to the largest banks in the U.S.[28]

[28] Board of Governors of the Federal Reserve System, "Agencies adopt supplementary leverage ratio final rule," Press release, September 3, 2014, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140903b.htm.

The SLR is meant to serve as a risk-blind complement to risk-weighted capital requirements, protecting against the possibility that risk-sensitive requirements, including actions that in theory are risk-mitigating, are improperly calibrated.[29] For example, mortgage-backed securities received low risk-weights in advance of the last crisis—one of the many reasons banks were highly undercapitalized to handle the risks they took. The two types of capital requirements work in tandem to ensure the largest banks have appropriate capital buffers to remain resilient and serve the real economy throughout the economic cycle. Deducting the initial margin held against centrally cleared derivatives from the SLR denominator would undermine the essential simplicity of the leverage ratio.

Moreover, as FDIC Vice Chairman Tom Hoenig has pointed out, when dealer banks provide a full guarantee to the clearinghouse for cleared swaps, they have a potentially unlimited loss exposure. As such, deducting collected margin, which is only the very first line of defense from those losses, makes no logical sense because capital is precisely designed to provide a cushion against *unexpected* losses. For the same reason, collateral, such as against loans, does not reduce the SLR calculation denominator in other contexts.[30] It is also unclear as to how Trump-appointed regulators may further change additional rules in this deregulatory environment. Proponents of H.R. 4659 point to the regulations against rehypothecation for segregated client margin as an important protection, but those rules may change. Using rules that may change to justify statutory changes is not wise.

Moreover, this proposed change would have the net effect of lowering the amount of equity capital with which the largest banks in the U.S. fund themselves. With bank capital requirements for the largest banks already below the socially optimal levels, no actions should be taken to deplete their loss absorbing equity buffers.[31] Unfortunately, this proposal is only one prong of the

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[29] Gregg Gelzinis, "3 Flawes Banking Industry Arguments Against a Key Postcrisis Capital Requirement," (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/news/2017/10/27/441413/3-flawed-banking-industry-arguments-against-a-key-postcrisis-capital-requirement/.

[30] FDIC Vice Chairman Thomas Hoenig, Letter to Chairman Conway and Ranking Member Peterson on margin and leverage, November 30, 2015, available at https://www.fdic.gov/about/learn/board/hoenig/hoenigletter11-30.15.pdf.

[31] Gregg Gelzinis, Andy Green, and Marc Jarsulic, "Resisting Financial Deregulation," (Washington: Center for American Progress, 2017), available at

efforts underway to undermine the SLR, which would be a significant mistake for those who care about ensuring the financial system can effectively serve the real economy and promote economic growth throughout the macroeconomic cycle.

H.R._____, To direct the Securities and Exchange Commission and Commodity Futures Trading Commission to review and harmonize rules relating to the regulation of over-the-counter swaps. (DERIV_001)

This bill would require the CFTC and SEC to review all of its rules and where any "inconsistencies" are found to immediately institute a *joint* rulemaking to harmonize the differences. Unfortunately, this bill masquerades as good government but is in reality a recipe for deregulation and regulatory gridlock. Moreover, it fundamentally ignores the genuine differences between the markets that the SEC and CFTC regulate, as well as the different authorities and traditions that the agencies and others bring to the regulation of the product markets underlying the derivatives. While similar regulatory approaches often make sense, there are also many instances where good public policy demands that rules be different because the markets are different.

Swaps as derivatives perform different based on the underlying nature of the product market being referenced. Interest rates, currencies, commodities, bonds (credit), and equities each behave – and are regulated – very differently from each other. Differences even exist between index markets and single-name markets. Yet, rules that have been tailored for relevant markets would have to be untailored?

To draw an analogy, this would be like saying that cars, trains, buses, and airplanes all need to have the same travel safety rules. Some similarities exist, meaningful differences do too, in part because they have different physical characteristics, travel at different speeds, etc.

https://www.americanprogress.org/issues/economy/reports/2017/12/04/443611/resisting-financial-deregulation/.

A far better approach is to continue to encourage the staffs of the two agencies to coordinate and communicate so that they can properly tailor their regulations to work best for the markets they regulate.

H.R._____, To amend the Dodd-Frank Wall Street Reform and Consumer Protection Act to establish an exemption from the credit valuation adjustment calculation for uncleared derivatives transactions with end-users so that United States companies are not disadvantaged, and for other purposes. (DERIV_002)

This bill would eliminate capital buffers mandated to protect financial institutions from the risk of loss from default by end-users. The argument being asserted is that Europe does not require it, so the U.S. should not, ostensibly on the grounds of international competitiveness. These arguments, however, are flawed, and capital should not be lowered simply because an end-user is in play.

Would anyone on this committee suggest that when a bank makes a loan to an ordinary "end-user" business, that it should not retain an appropriate capital buffer to protect itself against the risk of default by the borrower? When a dealer engages in a swap with a counterparty and does not require the collection of margin, the dealer has essentially combined a swap and a loan for the amount of the uncollected margin. Capital is the bare minimum risk protection for the financial system needed in that circumstance, and the CVA (via fair value) tailors that to the actual market risk created by the swap – which itself is valued on a fair value basis and can move significantly from day to day.

As an aside, it should be remembered that capital does not replace margin. During the financial crisis, dealers made increasingly widespread margin calls against counterparties as the swaps were moving against the counterparties on a daily basis. This created significant financial distress on the counterparties, ultimately leading to the widespread necessity for bailouts and extraordinary financial intervention by the central bank and the taxpayers. Capital would have better enabled dealers to withstand defaults and losses, but it would not have fully addressed the margin calls across the system.

Nor is international competitiveness really at issue here. European banks have long been undercapitalized, in part because European countries have a much greater tradition of bailing out both their banks and their end-user industrial companies. To the contrary, strong capital has long been a source of competitive strength, and of course taxpayer protections, for U.S. banks. As credit rating agencies increasingly recognize this, it will be increasingly difficult for European banks to sustain their derivatives competitiveness – which very much depends on credit worthiness of the dealer – in the face of U.S. capital strength. In any case, U.S. taxpayers will not be asked to rescue European counterparties and should not be asked to rescue U.S. banks for defaulted swaps exposures by European businesses. To that end, American regulators should not be pressed to follow European approaches that do not work here in the United States.

Furthermore, this proposal would also reduce competition in the market overall. As swaps depend on creditworthiness, to the extent that firms can improperly rely on their position in the Federal safety net to extend under-capitalized swaps to counterparties, other competitors will be challenged to compete.

H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to remove unfairness in the scope of end-user relief for end users hedging bona fide business risks, and for other purposes. (DERIV_003)

This bill would first extend "end-user" exemptions from swaps clearing provisions of Title VII to a new range of financial firms, including unregistered commodity pools (the CFTC equivalent of a private fund) and to private funds invested in physical assets, which would appear to include real estate, or engaged in owning commercial businesses, such as private equity funds. As a matter of principle, this would breach the wall separating commercial end-users that can enjoy a clearing exemption, from financial firms that should partake in the standard regulatory practices mandated for the derivatives market. The principle behind extending this relaxed regulatory treatment to commercial end-users is that these non-financial, "real economy" companies were both a small part of the market and not otherwise engaged in financial activities such that extending financial regulation to them was seen as inappropriate.

Putting aside the fact that even the commercial end-user exemption itself rests on shaky conceptual and risk-mitigation grounds,[32] this bill would extend those end-user exemptions to an as-yet-unclear, but potentially very large, array of financial actors (real estate funds, private equity funds, and private commodity pools). When more of the market is not subject to clearing, more of the risk is concentrated in the large dealer banks.

Moreover, the funds being considered in this bill are otherwise precisely in the business of providing services and making investments in the financial markets. Indeed, real estate (and not just mortgages) has long been a significant source of bubbles and busts in the financial system, including as recently as 2008.[33] From both a risk and "sympathy" perspective, there is no justification for this potentially large extension of the clearing exemption.

Second, the bill would create a new "de minimis" amount of non-hedging swaps activities – $1 billion notional average daily volume – for certain financial entities. This appears to be principally focused on financial units of non-financial firms. As such, it would appear to permit non-financial companies through their central treasury units (CTUs) or other financial special purpose vehicle affiliates to enjoy the end-user exemption not just to hedge the risk of its commercial affiliates but also to operate as a hedge fund speculating in the markets. Moreover, a $1 billion notional average daily volume is enormous for every market other than interest rates. As such, it would operate a large-scale deregulation of nearly every swaps markets other than interest rates. Such an approach would undermine the financial stability of the derivatives markets, be a significant investor protection problem, and be highly anti-competitive for other companies operating in those real economy markets.

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[32] A commercial end-user subject to a clearing requirement would still be serviced by a dealer bank, which would simply act as its agent for clearing and extend a line of credit to the end-user for the purposes of satisfying margin requirements. The end-user would be better protected from the failure of the dealer than in the current environment.

[33] Marc Jarsulic, *Anatomy of a Financial Crisis: A Real Estate Bubble, Runaway Credit Markets, and Regulatory Failure*, (Palgrave Macmillan US, 2010).

As noted elsewhere in this testimony, Title VII regulation was designed to extend the stability-enhancing benefits of regulation, such as clearing, margin, and pre- and post-trade transparency, as widely as possible and in particular to all financial participants in the swaps markets. Genuine non-financial businesses seeking to hedge their commercial risks have long been accorded special treatment, both on the grounds that they were not engaged in financial businesses and on the grounds that their footprint in the swaps market was small. Remember, by not requiring clearing or margin, the U.S. taxpayer is essentially encouraging the largest bank dealers to extend an uncollateralized loan to end-users in addition to the ordinary risks of the swap.

But this bill's so-called "de minimis" approach to speculative swaps of financial units of certain firms would violate both justifications for "end-user" treatment. The amount of swaps that would now enjoy "end-user" treatment could be quite large. And because it is not based on the principle of actually supporting the real economy, it fails on the public policy principle that Dodd-Frank has used to justify the increased threat to financial stability and U.S. economic growth that comes from the special regulatory treatment.

The proposed approach also undermines investor protection, worker protections, and competitiveness. By facilitating a greater amount of speculation in the treasury units of large corporations, investors and workers face a greater risk that the firm will collapse from its swaps activities. The history of prominent companies that saw large losses from swaps speculation in the 1990s shows that investors, especially retail investors and longer-term pension and mutual fund investors, are not well-equipped to judge the risks from swaps in large commercial companies. And with the dominance of today's passive index funds, they may not have much choice. Workers too make their "investment" of working at companies based on the reliability and future prospects of its operating business, and not its financial speculation units. The U.S. has long sought to ensure that financial speculation remains in speculative investment vehicles. When it has let those separations collapse, the results have been highly problematic.

Lastly, increased financial speculation by larger swaps parties poses competitiveness challenges to smaller firms. Swaps markets are highly dependent upon good credit ratings, which generally accrue to larger firms. A larger firm in a market may be able to use its size to engage in swaps trading to juice its returns, which its smaller competitors may not be able to do. Magnifying this trend will simply serve to solidify the dominance of larger firms in markets, and amplify the growing problem of monopoly across the U.S. economy. For those concerned with smaller energy and commodity companies, including farmers, this bill should be particularly worrying.

H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to clarify the relief from mandatory clearing available to centralized treasury units of nonfinancial affiliates, and for other purposes. (DERIV_004)

This bill is claimed to be a technical amendment to a revision to Dodd-Frank passed in 2015 that permitted central treasury units (CTUs) of non-financial end-users to be fully treated as end-users themselves and so qualify for an exemption from mandatory clearing under Title VII. However, it undermines the simple and straightforward approach that both Congress and the CFTC have taken to the treatment of CTUs by permitting a much broader web of swaps within the end-user. In particular, it eliminates the firewall between the end-user's commercial activities and the end-user's financial entity activities.

It should be remembered, that Dodd-Frank left in place the fact that some commercial end-users have affiliates engaged in financial activities, often in the form of specialized lending and related hedging with derivatives, to support the sales of their products or otherwise manage the risks of inputs to their products. The CTU exemption attempted to ensure that the end-user exemption remained on the true commercial end-user side, and not mingle the financial activities of the firm, which should not enjoy end-user treatment. Opening up co-mingling between commercial and financial entity activities, even if not directly trading with the CTU, undermines the simplicity and enforceability of a limited CTU provision and should not be adopted.[34]

[34] It has been asserted that some end-users are unable to utilize the 2015 CTU changes to Dodd-Frank owing to a quirk in their operations. These companies maintain affiliates located in foreign jurisdictions, such as in China, that are firewalled from the other operations of the firm, including CTU, because the foreign jurisdiction does not permit the free convertibility of its currency. In this firewall, at least as it exists today, all capital must be paid into the firewalled country and cannot be removed without foreign regulatory approval. Because of this firewall, the firm will also establish a special purpose vehicle (SPV) to make loans to support the firm's commercial business in China. Because the China-based commercial affiliate may enter into a swap with the China-based SPV, a financial entity, the entire organization could be seen to lose the CTU exemption.

