THE FUTURE OF THE CFTC: MARKET PERSPECTIVES

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THE FUTURE OF THE CFTC: MARKET PERSPECTIVES

TUESDAY, MAY 21, 2013

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Committee met, pursuant to call, at 10:18 a.m., in Room 1300 of the Longworth House Office Building, Hon. Frank D. Lucas [Chairman of the Committee] presiding.

Members present: Representatives Lucas, Neugebauer, Rogers, Conaway, Gibbs, Austin Scott of Georgia, Tipton, Crawford, Noem, Fincher, LaMalfa, Hudson, Davis, Collins, Peterson, McIntyre, David Scott of Georgia, Costa, Walz, McGovern, DelBene, Negrete McLeod, Vela, Kuster, Nolan, Enyart, Vargas, and Bustos.

Staff present: Debbie Smith, Jason Goggins, Josh Mathis, Kevin Kramp, Nicole Scott, Suzanne Watson, Tamara Hinton, Caleb Crosswhite, John Konya, C. Clark Ogilvie, Liz Friedlander, and Riley Pagett.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

The CHAIRMAN. This hearing of the Committee on Agriculture entitled, *The Future of the CFTC: Market Perspectives,* will come to order. I recognize myself for an opening statement. I apologize to the Ranking Member and the witnesses and the Committee Members for being a little late. Life has been a little bit challenging back home in Oklahoma in the last couple days, and I simply note that no matter how challenging Mother Nature may be, and no matter how sometimes our fellow citizens suffer, it is nonetheless in a small way redeeming to see how well in this country, whether it is in Oklahoma or on the East Coast or the West Coast, how well we still come together after a tragedy and how decently we treat each other, and how hard we help those who are hurt or hurting. I thank you for your indulgence.

And with that, let me also note that we are all here today to discuss the reauthorization of the Commodity Futures Trading Commission. This is the first hearing on this issue, and the first in a series of hearings this Committee plans to hold in advance of writing legislation. CFTC reauthorization gives the Committee an opportunity to review the CFTC's operations, examine the pressing issues facing the futures and swaps markets, evaluate how regulations are impacting end-users and the agricultural community, and determine how to best protect consumer funds while restoring confidence in our markets. The reauthorization also allows the Com-

mittee to take stock of past events, such as the passage of the Dodd-Frank Act of 2010, the ensuing rulemaking process, and the failures of MF Global, and PFG Best.

It is impossible to discuss the CFTC and the future of the CFTC without recognizing the impact of these events on the agency and its response to them. Today, nearly 3 years after the Dodd-Frank Act was enacted, numerous Main Street businesses are still waiting to understand how new regulations affect them and their operations. Our food producers, our manufacturers, our technology companies, and our public power companies have all been impacted by new financial regulations.

The agency's process for writing rules has lacked sequencing and coordination. For example, the agency defined *swap dealer* before it defined *swap,* which does seem to kind of defy logic. How do you know if you are a dealer if you don't know what you are dealing? Also, the SEC and the CFTC have failed to coordinate on cross-border rules. So now we have two different definitions of *U.S. person* for trades with foreign counterparts.

In the wake of missing implementation deadlines, the CFTC has also issued dozens of last-minute no action letters, which has only contributed to a greater sense of uncertainty as businesses try to understand how and when to comply, if ever. It is telling that the agency has issued more no action letters than finalized rules. It would be one thing if the CFTC missed deadlines as the result of a thoughtful rulemaking process that considers meaningful public comment and the unintended consequences of its actions, but that isn't the case. Rather, the agency has been moving in a haphazard way that defies Congressional intent and could jeopardize the United States competitiveness in the global marketplace.

Today, we will hear perspectives from the futures and swaps marketplace, including the two largest derivative exchanges, a futures commission merchant whose customers are farmers and ranchers, and industry trade associations who represent hundreds of companies. We hope to gain a greater understanding of the challenges they will face.

Moving forward, we will continue our hearings with perspectives from end-users, futures customers, and of course, the CFTC.

[The prepared statement of Mr. Lucas follows:]

PREPARED STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

Good morning.

Thank you all for being here today to discuss the reauthorization of the Commodity Futures Trading Commission. This is the first hearing on the issue, and the first in a series of hearings this Committee plans to hold in advance of writing legislation.