H.R.____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to exempt swap transactions between affiliated entities from the swaps rules issued by the Securities and Exchange Commission and Commodity Futures Trading Commission. (DERIV_005(2))

This bill is an extraordinarily broad and dangerous bill that would appear to exclude from swaps regulation all interaffiliate swaps. The bill itself reveals just how unwise that is, as it attempts to write back in certain aspects of swaps regulation such as risk management, reporting, and variation margin. Yet by eliminating the swaps regulatory authority and jurisdiction for oversight – and hence the CFTC and SEC's ability to monitor these swaps – the bill still amounts to a near complete deregulation of this critical segment of swaps. Importantly, the bill would appear to exempt uncleared interaffiliate swaps from capital requirements as well.

Appropriate oversight of interaffiliate swaps is important for a number of reasons, including ensuring market confidence in the funding stability of important financial subsidiaries, ensuring sufficient risk buffers between them, and protecting the U.S. affiliates from weak practices overseas. While some degree of tailoring may be appropriate for these types of swaps, a complete exemption from treatment as a swap is unacceptable. As discussed below, making publicly available more data about subsidiaries' swaps exposures would be helpful to a thoughtful dialogue.

H.R.____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to align margin and clearing requirements by clarifying the definition of "financial entity", and for other purposes. (DERIV_006)

Without evaluating the scope or veracity of the circumstance just described, nor the regulatory or commercial wisdom of the swap between the two China-based entities, to the extent this circumstance truly is the central challenge being met by this bill, it is far narrower than how the bill is drafted. Should policymakers wish to address the specific challenge noted above, a recommended approach would be to request a CFTC study and public report on the existence and necessity of addressing the problem and what options offer targeted solutions.

This bill claims to align the margin and clearing definitions, but it has no apparent purpose or clearly defined beneficiary and would insert enormous uncertainty and potentially vast loopholes into the law. One reading of the bill offers a rather absurd possibility whereby swaps dealers would be able to take advantage of the "end-user" clearing exemption because the "notwithstanding" clause does not clearly cure the exclusion of swaps dealers from the definition of financial end-user. Assuming that is not the sponsor's intent, is the bill really designed simply to exempt sovereign entities and multilateral lending institutions from clearing? If so, then the bill should clearly and simply state those entities. But even then care needs to be taken that state-owned enterprises not be covered.

More troubling is the possibility that the bill opens up a gap between the two definitions for the purposes of reducing the clearing requirement for some segment of financial entities or firms otherwise engaged in financial activities otherwise captured by the financial entity definition. Possibilities could include payments system companies, including potentially credit card processors and virtual currency platforms. Until further clarity is provided around the purpose and scope of the bill, given its dangerous drafting, it should not be advanced.

H.R._____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to encourage risk mitigation by excluding all hedging swaps from the swap dealer de minimis threshold, and for other purposes. (DERIV_007)

This bill is an extraordinary exercise in irresponsible policymaking. It would exclude from the *de minimis* swaps calculation used to trigger swap dealer registration any swaps that the entity trades to hedge commercial risk, including risks arising out of the entity's or its affiliates' swaps dealing activities.

First, it has such a broad sweep as potentially to eliminate swaps regulation for even some of the very largest dealers. We know, for example, that dealers already net their books such that gross exposures of upwards of *$90 trillion in swaps* for some of the largest bank dealers can be netted down to the range of $90 billion, simply by looking at offsetting trades. It seems not hard to imagine swap dealers claiming that this $90 billion could be further reduced – perhaps by up to the same multiple as the gross to net exposure reduction -- by claiming that many of its swaps trades were actually hedging its other swaps trades. For this reason, dealer registration rules permit only a very narrow amount of hedging to count as truly risk eliminating, and hence not part of the dealer registration threshold calculation. It specifically does not include such wide ranging concepts like "portfolio hedging," which has been credited with allowing problems such as the London Whale to arise.[35]

But at a deeper, conceptual level, the bill ignores the most basic risks that swap dealers face and why dealer (and major swap participant) regulation is in place to prevent widespread failures rippling across the financial markets. At its most fundamental, those with large swap positions, like dealers, face two risks that could lead to their collapse: 1) that the swaps they wrote will require them to pay out, in liquid assets, large sums of money, and 2) that others default on payments under swaps contracts owed *to* them. Under the first prong, firms manage those risks through keeping a supply of liquid assets on hand (liquidity) and also write "hedging" swaps to hopefully ensure that in a circumstance when they have to pay out another firm will also have to pay them. But a hedge is seldom a perfect match even just for the market exposure of the swap being created. Model failures or even simply the gap between standardized and customized swap exposures mean that what may be viewed as a "hedge" for the purposes of somewhat reducing risk on a trading desk may be very different from what represents a more fully reliable hedge, such as that which is required under CFTC's bona fide hedging rules let alone hedge accounting principles.

Moreover, the aforementioned situation is still focused on the performance of the swap itself in the market, not the credit risk of the counterparty that may not be able to make payment. To that point, because of the credit risk that the *second* firm might default, even while the dealer owes payment to another party, a hedge does not eliminate risk but in fact can increase it. In severe

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[35] Arwin G. Zeissler, Daisuke Ikeda, and Andrew Metrick, "JPMorgan Chase London Whale A: Risky Business," Yale Program on Financial Stability Case Study, December 1, 2014, available at http://som.yale.edu/sites/default/files/files/2014-2A-V1%20JPMorganChaseLondon%20WhaleA-RiskyBusiness.pdf; Commodity Futures Trading Commission, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"*, 17 CFR Part 240, 77 FR 30595.

circumstances, a failure of a hedge can leave a firm confronting both ways that a firm can be forced into bankruptcy: a) because the firm may be unable to pay its bills as they come due (illiquidity) and b) because the value of the firm's liabilities exceed its assets (because the swaps payments owed them, which are assets, lose value from the default) (insolvency). Precisely because large swaps exposures can give rise to quick and sharp risk of bankruptcy for a firm, swap dealer regulation minimizes the extent to which why the firm has entered into its swaps positions matters for the calculation. This bill dramatically expands what is currently in place – which itself has conceptual weaknesses – and creates a dangerous loophole that could potentially swallow enormous amounts of, if not all, of swaps regulation.

And indeed, the history of past financial crises is replete with instances where precisely these types of problems have emerged. In the 2008 financial crisis, swap dealer firms found that their hedges were only as reliable as the creditworthiness of their counterparties. For example, AIG was bailed out in no small part to ensure it could make large payments to its swap dealer counterparties, including the most prominent U.S. and foreign financial institutions, so that they could make payments to other firms if and when called upon. In the collapse and bailout of Long-Term Capital Management (LTCM) in 1998, LTCM found that its positions, which were supposedly hedged, were actually not hedged but were instead large, leveraged bets on declining volatility. When volatility emerged unexpectedly in the market – does this sound familiar? – its positions collapsed. The Federal Reserve Bank of New York led a private market bailout of LTCM to ensure that its positions could be wound down in an orderly way. Had that not happened, other large financial institutions that had positions in the fund, counterparty exposures to fund through swaps trades, and also were making the same directional bets as the fund were at risk of both of the risks described above.

In short, a hedge can quickly become a wedge. Swap dealer regulation helps ensure a) that a firm engaged in swaps activities has sufficient capital, liquidity, risk management, and other tools in place to weather the ups and downs that markets bring and b) that any risk of one firm's failure is minimized to others in the market by maximizing the amount of swaps cleared through central counterparties, among other regulatory protections to ensure markets are resilient for the manufacturers, airlines, farmers, and others that need the derivatives markets to function reliably.

H.R._____, To provide clarity regarding the de minimis exception annual thresholds for swap dealers and security-based swap dealers, and for other purposes. (DERIV_008(2))

This bill would stop the CFTC from setting in motion the already-in-regulation provision that would lower the amount of *de minimis* swaps activity (that can be engaged in without triggering swaps entity registration) from the current $8 billion aggregate, 12-month gross notional amount, down to $3 billion. For the SEC's markets, it would freeze the de minimis at $400 million annually in security-based swaps.

Swap dealer registration is vitally important for market integrity: registration and regulation are there to *protect* the end-users and other participants in the markets. Clearing, margin, governance rules, and other regulations that depend upon dealer registration, as well as the direct oversight and accountability that comes with registration, provide vital protections for the farmers, ranchers, manufacturers, airlines, and others that depend on these markets. Just because a market is small does not mean that it is not very important for these companies and Main Street users. And where a market is small, smaller dealers can have a larger impact on the market's participants. Without registration and regulation, these smaller markets can be unstable, with end-users unprotected from the risks both of default and abuses by major players.

And as the evidence increasingly shows, swaps regulation enhances competition and brings *down* costs for end-users. A policy that exempts from registration a small number of politically favored firms does a disservice to everyone else.

Strikingly, by treating CFTC and SEC markets differently, the bill reveals its own fundamental conceptual flaw: swaps markets are extraordinarily different based on the underlying asset being traded. The interest rate swaps market is enormous, while the market for many commodity swaps is quite small. Currency, equity, and credit default swaps depend on the particular currency, equity, or bond (or index) being referenced. The CFTC itself recognized these differences when it tailored its block trade rules according to different markets. Consider what $8 billion represents in terms of a large or block trade size for each asset class, selecting a few representative examples from the markets and applying the CFTC's block trade thresholds:

- About 7 large interest rate swaps of a 3 to 6 month maturity;
- About 67 large investment-grade credit default index swaps of a four to six year maturity;
- About 427 large foreign exchange swaps for USD/EUR swaps; or
- About 2,666 large commodity swaps ($60 million for WTI Crude Oil)).[36]

Ultimately, the current approach at the CFTC of an untailored *de minimis* threshold for dealer registration is problematic. For example, only two firms have had to register as swap dealers in the energy markets. This is not to say that registration should vary based on every single underlying. But some additional tailoring, similar to the approach to block trades, makes sense. Where only a small minority of dealing activity is captured by swap dealer regulation, this encourages a race to the bottom among dealers in an asset class, disadvantaging those that have implemented risk management and governance controls as required by Dodd-Frank.

H.R._____, To clarify the definition of "financial end user" as it applies to parent and holding companies. (DERIV_009)

The bill is somewhat opaque as to its true purposes. This bill could be designed to address the situation whereby the margin calculation across multiple affiliates sweeps in the parent company for certain margin posting requirements owing to its material swaps exposure. As a first order matter, it is far from clear that reducing the margin posting requirements of parties with large swaps exposure is a wise matter from a policy perspective. But even if so, a far narrower and constrained drafting approach, one that retains regulatory flexibility to address evolving risks and market practices, is a far more responsible approach, because this bill as drafted would appear to once again lock in extensions to the end-user exemption that are questionable wisdom narrowly and, in the aggregate, increasingly problematic.

[36] See 17 CFR Appendix F to Part 43, "Initial Appropriate Minimum Block Sizes by Asset Class for Block Trades and Large Notional Off-Facility Swaps."

Take a company that owns both commercial affiliates and financial affiliates. A conceptually rigorous approach to treating commercial end-users differently would only permit the parent to hedge the commercial risk of non-financial entities. This would require any financial affiliates to fully hedge their risk. Locking in a provision that permits the parent company to hedge the risks of the financial affiliate through the end-user exemption of the holding company violates the principles around the end-user exemption already discussed above. Continuing to expand these "end-user" exemptions undermines the financial stability benefits of derivatives regulation and puts at risk the reliability of the derivatives markets for entities that are genuine commercial end-users.

Owing to the breadth of its drafting, the bill may open up other risks. Proponents of the bill should more clearly explicate the concerns they are seeking to address, which will enable a more fulsome public policy debate and practical solutions, if appropriate, to emerge.

H.R._____, To exclude non-U.S. regulated funds from the definition of "United States person" and ensure consistent application of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to cross-border security-based swap and swap transactions, and for other purposes. (DERIV_010(2))

This bill would rewrite the definition of "U.S. person" across every single rule, regulation, or guidance in the Federal securities laws and derivatives laws to exclude investment funds and commodity pools that are organized outside the United States, publicly offered to non-United States persons, and not publicly offered to United States persons. First, the circularity inherent in the bill itself could cause significant problems for the oversight of fund-of-fund and feeder fund structures. But, taking its attempted carve out on its face, the bill excludes an enormous swath of entities that would still be physically located and managed here in the United States and owned by United States citizens, U.S. pension funds, U.S. insurance companies, and other American investors.

This enormously overbroad and dangerous bill would create a U.S. based haven for fraudsters, market abuse, and risk, potentially outside the reach of any law. As such, it would gut anti-fraud and many key regulatory protections that U.S. citizens, institutional investors, and others depend upon.

Nor is this "domestic Cayman Islands" approach cured by the fact that it would only be available to sophisticated U.S. entities or members of the foreign public. A large part of the failures and large losses during the financial crisis – ones that led to bailouts – occurred not in the retail markets but in the presumed sophisticated parts of the U.S. market. Even public listing, whether in the U.S. or outside, did not protect products from failure. That goes to show basic regulatory protections are critical for markets regardless of the size and sophistication of the parties.

Remember, strong cross-border regulation is essential for swapsbecause the risk can – because it historically has – come back to them United States. That can occur whether or not U.S. market participants in the relevant product or market are retail or institutional. Where foreign jurisdictions can stand up substantively comparable regimes, then U.S. regulators are in a position to recognize the compliance with those regimes. But opening up massive gaps in regulatory coverage through exclusions such as the one in this bill is a mistake of the largest proportion – one that would come back to haunt American and global financial stability and economic growth.

This bill would also undermine U.S. leadership in financial markets and regulation globally by creating a domestic regulatory haven right here in the U.S.

Sensible Steps to Enhance Financial Stability and Promote Competition

The United States financial markets are the most robust in the world because of the foundation provided by transparency, strong regulation, open competition, and the rule of law, including reliable, accountable and fair enforcement. The bills presented for consideration today chip – indeed, hack – away at that foundation, putting at risk America's position as the go-to market for financial services. Instead of this approach, which would raise costs for end-users, grow monopoly, and imperil protections for U.S. taxpayers, the Committee should consider policies that would enhance financial stability and promote competition in and through the derivatives markets.

First, the SEC should immediately finish and turn on its Title VII rules. In the interim, it should turn on portions that are completed, in particular market transparency provisions.

Second, the SEC and CFTC should work to dramatically expand, standardize, and make more publicly available the data that is and should be collected in the swaps markets. LEI should be a required part of every rule. Uniform product, transaction, and other identifiers should be implemented. Data should be required to be clean and far more available to public and researchers.

Third, as discussed above, the SEC should boost transparency across the derivatives markets by updating its financial institution disclosure guides to include significantly enhanced disclosures on derivatives activities, including and especially at the subsidiary level. As we have commented, the SEC should also enhance derivatives disclosures for non-financial firms, including at the subsidiary level, especially to help investors evaluate the risks and management of interaffiliate swaps.[37]

Fourth, the SEC and CFTC should both study high levels of market concentration in their respective swaps markets and develop policies designed to enhance competition.[38] This could include policies such as a) increasing requirements for pre-trade transparency (such as the number of quotes by SEFs); b) new rules and stronger enforcement related to conflict of interests, cartel-like practices uncovered in LIBOR, foreign exchange, and other markets, and the Volcker Rule; and even c) expanding the application of 10 percent market concentration caps under section 622 of the Dodd-Frank Act (itself, an expansion of the 10 percent cap on the deposit markets of the Riegle-Neal Act).

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[37] Andy Green and Gregg Gelzinis, Center for American Progress, "Letter to Brent Fields, Securities and Exchange Commission," July 7, 2017, available at https://www.sec.gov/comments/s7-02-17/s70217-1840087-154953.pdf
[38] On concentration, see Bank of International Settlements, *Statistical release OTC derivatives statistics at end-December 2016*, May 2017, 9, available at https://www.bis.org/publ/otc_hy1705.pdf; Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2017, graph 4, available at https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq317.pdf.

Fifth, the Committee should oppose the dismantling of oversight mechanisms governing systemically non-bank financial companies. As noted above, FSOC and OFR's abilities to monitor the markets and subject new emerging risks and institutions to oversight is being undone. If and when this results in a failure, the derivatives markets and those that rely on them will feel the damage.

Sixth, the Committee should work its colleagues on the Appropriations Committees to ensure the full funding of both the CFTC and SEC, especially with respect to their market monitoring and inspection functions. The former CFTC chairman wryly noted that "the amount of taxpayer dollars that were spent just to prevent the collapse of AIG as a result of its excessive swap risk was over 700 times the size of the CFTC's current budget."[39] Little has changed for the better on that front since 2015. Instead, the budgets for financial regulators and market oversight organizations, like FSOC and OFR, remain under pressure of cuts and constraints, including items such as the SEC's supplementary fund designed to support its long-term technology investment needs. Given the need to dramatically upgrade technological oversight across all the markets, this is the wrong direction.

Lastly, the Committee should explore the real risks that are emerging in the markets, and encourage regulators to do the same. The extraordinary – and somewhat inexplicable – volatility in the equity markets last week suggests that more needs to be done to first understand and then appropriately regulate increasing automation, growing use of volatility strategies, and the interactions between them. Given that these products are often directly (via exchange-traded notes) or indirectly (via exchange-traded funds' authorized participant structures) tied to large financial institutions, the Committee would be wise to ensure that the growing complexity and risk inherent in volatility trading does not put at risk the central nodes of the financial system or critical financial markets.

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[39] CFTC Chairman Timothy G. Massad, Testimony before the U.S. Senate Committee on Agriculture, Nutrition & Forestry, Washington, DC, May 14, 2015, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-22.

ISDA. Safe, Efficient Markets

Written Testimony of Scott O'Malia
Chief Executive Officer
International Swaps and Derivatives Association
Before the
U.S. House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Securities, and Investment
February 14, 2018

Chairman Huizenga, Ranking Member Maloney and Members of the Subcommittee, thank you for the opportunity to testify today.

On behalf of the International Swaps and Derivatives Association (ISDA)[1] and its 900 member firms across the globe, I would like to thank the subcommittee for holding this timely hearing to discuss potential adjustments to the regulatory regime for the swaps and derivatives markets. We believe it is critically important that this subcommittee look carefully at the result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and make the necessary corrections, whether it is to simplify unintended rule complexity, reduce costs, or eliminate duplication. Your leadership in examining potential ways to make regulation more effective and less costly is greatly appreciated by the business community.

In my testimony today, I will cover three areas. First, I'll provide an update on the progress made by regulators and the industry to implement derivatives market reforms. Next, I'll describe the important initiatives taken by ISDA and its members to develop mutualized solutions to facilitate implementation of the rules. Finally, I'll propose specific legislative recommendations where this subcommittee should focus its efforts. These important and necessary legislative reforms will improve the efficiency of the market, without compromising the safety and soundness of the existing regulatory framework.

Regulatory Progress Report

First, it is important to recognize that the U.S. financial system is currently stronger, better capitalized and more resilient than ever, largely due to the reforms introduced by Dodd-Frank,

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

the Basel capital rules, and the extensive efforts of market participants and regulators to implement the requirements.

For more than seven years, ISDA and its members have worked closely with the U.S. financial regulators to implement Title VII of Dodd-Frank and the related margin and capital standards. As a result, the swaps and derivatives markets have seen substantial improvements in market transparency and prudential safeguards and an overall reduction in systemic risks. It is important to stress that we are in no way advocating for a roll-back of this progress.

- Market transparency: trade data on swaps and derivatives is now required to be reported to swap data repositories and is fully accessible to regulators;
- Central counterparty clearing: 87.6% of interest rate derivatives notional traded in 2017 was cleared. 79.7% of credit default swap index traded notional was cleared over the same period;[2]
- Trading: more than half of all interest rate derivatives, or 55% of traded notional, was transacted on an electronic platform in 2017;[3]
- Capital adequacy: since 2009, globally systemically important banks (G-SIBs) have added approximately $1.77 trillion of Tier 1 capital to their balance sheets.[4] The Basel Committee has recently proposed the addition of further measures, which will result in an estimated $93.1 billion in additional capital;[5] and
- Collateral requirements: new initial margin (IM) and variation margin (VM) rules for non-cleared trades are reshaping the market, covering thousands of financial entities. According to an ISDA survey, approximately $977 billion of IM and VM was received by the 20 largest market participants for their non-cleared derivatives trades as of March 2017. It is important to keep in mind that we are only halfway through the phase-in of IM requirements, with many more buy-side participants entering into scope in 2019 and 2020.[6]

Industry Derived Solutions

As CEO of ISDA, I am pleased to report that ISDA and its members have worked hard to implement these regulations, and to provide new and innovative solutions to cut costs and increase operational efficiency in doing so. I would like to highlight a couple of examples.

I believe the ISDA Standard Initial Margin Model (SIMM) represents one of the most transformational changes ever made to industry operations. In response to new requirements to post collateral against non-cleared derivatives trades, ISDA and its members have developed a single, transparent and universally applied margin methodology that the entire market can use to

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[2] *See* ISDA SwapsInfo Full Year 2017 and Fourth Quarter 2017 Review (Feb. 2018), available at https://www.isda.org/a/IhhEE/SwapsInfo-Full-Year-and-Q4-2017-Review.pdf.
[3] *See* ISDA SwapsInfo Full Year 2017 and Fourth Quarter 2017 Review (Feb. 2018), *available at* https://www.isda.org/a/IhhEE/SwapsInfo-Full-Year-and-Q4-2017-Review.pdf.
[4] S&P Global Market Intelligence
[5] *See* Basel Committee on Banking Supervision, Basel III Monitoring Report: Results of the Cumulative Quantitative Impact Study (Dec. 2017), available at https://www.bis.org/bcbs/publ/d426.pdf.
[6] *See* ISDA Margin Survey 2017 (Sept. 2017), *available at* https://www.isda.org/a/VeiDE/margin-survey-final1.pdf

calculate its IM requirements. This new solution has been shared with regulators around the globe, and marks a departure from the previous opaque, bilateral margin models, making margin calculations more predictable and reducing the potential for disputes. Probably most important is that this model is more cost-effective than the standard look up tables developed by the Basel Committee and IOSCO.

ISDA has also coordinated industry implementation of new VM requirements, and has provided standard documentation to support universal adoption. In addition, we are in the process of developing a new automated solution to support the adoption of IM requirements across the industry to provide a more cost effective and efficient solution.

ISDA also leads industry work on various legal and regulatory matters related to bank recovery and resolution, including with respect to Title II of Dodd-Frank and the EU Bank Recovery and Resolution Directive (BRRD). A key part of that work has been to publish a series of protocols that allow firms to simultaneously amend their documentation with multiple other adhering parties on a global basis. By using the ISDA Universal Resolution Stay Protocol and the Resolution Stay Jurisdictional Modular Protocol, market participants are able to amend covered master agreements, including ISDA Master Agreements, to contractually recognize stays under resolution regimes in key jurisdictions that are consistent with globally agreed principles.

This recognition addresses one of the key impediments to an effective cross-border resolution identified after the recent financial crisis. As a result of this contractual solution, well over 90% of outstanding derivatives by notional amount would be subject to temporary stays, better enabling financial regulators to perform an orderly resolution.

I should note that proposals introduced in the European Commission could compromise the global application of the Universal Resolution Stay Protocol. We are working with the U.S. Treasury, the FSB and the Bank of England to find alternatives to ensure that EU banks remain within the globally agreed resolution framework.[7]

I'd also like to highlight the work ISDA is doing to help the industry transition from the London Interbank Offered Rate (LIBOR) and other interbank offered rates, or IBORs, to transaction-based risk-free rates.

Today, the value of derivatives, bonds, loans, mortgages, and securitized products that reference an interbank rate in U.S. dollar, pound sterling, euro, Swiss franc or Japanese yen is over $370

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[7] *See* ISDA Press Release, Major Banks Agree to Sign ISDA Resolution Stay Protocol (Oct. 11, 2014), *available at* https://www.isda.org/2014/10/11/major-banks-agree-to-sign-isda-resolution-stay-protocol/; ISDA Press Release, Major Banks Sign Relaunched ISDA Resolution Stay Protocol (Nov. 12, 2015), *available at* https://www.isda.org/2015/11/12/major-banks-sign-relaunched-isda-resolution-stay-protocol/; ISDA Press Release, ISDA Launches Resolution Stay Jurisdictional Modular Protocol (May 5, 2016), *available at* https://www.isda.org/2016/05/05/isda-launches-resolution-stay-jurisdictional-modular-protocol/; ISDA Press Release, Proposed Moratoria Under the BRRD and the Impact on the Universal Stay Protocol (Sept. 28, 2017), *available at* https://www.isda.org/2017/09/28/proposed-moratoria-under-the-brrd-and-the-impact-on-the-universal-stay-protocol/.

trillion (gross notional).[8] However, a lack of actual transactions in the unsecured bank funding markets on which IBORs are based has raised concerns about the long-term viability of these rates and the systemic implications of their potential discontinuation. As a result of these concerns, regulators and market participants have been working to identify transaction-based risk-free rates as alternatives to LIBOR and other key IBORs.

Now the industry must prepare to transition from the IBORs, which are referenced in so many financial instruments, to inherently different risk-free rates within a relatively short period of time. Significantly, the identified alternative rates, which include the secured overnight financing rate (SOFR) for U.S. dollar, are overnight rates, while LIBOR and other interbank rates are quoted in various tenors, including 3, 6, and 12 month. Additionally, during the transition from the interbank rates to the alternative risk-free rates, we may see a basis between the two rates, which the market will have to address. ISDA has stepped in to help with market education and solutions to these issues.

Since 2016, ISDA has also been working with the FSB to develop contractual fallbacks that would apply if LIBOR or other key IBORs cease to exist. All of this work is vitally important to address risks associated with the market's current dependence on IBORs.[9]

These are just a few examples of the most significant industry solutions ISDA has developed in support of the regulatory reform effort. ISDA's work has provided greater legal and regulatory certainty to the various national rules, which are similar, but not identical. We have provided cost savings through the development of standardized, universal documentation and operational standards, and we are working to develop solutions for IBOR benchmark reform and yet-to-be implemented rules such as Basel III.