CFTC reauthorization gives the Committee an opportunity to review the CFTC's operations, examine the pressing issues facing the futures and swaps markets, evaluate how regulations are impacting end-users and the agricultural community, and determine how best to protect customer funds while restoring confidence in our markets.

The reauthorization also allows the Committee to take stock of past events, such as the passage of the Dodd-Frank Act of 2010, the ensuing rulemaking process, and the failures of MF Global and PFG Best. It is impossible to discuss the CFTC and the future of the CFTC without recognizing the impact of these events on the agency and its response to them.

Today, nearly 3 years after the Dodd-Frank Act was enacted, numerous Main Street businesses are still waiting to understand how new regulations affect them and their operations. Our food producers, our manufacturers, our technology companies, and our public power companies have all been impacted by new, financial regulations.

The agency's process for writing rules has lacked sequencing and coordination. For example, the agency defined swap dealer before it defined swap, which defies logic. How do you know if you're a dealer if you don't even know what you're dealing? Also, the SEC and CFTC have failed to coordinate on cross-border rules, so now we have two different definitions of "U.S. person" for trades with foreign counterparts.

In the wake of missing implementation deadlines, the CFTC has also issued dozens of last minute "no-action" letters, which has only contributed to a greater sense of uncertainty as businesses try to understand how or when to be in compliance—if ever. It is telling that the agency has issued more "no-action" letters than finalized rules.

It would be one thing if the CFTC missed deadlines as the result of a thoughtful, rulemaking process that considers meaningful public comment and the unintended consequences of its actions. But, that isn't the case. Rather, the agency has been moving in a haphazard way that defies Congressional intent and could jeopardize the United State's competitiveness in the global marketplace.

Today, we will hear perspectives from the futures and swaps marketplace, including the two largest derivatives exchanges, a futures commission merchant whose customers are farmers and ranchers, and industry trade associations who represent hundreds of companies. We hope to gain a greater understanding of the challenges they face.

Moving forward, we will continue our hearings with perspectives from end-users, futures customers, and of course, the CFTC.

The CHAIRMAN. With that, the chair recognizes the Ranking Member for any opening comments he might have.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman, and with all due respect, I have to take some issue with the way you characterized how this is going, looking at the CFTC, and I do not disagree with you that it certainly could have been a better process, but the amount of money that has been spent by these groups to stop these regulations and ball up the works is phenomenal, if you look into it. It is not only focused on the CFTC and the SEC, but focused on Congress. It is unreal the amount of money that has been poured into stopping these regulations, so it is no wonder that it is 3 years and we don't have it done. It is amazing we have as much done as we have.

Why they took some of this stuff out of sequence and so forth I am not sure, but I point out to people that you have Republicans and Democrats on the CFTC. They haven't agreed, and it has been a difficult process.

But, at the end of the day they listen to people. A good example of that is a SEF rule that was completed last week which I didn't agree with. They watered that down. Initially it was going to be five—there had to be five calls or contacts made to try to determine the price. That was reduced to two, and then, I guess, three after some kind of process like that. And they allowed for phone brokering as opposed to electronic, which isn't going to give people that are interested in the market making as much information. So there is an example that they listened to all of these lobbyists and all of this pressure. I don't agree with it, but they went ahead and moved the process.

So, with that SEF rule out of the way now, they don't have that much left to do, and from everything I can tell, they are going to finish this up this summer. So again, my advice would be that we wait. You know, we are going to have hearings. Apparently we are going to have hearings at the Subcommittee level. That is good. But that we wait until these rules get completed so we know what we are dealing with, and we are not speculating about what might or might not happen.

And to go along with that, we have the farm bill to deal with. It is not going to be an easy thing to get that through the Floor, and then if we get it through conference, then that is going to take us most of June and July anyway to get the farm bill done. And I would hope we wouldn't get distracted in that effort by the reauthorization of the CFTC.

So I would, again, just encourage a little patience here, and not that I am defending the CFTC and everything that they have done, but they have had a tough job. And part of the problem, we created that last night when we did the conference on the Dodd-Frank bill when they required that the CFTC had to coordinate with the SEC and when that happened, I knew this was going to be a problem, and that bogged everything down. Hopefully they will get this thing resolved this summer and then we will know where we are at, and see if there is anything that needs to be changed in the reauthorization that regards the implementation of this Dodd-Frank rule or not.