Regulatory Reform Recommendations

With any regulatory reform effort the size and scope of Dodd-Frank, we are bound to find areas where the anticipated outcomes and the actual results don't align, create redundancies or exceed the expected cost or scope. We believe it is vital that appropriate adjustments are made to correct the errors and provide the statutory revisions where necessary. The implementation of these

[8] LIBOR is the predominant interest rate benchmark for USD, GBP, CHF and JPY derivatives contracts. EURIBOR is the most widely used interest rate benchmark for EUR contracts. The Market Participants Group on Reforming Interest Rate Benchmarks Final Report showed in 2014 that swaps and ETDs represent approximately 80% of LIBOR-linked contracts by outstanding notional value, and thus derivatives formed much of the early focus for global transition and reform initiatives. Going forward, this focus will broaden to include other products, such as securities, loans, ETDs and mortgages. *See* IBOR Global Benchmark Survey 2018 Transition Roadmap (Feb. 2018), available at https://www.isda.org/a/g2hEE/IBOR-Global-Transition-Roadmap-2018.pdf

[9] *See* IBOR Global Benchmark Survey 2018 Transition Roadmap (Feb. 2018), *available at* https://www.isda.org/a/g2hEE/IBOR-Global-Transition-Roadmap-2018.pdf; *see also* ISDA Press Release, ISDA, the Association of Financial Markets in Europe (AFME), International Capital Market Association (ICMA) and the Securities Industry and Financial Markets Association (SIFMA) and its asset management group (SIFMA AMG) have today launched a roadmap that highlights key challenges involved in transitioning financial market contracts and practices from interbank offered rates, or 'IBORs', to alternative risk-free rates (RFRs) (Feb. 1, 2018), *available at* https://www.isda.org/2018/02/01/isda-afme-icma-sifma-and-sifma-amg-launch-benchmark-transition-roadmap/

regulatory reforms has also revealed areas that could be improved, either through regulatory action or targeted legislation, without increasing systemic risk in U.S. financial markets. I commend the members of this subcommittee for taking the steps to make the necessary adjustments and corrections to ensure the rules are appropriately applied.

We believe that improvements can be made to the current regulatory regime by focusing on three broad themes:

I. Harmonizing Regulatory Requirements and Leveling the Playing Field for Market Participants
II. Reducing Operational Complexity and Cost
III. Providing Relief for Smaller Market Participants and End-Users

Many of the proposals under consideration today are consistent with these broad themes.

I. Harmonizing Regulatory Requirements and Leveling the Playing Field for Market Participants

One of the unique features—and great benefits—of the swaps and derivatives markets is their global nature. A global liquidity pool allows commercial end-users—which are the Main Street job creators, manufacturers and producers in the United States—to affordably protect against and hedge specific risks associated with their commercial operations.

As a result of the global reach of this business, the swaps and derivatives markets are particularly sensitive to regulatory requirements that are duplicative or contradictory or that may disadvantage one jurisdiction relative to another. This duplication may occur in both domestic and international situations. For these reasons, it is vital that both the domestic swaps regulatory frameworks among U.S. regulators, as well as the global regulatory frameworks as between the United States and foreign jurisdictions, are appropriately harmonized, that effective systems of regulatory recognition (i.e., "safe harbor", "substituted compliance" or "equivalence") are established, and that application in cross-border contexts is flexible enough to allow for resolving conflict of laws.

Let me focus on two areas where ISDA members believe harmonization and effective recognition in derivatives regulations are necessary. The first area addresses concerns surrounding the application of divergent and duplicative requirements, and the second area identifies concerns that market participants face when managing global risks.

CFTC SEC Rulesets

Ideally, the U.S. Commodity Futures Trading Commission (CFTC) and the U.S. Securities and Exchange Commission (SEC) would have effectively identical requirements for swaps and security-based swaps, which would allow firms to migrate between the two markets—hedging risks and providing liquidity in a cost-effective, yet well-regulated, manner. However, seven years after enactment of Dodd Frank, such an outcome has proven to be difficult to achieve in practice. As a result, ISDA instead recommends that the CFTC and SEC develop a holistic solution, such as a "safe harbor" approach.

Under such an approach, market participants that are in compliance with the CFTC's rulesets for swaps, including business conduct, capital and margin would be granted a safe harbor for the same rulesets issued by the SEC for security-based swaps, and vice-versa. If an entity were to comply with the CFTC's rules for registration as a swap dealer for their swaps activities, they would be eligible for a safe harbor from registration with the SEC for their security-based swaps activities, so long as they were fully compliant with the comparable CFTC rules.

To be clear, in either case, the derivatives activity would still be properly and thoroughly regulated; however, there would be an opportunity for a more effective and efficient oversight. This would eliminate the necessity to build out duplicative compliance systems for comparable (but not identical) rules, reduce market fragmentation and improve liquidity, while still ensuring that regulators have the transparency and tools necessary to oversee the markets.

Importantly, the safe harbor approach does not contemplate the relinquishment of the agencies' respective jurisdiction. Both the CFTC and the SEC would retain general anti-fraud and anti-manipulation enforcement authority and the respective Congressional Committees would also retain their legislative and oversight authority.[10]

Given the absence of a safe harbor regime, the impact of inconsistent rules is not insignificant, and will continue to grow. For example, the SEC's security-based swap dealer rules contain registration and compliance requirements that have no comparable requirement in the CFTC's swap dealer ruleset. Some of these add-on requirements create conflicts with laws of other countries. The disparity between the SEC's and CFTC's swap dealer rules may create artificial and arbitrary barriers to entry for non-resident dealers, limiting choice for U.S. businesses and, potentially, decreasing market liquidity.

It is important to note that the call for comparable rulesets between the CFTC's and SEC's implementation of Dodd-Frank is not a new concept; it is one that is hardwired in Dodd-Frank and was discussed during its passage. Section 712(a) of Dodd-Frank directs several areas where the CFTC and SEC must "consult and coordinate to the extent possible ... for the purposes of assuring regulatory consistency and comparability, to the extent possible."

The concept of allowing products to trade interchangeably under the respective CFTC and SEC regimes is also not without precedent. In a floor colloquy following passage of Dodd-Frank, then Senate Agriculture Committee Chairwoman Lincoln provided clarity regarding Dodd-Frank's flexibility for new and novel derivatives products, noting that:

[10] Notably, the CFTC provided similar safe harbor protections in the past. In April 2013, the Commission exempted from its oversight certain energy derivatives that are regulated by FERC. *See* Final Order in Response to a Petition From Certain Independent System Operators and Regional Transmission Organizations to Exempt Specified Transactions Authorized by a Tariff or Protocol Approved by the Federal Energy Regulatory Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act Pursuant to the Authority Provided in the Act, 78 Fed. Reg. 19880 (Apr. 2, 2013).

"We strongly urge the agencies to work together under these new provisions to alleviate the ills that they themselves have identified. The agencies should make liberal use of their exemptive authorities to avoid spending taxpayer resources on legal fights over whether these novel derivative products are securities or futures, and to permit these important new products to trade in either or both a CFTC- or SEC-regulated environment."[11]

Lastly, there have been calls for alignment from the current Administration. The U.S. Department of Treasury's October 2017 Capital Markets Report[12] called for the convergence of the SEC's and CFTC's Title VII rulesets, including a "framework of interagency substituted compliance or mutual recognition," and a call for Congress to "consider further action to achieve maximum harmonization in the regulation of swaps and security-based swaps."

One final word on this matter: while it has taken a significant amount of discussion, the U.S. and EU have found solutions to rely on one another's rules in terms of clearing and trade execution. It would be quite remarkable if we were to achieve such a determination with a foreign government, but not within our own.

Inter-affiliate Initial Margin

The second area requiring alignment of rules relates to market participants' internal management of commercial and financial risks. Specifically, ISDA supports global and domestic harmonization of the treatment of inter-affiliate transactions under non-cleared margin regulations and a universal exemption from IM requirements.

As their name implies, inter-affiliate swaps are internal risk transfers between two legally separate subsidiaries. They are commonly used by financial institutions in connection with their role as market intermediaries and by end-users to hedge capital and manage balance sheet risk.

For example, global institutions often offer swaps and derivatives to clients out of a legal entity in the local jurisdiction in which the client resides. This arrangement occurs either to comply with the local regulatory authority's requirements or to meet the needs of the client. Rather than house risk in multiple legal entities in multiple jurisdictions, these global institutions may enter into the external-facing derivative with the client, and then enter into a mirroring internal transaction to transfer the risk associated with the external transaction to a centralized foreign entity. These internal transactions allow global institutions to net down their firm-wide exposures and centrally manage their derivatives exposure.

It is important to recognize that these transactions do not create additional counterparty exposures outside of the corporate group and they do not increase interconnectedness between third parties. Rather, they are a vital risk management tool and industry best practice that help to promote safety and soundness by allowing firms to manage their risk in a centralized way that

[11] Senator Blanche Lincoln, Congressional Record Volume 156, Number 105, Page S5923 (July 15, 2010), *available at* https://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/html/CREC-2010-07-15-pt1-PgS5902.htm
[12] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Capital Markets (October 2017).

ultimately limits overall credit exposure to third parties. Even my former colleague, Chairman Gary Gensler, explicitly recognized these benefits, noting "the risk-mitigating characteristics of inter-affiliate swaps and the sound risk management practices of corporate groups that rely on inter-affiliate swaps" when providing these swaps with an exemption from clearing requirements.

Chairman Gensler's successor, Tim Massad, further memorialized the CFTC's views regarding the importance of these transactions in its final margin rule,[13] which also provides an exemption – consistent with jurisdictions such as the EU[14] and Japan[15] – for such swaps from IM requirements.[16] The rule promulgated by the U.S. prudential regulators,[17] however, does not provide such an exemption. As a result, prudentially regulated banks have had to hold in reserve significant and often excessive amounts of capital – estimated at approximately $29 billion – against internal transactions.[18] This disparate treatment disadvantages certain firms doing business in the United States both domestically and abroad. The legislation being discussed today would remedy this disparity.

II. Reducing Operational Complexity and Cost

The second broad area in which ISDA members believe improvements can be made entails requirements that unnecessarily – and significantly -- add to the cost and complexity of using derivatives. I can think of no better example of where that problem is most apparent than the treatment of margin under the supplemental leverage ratio (SLR) requirements.

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[13] "Some have suggested that, even if inter-affiliate swaps do not increase exposure to third parties, we should require initial margin for all inter-affiliate swaps to enhance that internal risk management. But that would be a very costly and not very effective way for us as a regulator to enhance such risk management. .. if the concern is the adequacy of central risk management, then we should focus on that subject more generally. We should not attempt to address it by imposing on all inter-affiliate trades an initial margin requirement that is designed to address default risk on trading relationships between unaffiliated parties." Statement of CFTC Chairman Timothy Massad, Final Rule on Margin for Uncleared Swaps (Dec. 16, 2015), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement121615d

[14] *See* Article 11(5)-(11) EMIR.

[15] *See* Cabinet Office Ordinance on Financial Instrument Businesses, etc. (Cabinet Office Ordinance No. 52 of August 6, 2007), as amended, Article 123, paragraphs 10-11.

[16] Under the CFTC rule, firms are required to post variation margin to cover market fluctuations, but do not post initial margin, which is generally used to cover counterparty "replacement" (i.e., credit) risk.

[17] See Final Rule, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74839 (Nov. 30, 2015), available at https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf. The following U.S. prudential regulators adopted this joint rulemaking: Office of the Comptroller of the Currency, Treasury ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); Farm Credit Administration ("FCA"); and the Federal Housing Finance Agency ("FHFA").

[18] A recent survey conducted by ISDA of the so called "Group of 14" or "G14" – the world's 14 largest derivatives dealers - found that 11 of the firms are posting inter-affiliate initial margin under the prudential regulators' margin rules at a combined total of over $29 billion.

Treatment of Margin under the SLR

The central clearing of derivatives transactions is a key objective of the G-20 derivatives reforms and a central tenet of Dodd-Frank. The leverage ratio is a non-risk based measure meant to complement risk-based bank capital requirements and is designed to act as a backstop.

In its current form, however, the leverage ratio acts to disincentivize clearing. That is because it doesn't take client margin into account when determining the exposures banks face as a result of their client clearing businesses. This perverse impact has been highlighted by numerous policy makers over the past several years. This is not a partisan issue; CFTC Chairmen under two separate administrations have raised these concerns.[19]

Properly segregated client cash collateral is not a source of leverage and risk exposure. However, the rule requires firms to include these amounts in their calculations. This approach is unreasonable as cash collateral mitigates risk. Strict rules exist to protect this collateral and ensure it cannot be used to fund the bank's own operations. Instead, it can only be used to further the customer's activities or resolve a customer default. As such, it acts to reduce the exposure related to a bank's clearing business by covering any losses that may be left by a defaulting client.

The failure of the leverage ratio to recognize the risk-mitigating effect of segregated client cash collateral could mean the amount of capital needed to support client clearing services increases considerably. The end result is that the economics of client clearing would make it extremely difficult for banks to continue to provide this service and may cause them to pull out of the market, harming liquidity and limiting opportunities for end-users. This perverse outcome runs counter to the objective set by the G-20, as implemented by Congress in Dodd-Frank, to encourage central clearing.

ISDA appreciates the steps this subcommittee has taken to recognize the risk-reducing effect of segregated client collateral in the centrally cleared derivatives market. Moreover, even end-users that are not required to clear derivatives will see the impact of the SLR in the form of rising costs for hedging as their bank counterparties will face the substantial increase in their clearing costs.

[19] *See* CFTC Chairman J. Christopher Giancarlo, Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets (May 10, 2017), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 ("Applying the SLR to clearing customer margin reflects a flawed understanding of central counterparty (CCP) clearing. Swaps clearing was adopted in the 2009 Pittsburgh Accords and Dodd-Frank Act to move customer margin off the balance sheets of bank FCMs and into CCPs. Yet applying a capital charge against that customer margin continues to treat FCMs as having retained the exposure."); *see also* CFTC Chairman Timothy Massad, Remarks of Chairman Timothy Massad before the 2016 P.R.I.M.E. Finance Annual Conference (Jan. 25, 2016), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-38 ("I am concerned, however, about how SLR impacts clearing . . .The issue here is how a clearing member's potential future exposure arising from cleared derivatives should be measured. The SLR does so through a schedule-based approach that many feel is flawed. Among other things, it doesn't take collateral held by the clearinghouse into account. The concern is that the way the SLR measures potential future exposure could have a significant, detrimental effect on clearing, and in turn, on clearinghouse resiliency")

III. Providing Relief for Smaller Market Participants and End-Users

The final area I will discuss is providing relief for smaller market participants and end-users. Here, ISDA believes Congress can have an immediate impact. We applaud the subcommittee's focus on the uneven playing field created by the credit valuation adjustment (CVA), a technical fix to the exemption for centralized treasury units (CTUs), and ending the debate over the level of the CFTC's swap dealer *de minimis* threshold.

CVA

Part of the Basel III regulatory framework, the CVA assesses a capital charge on banking organizations to address the counterparty credit risk on their uncleared derivatives transactions. Included in the CVA calculation in the United States—but not in Europe—are non-cleared derivatives transactions with end-users. The CVA requires banks to retain additional capital to protect against potential mark-to-market losses in situations where their derivatives counterparty's creditworthiness deteriorates. When banks that are subject to the CVA execute non-cleared swaps with end-users, the end-users are likely to see increased transaction costs since the banking organizations generally pass through the costs of the CVA capital charge in the form of higher pricing on their uncleared swap transactions.

A revised CVA framework was published by the Basel Committee in December 2017, but the impact will not be clear until the revisions have been thoroughly tested. ISDA remains a supporter of global consistency in the application of regulatory reforms. However, given the deficiencies in the current CVA framework, it has been a source of significant divergence across jurisdictions. The CVA capital charge increases costs on U.S. end-users that are using derivatives to hedge their risks. The value of end-user hedging practices has been recognized by Congress in enacting exemptions from clearing and margin requirements for qualifying derivatives transactions.

Applying a CVA capital charge to these end-user hedging transactions that are otherwise exempt from clearing and margin requirements undermines the goals of encouraging prudent risk management. By contrast, the Europeans recognize that end-users' activities are risk reducing, and thus exempt derivatives transactions from the CVA capital charge. The absence of a similar exemption in the United States creates disadvantages for U.S. commercial businesses, making risk management more affordable in Europe and allowing such savings to be reinvested in EU growth and passed on to EU customers.

Centralized Treasury Units (CTUs)

In 2015, Congress amended Section 2(h)(7)(D) of the Commodity Exchange Act to provide an exemption from mandatory clearing for non-financial end-users that utilize a CTU to hedge or mitigate commercial risk of the company's non-financial affiliates. This statutory exemption was intended to codify certain CFTC staff no-action relief in order provide greater certainty to end-users seeking to elect the CTU exemption from the CFTC's mandatory clearing requirements. The language that Congress enacted in amended CEA Section 2(h)(7)(D), however, is slightly different than the language in the CFTC staff no-action relief.[20] This slight difference made it unclear whether a CTU would be disqualified from electing the exemption as a result of one of the CTU's affiliates executing swaps with a financial-entity affiliate that is also part of the same corporate group but is not claiming an exemption. Essentially, these entities are being penalized simply as a result of their corporate structure and their risk management practices.

We believe that a technical difference between the language in the statute and the language in existing CFTC no-action relief should not create such a result. An amendment to the statutory text to fix this technical difference would align the language with CFTC no-action relief and allow end-users to benefit from this exemption as Congress intended.

Swap Dealer *De Minimis* Threshold

The *de minimis* threshold is an arbitrary threshold set by the CFTC without any appropriate or rigorous data collection or analysis. It was a heavily debated topic at the CFTC, and, at the time, I offered an amendment to require the Commission collect data before it made any changes to the *de minimis* threshold. The CFTC would agree to collect data, but, would not concede to require a vote before taking action. Thankfully, future Commissions took a more sensible approach and delayed the decision until all the facts were gathered. It is crucial to assess the full impact of other regulations and take into account the overall ramifications of new rules that will be coming into effect related to non-cleared margin and various Basel III related rules. We support retention of the $8 billion threshold but understand that both the CFTC and this subcommittee are assessing the appropriateness of this level.

In this regard, any modification to the threshold should be based on good data analysis as even a slight adjustment in the *de minimis* threshold could result in additional and significant compliance costs for institutions.

* * *

As noted earlier, ISDA and its member firms support regulatory reform that mitigates systemic risk by reducing counterparty credit risk and increasing regulatory transparency. Some of the current regulatory framework for the swaps markets could, however, be simplified to harmonize requirements, reduce cost and complexity and provide relief to smaller market participants and end-users. ISDA looks forward to working with Congress and United States and international regulators to develop solutions to further these goals.

[20] CFTC No-Action Letter 14-144, *available at* http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/14-144.pdf

Cboe Global Markets

Statement for the Record from Cboe Global Markets, Inc.
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Securities, and Investment
"Legislative Proposals Concerning Derivatives"
February 14, 2018

Cboe Global Markets, Inc. ("Cboe"), on behalf of Cboe Options, C2 Options, BZX Options, and EDGX Options, appreciates Chairman Huizenga, Ranking Member Maloney and Members of the Subcommittee holding a hearing on legislative proposals concerning derivatives and is grateful for the opportunity to raise important issues impacting the listed options market. Cboe is a leader in centrally-cleared, exchange-listed options, and we applaud the Subcommittee's efforts to consider legislative proposals that will strengthen the derivatives markets and our financial system. In particular, we support the legislative language of H.R. 4659, which would address the significant defects of the current regulatory regime governing the capital treatment of initial margin for centrally cleared derivatives by exempting initial margin from the supplemental leverage ratio ("SLR") denominator. In doing so, H.R. 4659 would further the post-crisis goal of promoting centralized clearing.

Cboe also would like to take this opportunity to bring to the Subcommittee's attention another issue with current bank capital rules that inhibits central clearing—the capital treatment for listed options. In its October 2017 Report on Capital Markets ("Treasury Report"), the Department of the Treasury identified the SLR as a risk-insensitive capital rule that is discouraging central clearing and increasing costs to customers. The Treasury Report noted two particular problems with the SLR. The first—the treatment of initial margin—is addressed by H.R. 4659. The second—the current approach for calculating the exposure for cleared options—should also be addressed by the Subcommittee.

As the Treasury Report explained, current regulations require banks to calculate charges for cleared options using the Current Exposure Method ("CEM"). Unfortunately, CEM is risk-insensitive and "requires options contracts to be sized on their notional face value rather than allowing for a risk adjustment to notional to reflect the actual exposure associated with these derivatives."[1]

CEM's failure to account for the actual risk of listed options positions forces firms using CEM to grossly overstate actual economic exposure to listed options. As a result, bank holding companies ("BHCs") with affiliate clearing firms are required to hold capital that is disproportionate to the actual risks posed by an affiliate clearing firm's listed options business. Thus, CEM constrains the ability of options market-makers to accumulate positions (even off-setting positions), which hinders their ability to provide liquidity. We believe that because options market-makers are responsible for nearly all liquidity in the options industry, the knock-on effects of reduced liquidity are increased costs to investors, an increased possibility of market dislocation during volatile environments, and an illogical bias against centrally-cleared products that limit systemic risk.

Given the demonstrably negative impact that CEM has on the options marketplace, it is unsurprising that the Treasury Report recommended moving to a "risk-adjusted approach for valuing options for purposes of the capital rules to better reflect the exposure, such as potentially weighting options by their delta."[2] Accordingly, we urge the Subcommittee to consider targeted legislation that allows BHCs to risk-adjust their listed options exposures, thereby alleviating the harmful effects described above, while promoting central clearing and aligning the exposure calculation with the economic reality of cleared options transactions.

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Cboe appreciates the Subcommittee's efforts to develop legislative solutions that benefit investors, and we welcome further discussions on these important issues.

[1] Treasury Report on Capital Markets, at page 136.
[2] Treasury Report on Capital Markets, at page 138.

United States House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets, Securities and Investments

Legislative Proposals Regarding Derivatives

Statement of Walter L. Lukken

President and Chief Executive Officer

FIA

Introduction

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee, thank you for reviewing the regulatory treatment of derivatives and for allowing me to offer FIA's strong support for bipartisan legislation, H.R. 4659.

I am the President and Chief Executive Officer of FIA. FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system and to promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members help reduce systemic risk in global financial markets.

I appreciate having the opportunity to discuss capital and margin matters impacting the derivatives industry and to express our strong support of H.R. 4659, legislation that would provide an offset for initial client margin in the supplementary leverage ratio. H.R. 4659 was introduced by Chairman Blaine Luetkemeyer, and Representatives Frank Lucas, David Scott, Tom O'Halleren and Filemon Vela are original co-sponsors of this bipartisan legislation. Enacting H.R. 4659 will provide needed relief to agricultural and other end-users who are facing rising costs and fewer choices in the cleared derivatives markets and will ensure that U.S. clearing banks can compete on a level playing field relative to their foreign competitors who are receiving an offset from their regulators.

The offset for initial client margin Chairman Luetkemeyer included in H.R. 4659 has enjoyed bipartisan support in the House Committee on Agriculture for years. FIA has appreciated the advocacy of former Chairman Frank Lucas, Chairman Michael Conaway and Ranking Member Collin Peterson. Additionally, bipartisan chairmen of the Commodity Futures Trading Commission, Democratic Chairman Timothy Massad and Republican Chairman Christopher Giancarlo, have both indicated their support for this reform to the supplementary leverage ratio.

Nature and Importance of Central Clearing

Central clearing ensures that parties to a transaction are protected from the failure of a buyer or seller to perform its obligations, thus minimizing the risk of a counterparty default. The central clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members, which also guarantee the performance of their clients to make good on their transactions. To protect against default by a client, clearinghouses require that all transactions are secured with a pool of appropriate margin. This pool of margin is often called "initial margin," because it is first collected at the outset of the transaction to form a buffer against intraday losses, and is distinguished from "variation margin," which is a payment made at least daily based on short-term price movements.

Clearing members, acting as agents for their clients, collect initial margin and segregate it away from their own funds as required by the Commodity Exchange Act. They have long performed this function for futures clients, who have historically been required to clear their transactions. More recently, the Dodd-Frank Act in the U.S. and the European Market Infrastructure Regulation (EMIR) in Europe extended the clearing requirement beyond futures and options to certain over-the-counter swaps. As such, more products are being cleared and the role of the clearing member has expanded. Despite this expansion, over the ten-year period between December 2007 and December 2017, the number of active clearing firms in the U.S. has decreased from 84 to 55.

While there are several factors contributing to the consolidation of clearing members, today I want to focus on how Basel III capital requirements for prudentially regulated clearing members are decreasing clearing options for end-user clients who use futures and cleared swaps to manage their business risks. These capital requirements have made it difficult for many bank-affiliated clearing members to offer clearing services to their clients—a result that is at odds with recent efforts by the Group of 20 nations (G-20) to increase the use of clearing as a counterparty risk mitigation tool.

At issue is the supplementary leverage ratio under Basel III, a measurement tool used by global banking regulators to determine the amount of leverage that should be backed by capital. Unfortunately, the supplementary leverage ratio fails to properly recognize that client margin posted to a bank-affiliated clearing member belongs to the client, is provided by the client to offset the clearing member's exposure to the client's default, and actually reduces the clearing member's economic exposure. As stated by CFTC Chairman Giancarlo "Applying the SLR to clearing customer margin reflects a flawed understanding of central counterparty (CCP) clearing"[1]. As a result, the supplementary leverage ratio significantly overstates the clearing member's actual economic exposure, which artificially inflates capital requirements, and in turn, disincentivizes banking organizations from providing clearing services to clients.

Background - Supplementary Leverage Ratio

One of the central reforms to bank capital requirements following the financial crisis was the decision by the Basel Committee on Bank Supervision (Basel Committee) to implement a new type of leverage ratio on a global basis. In January 2014, the Basel Committee finalized its leverage ratio standard, which it later revised in December 2017. The Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) have implemented the Basel supplementary leverage ratio in the United States (the SLR) and added an "enhanced" supplementary leverage ratio for global systemically important banking organizations, or eSLR. The SLR is similar to the international Basel supplementary leverage ratio standard, but the eSLR imposes a quantitatively higher capital requirement than the international standard, which exacerbates the leverage ratio's distortive effects and makes it all the more important to get the standard right in the United States. The Basel supplementary leverage ratio, SLR, and eSLR all took effect as binding requirements at the beginning of this year.