So with that, I would yield back.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you Chairman Lucas.

Oversight of the CFTC and its implementation of Dodd-Frank has been the subject of numerous Committee hearings over the last few years, and at each of these hearings I've urged my colleagues to be patient. I'm maybe beginning to sound like a broken record, but as we begin today's hearing on CFTC reauthorization, I still think it's important we don't get ahead of ourselves.

The CFTC is still in the process of implementing the reforms called for by Dodd-Frank, and I believe we need to give them the necessary time to get this right. In my discussions with Chairman Gensler, he seems optimistic that they will be finished with their rule-making sometime this summer. Again, we would be better served by exercising caution and waiting until the rules are finalized before moving ahead with CFTC reauthorization. Once the rules are completed, we will have a much clearer picture and the opportunity to fix anything that we feel needs to be fixed.

Additionally, I don't want CFTC reauthorization to distract us from the Committee's primary task at hand—getting a 5 year farm bill across the Floor of the House. We passed a good, bipartisan bill last week, but we know there will be numerous challenges on the Floor. I think we're going to need all hands on deck to keep the Committee bill largely intact.

Once that is done, conferencing the House farm bill with the Senate version will be another challenge. Having been through this in 2008, I know that trying to pass another major piece of legislation could inadvertently hurt or hinder our goal of getting a new farm bill enacted before current law expires. I think we owe it to our farmers, who have waited far too long, to remain focused on finishing the farm bill.

Again, I thank the chair and welcome our witnesses.

The CHAIRMAN. The gentleman yields back the balance of his time. The chair requests that other Members submit their opening

statements for the record so that the witnesses may begin their testimony, and to ensure that there is ample time for questions.

We call our first panel to the table. I would like to welcome the witnesses. Mr. Terrence A. Duffy, Executive Chairman and President, CME Group Incorporated, Chicago Illinois; Mr. Jeffrey C. Sprecher, Chairman and CEO, IntercontinentalExchange, Incorporated, Atlanta, Georgia; Mr. Daniel J. Roth, President and CEO of National Futures Association, Chicago, Illinois; the Honorable Walter L. Lukken, President and CEO, Futures Industry Association, Washington, D.C.; Mr. Stephen O'Connor, Chairman of the International Swaps and Derivatives Association, Incorporated, New York, New York; and Mr. William Dunaway, Chief Financial Officer of INTL FCStone Incorporated, Kansas City, Missouri.

Mr. Duffy, please begin when you are ready, sir.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Mr. DUFFY. Thank you, Mr. Chairman, and first, may I say that our thoughts and prayers are with you and all the people in Oklahoma for these tragic events that you are all suffering through down there. It is—as a father of two young sons, I just can't even imagine what the people of Oklahoma are going through, so our thoughts and prayers are with you, sir.

That being said, Mr. Chairman, Ranking Member Peterson, Members of the Committee, I want to thank you for the opportunity to offer market perspectives on the future of the CFTC as the Committee considers agency reauthorization.

Four critical issues to the future of the agency include agency funding, rulemaking, market structure, and customer protection. We support appropriate funding for the agency, but oppose the Administration's proposal to fund any of the $315 million budget with a transaction tax for many reasons, the main reason being a proposed tax will substantially increase the cost of market making. For some market makers, this cost could go up as much as 100 percent. Market making is an essential source for market liquidity. Imposing this new tax would increase the cost of business for all customers because it would reduce liquidity, increase volatility, and impair efficiency. Hedging cost for farmers, ranchers, and other commercials will likewise increase and be passed on to the consumers in the form of higher prices of food and other goods.

Although the Administration calls for an exemption for end-users and some others by taxing market making liquidity pool, their costs will go up dramatically due to the lack of liquidity and efficiency in the market. The Commission's misuse of Dodd-Frank to expand its role is evident in unnecessary departure from the principal-based regulatory regime.

Regulated futures markets performed flawlessly throughout the financial crisis. The Commission's efforts to micromanage markets and clearinghouses is inefficient, hampers innovation, and increases costs and budgets. The Commission's implementation of Dodd-Frank by an uncoordinated and often inflexible set of rules, resulted in conflicts, confusion, and over-inclusion. Our industry would have grounded to a standstill without dozens, as the Chair-

man has recognized, no action letters. I have illustrated these concerns in my written testimony.