The Basel supplementary leverage ratio was intended to be "a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements."[2] FIA supports the goals of stronger capital requirements and recognizes that leverage ratios can be an important backstop to keep systemic leverage in check. But we also believe that leverage ratios should accurately reflect the actual economic exposures of a banking organization, which the Basel supplementary leverage ratio fails to do in the case of a centrally-cleared derivative transaction.

Unlike traditional leverage ratios, which require a bank to maintain a minimum amount of capital relative to its on-balance sheet assets, the Basel supplementary leverage ratio also requires capitalization for off-balance sheet exposures, including those arising from a bank-

[1] www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 - *Remarks of Acting Chairman J. Christopher Giancarlo*, May 10, 2017

[2] Basel Committee on Banking Supervision - *Basel III leverage ratio framework and disclosure requirements*, January 2014.

affiliated clearing member's guarantee of client obligations to clearinghouses in futures, options, and other derivative transactions.

Importantly, in a centrally-cleared derivative transaction, the clearing member collects margin from its client to ensure that its economic exposure arising out of this guarantee to the clearinghouse is reduced, if not eliminated entirely. This structure is critical to making the markets work, because it allows the clearing member to offer the client access to the cleared derivatives markets' risk management tools. That is, an end user that utilizes the futures market to hedge its business risks is required to clear such a transaction through a clearinghouse, and in order to do so it must post margin through a clearing member for the purpose of offsetting the clearing member's economic exposure to the client.

Unlike making a loan or taking a deposit, guaranteeing a client's trades exposes the bank to losses only if a client defaults and to the extent that the margin collected from the client is insufficient to cover the client's obligations. Indeed, to make sure that initial margin is always available to absorb losses arising from the client's transaction, Commodity Futures Trading Commission (CFTC) rules require that it be posted in the form of either cash or extremely safe and liquid securities such as U.S. Treasuries. Moreover, Congress, through the Commodity Exchange Act, has required the clearing member to treat the margin as belonging to the client and to be segregated from the clearing member's own funds. In other words, these are client funds provided specifically by the client to offset the clearing member's exposure arising from its obligation to pay the clearinghouse on behalf of the client. Such client margin should therefore be considered as an offset in determining the bank's exposure. That is, the very nature of initial margin posted by a derivatives client is solely exposure-reducing with respect to the clearing member's cleared derivatives exposure.

Given these longstanding regulatory requirements and the exposure-reducing function of margin, it stands to reason that the Basel supplementary leverage ratio should recognize segregated client margin as reducing a bank's actual economic exposure to a clearinghouse for purpose of measuring exposure under the leverage ratio. But the Basel leverage ratio does not recognize this plainly exposure-reducing effect of margin. As a result, we believe the exposure measure under the leverage ratio is artificially inflated relative to a bank's actual economic exposure in a client-cleared derivatives transaction. This real and significant overstatement of actual economic exposure results in unwarranted capital costs for banks and their clearing member affiliates. Having examined the profiles of a group of firms, the FIA estimates that aggregate leverage exposure of firms would be 80 percent higher without an offset for margin from the leverage ratio[3].

Negative Consequences

The Basel supplementary leverage ratio is undermining recent financial regulatory reforms by discouraging banks from participating in the clearing business, thereby reducing access to clearing and limiting hedging opportunities for end users. Despite an overall migration to clearing in recent years, five major banks have announced their departure from the swaps clearing business since 2014, due in substantial part, we believe, to disproportionately high capital requirements that have made derivatives clearing uneconomical.[4]

Left unchanged, the failure of the Basel supplementary leverage ratio to recognize the exposure-reducing effect of segregated margin will continue to substantially and unnecessarily inflate the amount of required capital that will need to be allocated to the clearing businesses within banking organizations. Because derivatives clearing is traditionally a very low risk, low return business, banks are less likely to take on new clients for derivatives clearing and instead are allocating their capital to higher risk, higher returning activities. As stated by Governor Powell: "such a ratio can have perverse incentives if it is the binding capital requirement because it treats relatively safe activities, such as central clearing, as equivalent to the most risky activities."[5] The US implementation of the Basel supplementary leverage ratio is creating precisely this perverse incentive.

Increases in required capital also greatly increase costs for end users, including pension funds and businesses across a wide variety of industries that rely on derivatives for risk

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[3] https://fia.org/sites/default/files/2016-07-06_FIA_Comment_Letter_Basel_Committee_Leverage_Ratio.pdf , *FIA Response to Basel Leverage Ratio Consultation Regarding the Proposed Calculation of Centrally Cleared Derivatives Exposures Without Offset for Initial Margin and its Impact on the Client-Clearing Business Model*, July 6, 2016

[4] Deutsche Bank: https://www.ft.com/content/2392bc42-ee47-11e6-930f-061b01e23655; Nomura: https://www.ft.com/content/e1883676-f896-11e4-be00-00144feab7de; RBS: http://uk.reuters.com/article/uk-rbs-primeservices-divestiture-idUKKBN0DY0PU20140519; State Street: https://www.bloomberg.com/news/articles/2014-12-04/state-street-exiting-swaps-clearing-businesscitingnew-rules; BNY Mellon: http://www.pionline.com/article/20131210/ONLINE/131219993/bny-melloncloses-us-derivatives-clearing-business.

[5] https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm - *Speech by Governor Jerome H. Powell on Central Clearing and Liquidity*, June 23, 2017

management purposes, including agricultural businesses and manufacturers.[6] As a result, market participants may be less likely to use cleared derivatives for hedging and other risk management purposes or, as a result of mandatory clearing obligations for some derivatives, some market participants may not be in a position to hedge their underlying risks. As stated by Chairman Giancarlo, "we witness diminishing market access for smaller market participants, who will have a much tougher time laying off risk during stressed market conditions."[7]

In addition, the liquidity and portability of cleared derivatives markets could be significantly impaired, which would substantially increase systemic risk. The lack of an offset within the Basel supplementary leverage ratio would severely limit the ability of banks to purchase portfolios of cleared derivatives from other distressed clearing members—including distressed banks. This will leave clearinghouses and clients of any failing clearing member with an added strain during an already stressful situation. Moreover, as the levels of margin required by clearinghouses increase in times of stress, Basel supplementary leverage ratio capital costs will correspondingly increase, aggravating the constraint on portfolio purchases. Such a constraint on providing liquidity to stressed markets would accelerate downward price pressure at exactly the wrong moment, thereby increasing risk to the system.

The Basel supplementary leverage ratio is also likely to continue to result in market exit by derivatives clearing members that no longer find the business economically viable in terms of producing a sufficiently high return on equity. The resulting industry consolidation would increase systemic risk by concentrating derivatives clearing activities in fewer clearing member banks and potentially reduce end user access to the risk mitigation benefits of central clearing. As stated by CFTC Chairman Massad: "if some clearing members choose to limit customers, or get out of the clearing business altogether, that may make it harder to deal with the next time a clearing member defaults"[8].

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6 *See, e.g., SIFMA AMG Submits Comments to the Basel Committee on Banking Supervision on Higher Prices and Reduced Access to Clearing Experienced by Asset Managers* (June 30, 2016), available https://www.sifma.org/resources/submissions/sifma-amg-submits-comments-to-the-basel-committee-on-banking-supervision-on-revisions-to-the-basel-iii-leverage-ratio-framework/ (sixty percent of asset managers surveyed reporting an increase in clearing fees for interest rate swaps).

7 www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-22 - *Remarks of Acting Chairman J. Christopher Giancarlo*, May 10, 2017

8 http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-38 - *Remarks of Chairman Timothy Massad before the 2016 P.R.I.M.E. Finance Annual Conference*, January 25, 2016

Finally, I note that FIA represents bank and non-bank clearing members and I can assure you that this situation is not one that will benefit non-bank clearing firms. In fact, many non-bank clearing members – those clearing members not subject to Basel III capital requirements – have weighed in to explain their inability to assume the clearing volume currently done through banks due to their own balance sheet constraints. Moreover, these non-bank clearing members are concerned about the broader market impacts that may arise as a result of fewer access points to the cleared derivatives markets. This harms farmers seeking to manage commodity price fluctuations, commercial companies wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. The negative impacts to the real economy are significant.

The consequences I have just outlined are fundamentally inconsistent with market regulators' global policies designed to enhance the appropriate use of centrally cleared derivatives. In various speeches, CFTC Chairman Giancarlo and former CFTC Chairman Massad have consistently expressed concern about the Basel supplementary leverage ratio's treatment of initial margin for client cleared derivatives and the resulting declining population of clearing members as well as systemic concerns related to the portability of client positions and margin funds.

U.S. Economic Competitors Offering Offset

Our nation's economic competitors have taken steps to provide their countries' end-users, clearing members, and derivatives markets by implementing an offset for initial client margin within their domestic leverage ratios. Financial regulators in the United Kingdom have announced they will do so, and legislation has been introduced in the European Union to provide banks with an offset, as well.[9]

Should the U.S. fail to similarly provide an offset within the supplementary leverage ratio and enhanced supplementary leverage ratio, U.S. banking organizations and their clients will be placed at a significant disadvantage to their overseas competitors. Our regulations should be designed not to inhibit economic activity and risk-mitigating hedging being conducted in the United States, so long as U.S. banks have adequate capital.

Insignificant Impact on Overall Capital Levels

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9 In December 2017, the Basel Committee said it will take two years to study the impact of the leverage ratio on client clearing, and together with other international standard-setting bodies, launched a survey of market participants to evaluate those effects.

FIA supports strong capital requirements that ensure banks and the financial system are adequately protected. The offset provide by H.R. 4659 would have a negligible impact on banks' overall capital levels, reducing them by approximately less than 1 per cent[10]. This minimal impact on overall capital levels does not justify the harmful consequences on the cleared derivatives markets caused by the SLR's failure to recognize the exposure-reducing effect of initial margin.

And to be clear, my testimony has nothing to do with trades undertaken by banks on their own account. Our concerns solely relate to risk-mitigating trades that banks clear as agents on behalf of their clients.

Conclusion

FIA strongly supports the efforts of Chairman Luetkemeyer and his colleagues to provide an offset for initial client margin in the supplementary leverage ratio. The SLR's failure to recognize the exposure reducing nature of initial client margin harms end-users who utilize the cleared derivatives markets to hedge. Failure to provide such an offset will saddle end-users with higher clearing costs and fewer choices of those offering clearing services. FIA has determined that enacting an offset would have an inconsequential impact on overall capital levels. Furthermore, our economic competitors have already offered or plan to offer an offset for client margin in the very near future, placing U.S. market participants at a disadvantage relative to their foreign competitors at a time when we should be encouraging as much economic activity in the U.S. as possible.

[10] http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement062017 - *Statement of Acting Chairman J. Christopher Giancarlo before the Market Risk Advisory Committee Meeting*, June 20, 2017

February 12, 2018

The Honorable Blaine Luetkemeyer
2230 Rayburn House Office Building
United States House of Representatives
Washington, DC 20515

Dear Chairman Luetkemeyer,

We write today in strong support of the legislation you have authored, H.R. 4659, which will provide much-needed relief to agricultural end-users, the energy industry and other participants in the cleared derivatives markets. We also commend H.R. 4659's original co-sponsors, Reps. Frank Lucas, Tom O'Halleran, Filemon Vela and David Scott, for their work on behalf of a robust, affordable cleared-derivatives market in the United States.

This legislation is necessary because, despite calls for reform by Republican and Democrat members of both the House Agriculture and Financial Services Committees, the current and previous Chairmen of the Commodity Futures Trading Commission, the United States Treasury Department's Report on Capital Markets, and market participants, U.S. implementation of the leverage ratio rule continues to suffer from a flawed and damaging approach to cleared derivatives.

As currently constructed, the leverage ratio does not allow an offset for exposure-reducing margin provided by clients for their cleared derivatives. The inability to recognize an offset for client initial margin increases the cost of client clearing and limits the amount of client clearing that banks will conduct. This in turn will lead to a smaller and less diverse set of clearing participants, thereby reducing access to clearing, limiting hedging opportunities for end-users, and reducing the ability to transfer clients in stressed market conditions. This regulatory approach harms farmers and manufacturers seeking to manage commodity price fluctuations, commercial firms wishing to lock in prices as they distribute their goods, and pension funds using derivatives to enhance workers' retirement benefits. In addition, the reduced ability to transfer clients is likely to increase the volatility in already stressed market conditions, thus increasing systemic risk.

This result is an unintended consequence of the post-crisis financial reforms and undermines the incentives and benefits of central clearing for derivatives. Furthermore, the U.S. approach to the leverage ratio rule puts U.S. firms at a disadvantage to their European counterparts. The European Union has proposed legislation that would provide offsets for client initial margin on centrally cleared derivatives in their implementation of the leverage ratio rule. H.R. 4659 would ensure that our country's firms are not placed at a competitive disadvantage with their foreign counterparts due to a flawed leverage ratio calculation.

Thank you once again for your leadership on this important issue. We appreciate the work you and your bipartisan coalition of co-sponsors are doing to encourage robust and affordable cleared derivatives markets while maintaining capital levels to ensure financial stability in our economy.

Yours respectfully,

Walt L. Lukken
President & Chief Executive Officer
FIA

Gregg Doud
President
Commodity Markets Council (CMC)

Sunil Cutinho
President
CME Clearing

Scott Hill
Chief Financial Officer
Intercontinental Exchange (ICE)

About FIA:

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to:

- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

About CMC:

The Commodity Markets Council ("CMC") is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal, and soft commodities. Its industry member firms also include regular users and members of swap execution facilities (each, a "SEF") as well as designated contract markets (each, a "DCM"). Along with these market participants, CMC members also include regulated derivatives exchanges and price reporting agencies. The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs, and over-the-counter ("OTC") markets.

About CME Group:

CME Group is the parent of four U.S.-based designated contract markets ("DCMs"): Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). These Exchanges offer a wide range of products available across all major asset classes, including: futures and options based on interest rates, equity indexes, foreign exchange, energy, metals and agricultural commodities. 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 facility in Chicago, as well as through privately negotiated transactions. CME Group also includes the clearinghouse division of CME ("CME Clearing"), a derivatives clearing organization ("DCO") which provides clearing and settlement services for exchange-traded and over-the-counter derivatives transactions, as well as a swap data repository ("SDR").

About ICE:

Intercontinental Exchange (NYSE: ICE) is a Fortune 500 and Fortune Future 50 company formed in the year 2000 to modernize markets. ICE serves customers by operating the exchanges, clearing houses and information services they rely upon to invest, trade and manage risk across global financial and commodity markets. A leader in market data, ICE Data Services serves the information and connectivity needs across virtually all asset classes. As the parent company of the New York Stock Exchange, the company raises more capital than any other exchange in the world, driving economic growth and transforming markets.

INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

February 15, 2018

STATEMENT FOR THE RECORD OF THE INVESTMENT COMPANY INSTITUTE ON DISCUSSION DRAFT LEGISLATION:

TO EXCLUDE NON-US REGULATED FUNDS FROM THE DEFINITION OF "UNITED STATES PERSON" AND ENSURE CONSISTENT APPLICATION OF TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT TO CROSS-BORDER SECURITY-BASED SWAP AND SWAP TRANSACTIONS, AND FOR OTHER PURPOSES

Hearing on "Legislative Proposals Regarding Derivatives"
Subcommittee on Capital Markets, Securities, and Investment
Committee on Financial Services Committee
US House of Representatives
February 14, 2018

Members of the Investment Company Institute[1] include both US mutual funds and similar regulated funds offered to investors in jurisdictions worldwide ("non-US regulated funds"). ICI supports the discussion draft which would exclude non-US regulated funds from the definition of "United States person" and ensure consistent application of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to cross-border security-based swap and swap transactions. The discussion draft would ensure that non-US regulated funds, such as UCITS,[2] are not subject to conflicting derivatives rules of two jurisdictions – the fund's home jurisdiction and the United States, solely because they have a US subadviser. As discussed below, these foreign funds have little connection to the United States, and applying US derivatives rules to them only because the funds hire US managers would place American businesses at a significant disadvantage to their non-US counterparts.

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.1 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Non-US regulated funds are offered and sold in countries around the world, and include, for example, "undertakings for collective investment in transferable securities," or UCITS. These funds generally are the non-US equivalent of US mutual funds – publicly offered funds sold to retail investors (as compared to privately offered hedge funds). UCITS are subject to detailed requirements including those related to disclosure and custody, as well as investment restrictions and limitations. They are required to have a European primary manager that remains fully responsible for management of the fund, although the primary manager may appoint a subadviser, including a US subadviser (e.g., to manage the US equities portion of the portfolio).

Background

SEC Rulemakings

The SEC, in a series of rulemakings, has addressed when Title VII of the Dodd-Frank Act would apply to cross-border derivatives activities. The SEC defines a "US person" to include, among others, a "[a] partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States . . ."[3] The definition further provides that, "[f]or purposes of this section, ***principal place of business*** means the location from which the officers, partners, or managers of the legal person primarily direct, control, and coordinate the activities of the legal person. With respect to an externally managed investment vehicle, this location is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle. . . ."[4]

The SEC's definition of "US person" fails to exclude non-US regulated funds that are authorized to be publicly offered to non-US persons, but are not publicly offered to US persons. Without an explicit exclusion, non-US regulated funds that have a US subadviser must make a facts and circumstances determination as to whether or not they have "a principal place of business in the United States." These funds could be deemed to be a "US person," even though these funds do not intend to be active in the US markets, the risks of their related transactions reside outside the United States, and investors have no reasonable expectation that US laws would apply to them.[5]

CFTC Guidance and Rulemakings

Title VII of the Dodd-Frank Act added section 2(i) to the Commodity Exchange Act excluding all swap activities outside the United States from its scope, unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States." The CFTC issued interpretive guidance in 2013 to implement the new section and clarify the CFTC's cross-border policy applicable to swap transactions. That guidance defined "US person," identifying persons that the CFTC deemed to meet the jurisdictional nexus to the United States under section 2(i), and were therefore subject to the CFTC's regulations. To ensure that non-US regulated funds with a US manager that have only a nominal nexus to the United States are not

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[3] 17 C.F.R. 240.3a71-3.

[4] The SEC explained that "[t]his definition directs market participants to consider where the activities of an externally managed investment vehicle generally are directed, controlled, and coordinated, even if this conduct is performed by one or more legally separate persons." *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities,* 79 Fed. Reg. 47277, 47310-11 (Aug. 12, 2014). The SEC suggests this usually will be the location of the primary manager of the investment vehicle. With respect to a UCITS, for example, this generally would be the location of the European manager.

[5] This would be true whether a non-US regulated fund publicly offers its shares to non-US investors, or only is authorized to do so. Generally, non-US retail funds are regulated to make their shares eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds, like US registered investment companies, typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). *See, e.g., supra* note 2. Such non-US funds similarly do not raise any US jurisdictional interest, and should not be considered US persons.

subject to the CFTC's regulations, the guidance specifically excluded from the "US person" definition non-US regulated funds that are publicly offered to non-US persons but not offered to US persons, such as UCITS. The definition of US person in recent CFTC rulemakings, however, like SEC rulemakings, does not contain a similar exclusion.[6]

Nominal Nexus to the United States

The Committee's discussion draft would recognize that non-US regulated funds that are authorized to be publicly offered to non-US persons and are not publicly offered to US persons do not have a "direct and significant connection" with the United States or otherwise raise a US jurisdictional interest that would merit imposing US derivatives rules. Although non-US regulated funds may contract with a US manager to manage their assets (e.g., a UCITS that employs a US subadviser to manage the US equities portion of its portfolio), non-US regulated funds have only a nominal nexus to the United States. These funds are marketed and sold publicly to retail investors outside the United States, they do not intend to be active in the US markets, and investors have no reasonable expectation that US laws would apply to them. Furthermore, the financial risks of the transactions of non-US regulated funds remain with the non-US fund and don't migrate to the United States with the use of the services of a US adviser. Each fund is a separate pool of securities with its own assets, liabilities and shareholders, and the non-US regulated fund's US adviser or promoter does not guarantee the fund's transactions.

Promoting a Level Playing Field

Without an explicit exclusion, non-US regulated funds that have a US subadviser could potentially be subject to the conflicting rules of two separate jurisdictions – those of the fund's home jurisdiction as well as SEC or CFTC regulations, a costly and burdensome prospect. To avoid this result, non-US regulated funds may terminate a US asset manager and/or avoid hiring a US asset manager. Non-US dealers may seek to avoid engaging in transactions with non-US regulated funds that could be US persons so that these foreign dealers won't become subject to US requirements. Thus, being deemed a US person could significantly disadvantage US asset managers to non-US regulated funds vis-à-vis their non-US counterparts, resulting in harm to US business and potentially driving asset management business overseas.

A Uniform Standard is Critical

The SEC and CFTC approaches to the regulation of cross-border activities differ. The discussion draft provides an ideal opportunity to achieve consistency in the approach to "US person" by the two agencies. This is important because if non-US regulated funds are subject to inconsistent definitions of "US person," the result will be confusion, operational challenges, and potentially different regulatory treatment of entities transacting in otherwise similar instruments and often from the same trading desk. Global firms face significant costs and burdens if the SEC's and CFTC's regulatory approaches produce different outcomes regarding whether an entity or transaction would be subject to the Dodd-Frank Act. Attempting to analyze derivatives

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[6] *See, e.g., Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 71946 (Oct. 18, 2016); *Uncleared Swaps for Swap Dealers and Major Swap Participants— Cross-Border Application of the Margin Requirements*, 81 Fed. Reg. 34818, 34824 at n.62 (May 31, 2016).

transactions differently for swaps and security-based swaps that are traded typically by the same trading desk or desks of asset managers is unworkable.

Conclusion

For these reasons, we support the discussion draft's exclusion of non-US regulated funds from the definition of "US person," and the bill's requirement that the SEC and CFTC harmonize their definitions.

mastercard.

February 15, 2018

Rep. Bill Huizinga
Chairman, Subcommittee on Capital Markets, Securities and Investment
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Support for a Legislative Proposal Discussed at the February 14, 2018 Hearing of the Subcommittee on Capital Markets, Securities, and Investment entitled "Legislative Proposals Regarding Derivatives."

Dear Chairman Huizinga:

On behalf of Mastercard International Incorporated ("**Mastercard**"), thank you for the opportunity to submit this statement for the record for the hearing titled, "Legislative Proposals Regarding Derivatives" and the chance to support one of the legislative proposals discussed at the February 14, 2018 Subcommittee on Capital Markets, Securities and Investment hearing. Specifically, and as discussed further below, Mastercard would like to express its support for H.R. ______, To align the margin and clearing requirements by clarifying the definition of "financial entity" (the "**Margin and Clearing Alignment Proposal**").

We believe the Margin and Clearing Alignment Proposal is important to address an unintentional misalignment within the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") and the regulations promulgated thereunder with respect to the "clearing mandate" for certain swaps and the margin requirements for certain uncleared swaps. Commercial enterprises use swaps for hedging and risk management purposes. Both clearing and margin increase the cost to commercial enterprises of this important risk management tool and decrease the amount of capital otherwise available to invest in job creating activities.

Dodd-Frank includes an "end-user exception" from mandatory clearing under which a person that is not a "financial entity" and is using a swap to hedge or mitigate commercial risk need not clear a swap that would otherwise be required to be cleared. Dodd-Frank also included instructions to the CFTC and U.S. banking regulators to adopt margin requirements for all non-cleared swaps. Those instructions did not specify to whom margin requirements should apply, and did not include any "end-user exception." However, the regulators adopted an exception from mandatory margin that is similar – but not identical – to the end-user exception. Under this exception, a person that is not a "financial end-user" is excluded from margin requirements. "Financial entity" is, in some respects, defined more broadly than is "financial end-user," as it includes any "person predominantly engaged in activities that are financial in nature, as defined in section 4(k)" of the Bank Holding Company Act (the "**BHCA**")[1] – a broad range of entities including entities that are not banks, insurance companies or securities firms and that do not engage in derivatives trading for profit – while "financial end-user" does not include this reference to section 4(k) of the BHCA. This misalignment between the two exceptions creates a category of commercial entities that are "financial entities" but are not "financial end-users" and that therefore

[1] 7 U.S.C. § 2(h)(7)(C)(i)(VIII).

are exempt from the uncleared swaps margin requirements but do not qualify for the end-user exception to the clearing mandate. We believe the category of "financial end users" more precisely captures those financial entities whose swaps activities were intended to be subject to the clearing mandate. To this end, and to remedy the misalignment between the two exceptions, we support the Margin and Clearing Alignment Proposal.

Thank you for your consideration. We look forward to working with you to advance this important proposal.

Sincerely,

Alfred Kibe
Corporate Treasurer
Mastercard International Incorporated
2000 Purchase Street
Purchase NY, 10577

cc: Rep. Carolyn Maloney, Ranking Member, Subcommittee on Capital Markets, Securities and Investment

MANAGED FUNDS ASSOCIATION

WRITTEN STATEMENT

OF

RICHARD BAKER
PRESIDENT & CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing
To Review Legislative Proposals Regarding Derivatives

BEFORE THE

U.S. HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES & INVESTMENT

FEBRUARY 14, 2018

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600 14th Street, NW, Suite 900 Washington, DC 20005 Phone: 202.730.2600 Fax: 202.730.2601 www.managedfunds.org

WRITTEN STATEMENT OF MANAGED FUNDS ASSOCIATION

To Review Legislative Proposals Regarding Derivatives
February 14, 2018

Chairman Huizenga, Ranking Member Maloney, I am Richard Baker, President & Chief Executive Officer of the Managed Funds Association ("**MFA**"). I am pleased to provide this statement on behalf of MFA to present our members' views on one of the legislative proposals regarding derivatives that are the focus of today's important hearing. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices for hedge funds, funds of funds, managed futures funds, and service providers. MFA's members manage a substantial portion of the approximately $3 trillion invested in hedge funds around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated investors and play an important role in our financial system. They are active participants in the commodity and securities markets, including over-the-counter ("**OTC**") derivatives markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. MFA members engage in a variety of investment strategies across many different asset classes. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Hedge fund managers are fiduciaries that invest funds on behalf of institutional and high-net worth investors. Our members' skills help their customers plan for retirement, honor pension obligations, and fund scholarships, among other important goals.

As part of their asset management strategies, MFA members are active participants in the derivatives markets, and have consistently supported reforms to the OTC derivatives markets in Title VII ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") that mitigate systemic risk, increase transparency, and promote an open, competitive, and level playing field. The implementation of central clearing was a central goal of the 2009 G-20 commitments and the U.S. has been at the forefront of the move to central clearing. Clearing provides many benefits to the derivatives markets, including improved market liquidity and market integrity. We also have been a consistent supporter of the European Market Infrastructure Regulation, or EMIR, to ensure that European markets have similar benefits of central clearing of derivatives. As active participants in the U.S. markets for OTC derivatives, we would like to work with the G-20 countries, Congress, the Committee, the U.S. Prudential Regulators, the Basel Committee on Banking Supervision ("**Basel Committee**"), and all other interested parties to further the optimal implementation of derivatives clearing and bank capital and margin rules, which will reduce systemic risk, ensure affordable and impartial access to our financial markets, and strengthen our Nation's economy.

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As a result, MFA strongly supports H.R. 4659, bipartisan legislation to require the appropriate Federal banking agencies to recognize the exposure-reducing nature of client margin for cleared derivatives. We commend the bipartisan cosponsors of this measure, including Representative Luetkemeyer, Representative Lucas, and Representative David Scott for this thoughtful approach. We believe that the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System ("**Federal Reserve**"), and the Comptroller of the Currency (collectively, "**U.S. Prudential Regulators**") should modify their treatment of initial margin for centrally cleared derivatives for purposes of the U.S. Supplementary Leverage Ratio ("**SLR**"), including the enhanced SLR ("**eSLR**") for U.S. global systemically important banks ("**G-SIBs**"), to ensure that central clearing remains accessible and affordable for customers.

ENSURING THE ACCESSIBILITY AND AFFORDABILITY OF CUSTOMER CLEARING

Customers are a vital part of the derivatives markets and have been critical to the success of central clearing in the U.S. While some clearing of swaps between dealers existed prior to enactment of the Dodd-Frank Act, artificial barriers to entry prevented customers as clients of dealers from similarly participating in the cleared swaps market. Title VII's mandates requiring central clearing eliminated many of those artificial barriers and resulted in substantial dealer and customer clearing of derivatives.

MFA opposes the current formulation of the SLR because it undermines derivatives clearing and therefore is at cross purposes with Title VII. The SLR does not consider initial margin ("**IM**") that our members post with their respective clearing firms as a risk mitigant. Accordingly, the capital rules force the clearing firm to hold capital against such margin as if it were a conventional liability. The eSLR's additional capital buffer imposed on U.S. G-SIBs exacerbates this adverse effect by raising further the cost of clearing with resulting unintended adverse consequences that undermine systemic risk reduction. MFA echoes the call in the Banking Treasury Report and the Capital Markets Treasury Report for recommended adjustments to the SLR to address such unfavorable impacts caused by high leverage ratio capital charges.[1]

[1] *See* U.S. Department of the Treasury Report to President Donald J. Trump in response to Executive Order 13772 on Core Principles for Regulating the United States Financial System, "A Financial System That Creates Economic Opportunities, Banks and Credit Unions", June 2017 ("**Banking Treasury Report**"), at pp. 54 and 126, *available at*: https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf. *See also* U.S. Department of the Treasury Report to President Donald J. Trump in response to Executive Order 13772 on Core Principles for Regulating the United States Financial System, "A Financial System That Creates Economic Opportunities, Capital Markets", October 2017 ("**Capital Markets Treasury Report**"), at pp. 138 and 215, *available at*: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

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Prudential requirements that inflate the economic risk of derivatives, particularly the SLR, impose artificial barriers for asset managers' clients to access cleared derivatives and work at cross-purposes with mandates to clear. Recognizing these effects, Federal Reserve Board Member Jerome H. Powell recently stated that "[g]lobal authorities . . . have a responsibility to ensure that bank capital standards and other policies do not unnecessarily discourage central clearing."[2]

At present, swaps customers exclusively access central counterparties ("**CCPs**") indirectly through clearing members, rather than becoming direct members of CCPs, for a variety of reasons, both financial and operational. MFA anticipates that the demand for clearing services will increase as regulators in different jurisdictions fully implement their respective mandatory clearing initiatives.[3] As a result, it is critical that customer clearing services remain available at an affordable price to ensure that customers have fair and equal access to CCPs.

MFA's request for recalibration of the SLR is premised on the fact that CCPs' risk management methodologies are predicated on the collection of IM and variation margin from clearing members and customers to collateralize potential exposure. In addition, direct clearing members guarantee payment of their customers' obligations to the CCP. Because the IM is the customer's money,[4] rules adopted by the CFTC require clearing members to segregate customer funds from the clearing member's own assets.

While the leverage ratio framework captures a clearing member's guarantee to the CCP as an off-balance sheet exposure, leverage ratio rules fail to provide an offset that recognizes the exposure-reducing effect of customer IM for cleared derivatives. In the U.S., segregation rules severely restrict the ability of IM to be held in anything other than extremely low-risk and extremely liquid assets, assuring that it is always available to

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[2] Remarks by then Federal Reserve Governor Jerome H. Powell at the Federal Reserve Bank of Chicago Symposium on Central Clearing, *Central Clearing and Liquidity*, at p. 3 (June 23, 2017), *available at* https://www.federalreserve.gov/newsevents/speech/files/powell20170623a.pdf. Mr. Powell made these comments before he became Chairman of the Federal Reserve.

[3] For example, mandatory central clearing of certain OTC derivatives began in the EU in mid-2016. In addition, central clearing has already begun in Australia and Mexico, and is expected to begin soon in other countries, including Canada, Hong Kong, Singapore, and Switzerland. Notably, in light of these global developments, the Commodity Futures Trading Commission ("**CFTC**") has finalized rules that will expand the central clearing requirement in the U.S. to harmonize with these foreign jurisdictions. *See* CFTC final rule on "Clearing Requirement Determination under Section 2(h) of the CEA for Interest Rate Swaps", *available at*: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-23983a.pdf.

[4] Under CFTC rules, a clearing member must separately account for, and segregate as belonging to the customer, all money, securities and property it receives from a customer as margin. *See* 17 C.F.R. §§ 1.20-1.30; 17 C.F.R. §§ 22.2-22.7.

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absorb losses ahead of the bank.[5] Moreover, the substantial majority of segregated customer IM is posted to the CCP, and therefore, is entirely outside the control of the clearing member.[6]

The current failure of the SLR to recognize the purpose and exposure-reducing nature of customer IM is a threat to the use of cleared derivatives by customers. Because of the lack of offset for customer IM, clearing members will incur large leverage ratio exposures, which will likely raise prices for customer clearing significantly. This substantial cost increase may cause customers to reduce their hedging activities to levels that are inadequate to manage their risk, which could result in price increases and volatility for food, gasoline, and other consumer goods.

MFA notes that, on November 23, 2016, the European Commission proposed changes to the EU capital requirement regulation and directive that would, among other things, allow clearing firms to reduce the leverage ratio exposure measure by the IM received from clients for cleared derivatives.[7] MFA applauds this European Commission proposal.

Therefore, to ensure the continued affordability and robustness of customer clearing in the U.S., MFA respectfully requests that the Committee encourage the U.S. Prudential Regulators to consider the EC's proposal and industry-wide concerns in their rulemaking processes, and provide an offset for clearing members to the extent that customer IM is posted to the CCP, or is segregated under the U.S. regulatory regime. MFA emphasizes that our recalibration request is consistent with the recommendation of the Treasury Department in the Banking and Capital Markets Treasury Reports[8] and with remarks by Federal Reserve Governor Powell at its Global Finance Forum in Washington, D.C. on April 20, 2017, who called for recalibration of the SLR in the U.S. due to its damaging impact on client clearing.

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[5] In the United States, segregated margin cannot be reinvested except for investments in low-risk and highly liquid assets, such as U.S. government securities, managed "with the objectives of preserving principal and maintaining liquidity". *See* 17 C.F.R. § 1.25(b).

[6] Applicable U.S. margin and CCP regulations result in a significant majority of margin being passed onto the CCP. Although margin rules vary across jurisdictions outside of the U.S., non-U.S. margin frameworks for centrally cleared derivatives generally result in a substantial portion of margin held at the CCP rather than the clearing member.

[7] *Available at*: https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF. Paragraph (11) at p. 26 states: "A leverage ratio should also not undermine the provision of central clearing services by institutions to clients. Therefore, the initial margins on centrally cleared derivative transactions received by institutions in cash from their clients and that they pass on to central counterparties (CCP), should be excluded from the leverage ratio exposure measure".

[8] *See supra* note 1, Banking Treasury Report at p. 126 (recommending "significant adjustments" to the supplementary leverage ratio and a deduction from the leverage exposure denominator for IM for centrally cleared derivatives). *See also supra* note 1, Capital Markets Treasury Report at p. 215 (reiterating the Banking Treasury Report recommendation).

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H.R. 4659 addresses these concerns, amending the relevant banking statutes by directing the U.S. Prudential Regulators to ensure that any leverage-based bank capital rule, guideline, standard, or requirement deducts the amount of client initial margin for centrally cleared derivatives from the amount of leverage exposure arising from a banking organization's guarantee of a client's derivative obligation to the CCP. This provision will further the policy goals of supporting derivatives clearing and reducing systemic risk. At the same time, we believe that the bill's requirements will not in any way raise risks to banks or add to systemic risk. Finally, this legislation would be consistent with the European Commission's similar recommendations, thereby ensuring a level playing field between U.S. and EU clearing requirements.

CONCLUSION

MFA appreciates the Committee's review of the legislative proposals for derivatives. MFA's is strongly supportive of H.R. 4659. As discussed, we respectfully ask Congress to encourage the U.S. Prudential Regulators to modify the U.S. Supplementary Leverage Ratio to ensure that central clearing remains accessible and affordable for customers by providing a deduction in the SLR for customer initial margin. We believe that, by promoting, rather than discouraging, central clearing in the OTC derivatives markets, this modification will advance the G-20's and Congress's goal of reducing systemic risk in the derivatives markets.

MFA is committed to working with Members and staff of Congress, the Committee, regulators, and all interested parties to reduce systemic risk, ensure affordable and impartial access to our financial markets, and strengthen our Nation's economy.

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February 14, 2018
Rep. Bill Huizenga
Chairman, Subcommittee on Capital Markets, Securities and Investment
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Support for Certain Legislative Proposals Discussed at the February 14, 2018 Hearing of the Subcommittee on Capital Markets, Securities, and Investment entitled "Legislative Proposals Regarding Derivatives."

Dear Chairman Huizenga:

On behalf of Western Union, thank you for the opportunity to submit this statement for the record for the hearing titled, "Legislative Proposals Regarding Derivatives" and the chance to support certain legislative proposals discussed at the February 14, 2018 Subcommittee on Capital Markets, Securities and Investment hearing. Specifically, and as discussed further below, Western Union would like to express its support for the following proposals:

- H.R. _____, To amend the Securities Exchange Act of 1934 and the Commodity Exchange Act to encourage risk mitigation by excluding all hedging swaps from the swap dealer *de minimis* threshold, and for other purposes (the "**Swap Dealer Proposal**"); and
- H.R. _____, To clarify the definition of "financial end user" as it applies to parent and holding companies (the "**Financial End-User Proposal**").

Swap Dealer Proposal

Western Union supports the Swap Dealer Proposal.

Western Union believes that, if adopted, the Swap Dealer Proposal would provide additional legal certainty with respect to the *de minimis* exception from the swap dealer definition by setting forth in the statute that swaps entered into to hedge risks incurred as a result of swap dealing activity are not swap dealing activity.

Financial End-User Proposal

Western Union supports the Financial End-User Proposal.

Many corporate organizations are structured such that one or more parent holding companies wholly own (directly or indirectly) all of the organization's subsidiaries. In some cases, these subsidiaries conduct certain financial activities while the parent company and intermediate holding companies do not. The first ten prongs of the financial end user definition in CFTC Rule 23.151 (the "**Financial End-User Definition**") identify specific types of entities that are financial end users, such as banks, broker-

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dealers, investment advisers and insurance companies. Parent and holding companies do not specifically fall within any of these categories, and the fact that such parent and holding companies may own entities that are themselves financial end users would not appear to cause the parent or holding company to be treated as a financial end-user. We believe this is the correct interpretation of the rules, but we believe there is some ambiguity about how to apply the rule to parent and holding companies and that the Financial End-User Proposal would eliminate that ambiguity. Western Union believes that clarifying that the Financial End-User Definition does not apply to parent and holding companies that do not themselves fall into any of the categories of the definition would increase certainty for many market participants, which otherwise may unnecessarily be required to comply with onerous margin requirements for their uncleared swaps entered into with swap dealers.

Thank you for your consideration. We look forward to working with you to advance these important Proposals.

Sincerely,

Tim Daly

Senior Vice President, Global Public Policy

Western Union

cc: Rep. Carolyn Maloney, Ranking Member, Subcommittee on Capital Markets, Securities and Investment