We urge the Committee to direct the agency to reexamine its rulemaking with genuine attention to a cost-benefit criteria and a commitment to return to a principle-based regulation. Dodd-Frank makes clear that futures and swaps are different products and should receive similar, but not identical regulation. Claims that futurization is leading to unfair competition or as a means to secure more favorable margin treatment are simply wrong. A well-run and regulated clearinghouse, like ours, does not set margin based on the name or label of a cleared contract. CME sets margins based on the underlying volatility and liquidity risk of that contract. Many of our most important futures contracts use 2 day volatility measures in excess of the CFTC's regulatory floor. Market participants will continue to use both customizable swaps and standardized futures. Innovation, competition, and customer choice among well-regulated markets is not only a positive development for customers and the public, but it is entirely consistent with Dodd-Frank's goals, including the goal of reducing risk through central clearing.

I reported about the rules CME and NFA have implemented to strengthen the protection of customers' property at FCMs, timely access to aggregated customer balances at banks, for example. Facilities have risk-based reviews of the FCMs. The CFTC has proposed rules that codify our initiatives which we support, but the proposed rules would also change how the industry operates in fundamental ways. The industry is studying their impact, which could be significant on smaller FCMs that serve the agricultural community. We have urged the CFTC to let the industry complete its work before moving forward with the proposal. We believe that Congress could also further enhance customer protection to amendments to the Bankruptcy Code. Potential changes would enhance a clearinghouse's ability to transfer positions of non-defaulting customers or facilitate individual segregation of customer property.

With respect to the question of insurance, CME, FIA, NFA and others are sponsoring a database study of insurance scenarios so policymakers can determine whether insurance for futures would be viable. The data provided in this study should inform decisions regarding the costs and benefits of various insurance approaches.

I want to thank you for the opportunity this morning and look forward to your questions.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, INC., CHICAGO, IL

Good morning, Chairman Lucas, and Ranking Member Peterson. Thank you for the opportunity to offer market perspectives on the future of the CFTC as the Committee considers reauthorization of the Agency. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Four critical issues to the future of the Agency include Agency funding, rulemaking, market structure and customer protection.

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, ag-

Agency Funding

We support adequate funding for the CFTC, but oppose the Administration's proposal to fund the entire amount with a "user fee," which is just another name for a transaction tax. The Administration's FY 2014 Budget proposes to increase the CFTC's budget by $109 million to $315 million and to fund the entire amount with a "user fee" levied on futures and derivatives trades. Such a "user fee" will impose a $315 million per year transaction tax on market making. For some market makers, this tax could represent a 100% cost increase. Market-making is an essential source of market liquidity. Imposing this new tax would increase the cost of business for all customers because it would reduce liquidity, increase volatility, and impair the efficient use of U.S. futures markets. It will make it more difficult and expensive for farmers, ranchers, and other end-users to hedge commodity price risk in the market. This will force farmers and other market participants to pass along these higher costs to consumers in the form of higher food prices.

Moreover, the tax will change the competitive balance in favor of foreign and OTC markets with lower transaction costs where, in an electronic trading environment, market users can and will shift their business; lessen the value of the information provided to farmers and the financial services industry by means of the price discovery that takes place in liquid, transparent futures markets with low transaction costs; increase the cost to the government resulting from less liquid government securities markets; and fail to actually collect the funds anticipated when market participants choose lower cost alternative jurisdictions and markets.

For all of these reasons, Congress should reject a transaction tax to fund the CFTC.

Rulemaking

We have been strong advocates for the primary driver behind the Dodd-Frank Act: bringing transparency and clearing to the opaque over-the-counter swaps market. However, the Commission has misused the DFA to expand its role, as primarily evidenced by its unnecessary departure from the principles-based regulatory regime which has operated so successfully. Regulated futures markets performed flawlessly throughout the financial crisis. The Commission's efforts to impose unnecessary new regulations on futures markets and clearing houses are inefficient, hamper innovation, and ultimately increase consumers' costs. Consequently, the use of regulated markets and clearing as risk management tools is becoming less appealing to market participants—increasing overall risk in complete contravention of the intention of DFA

The Commission implemented DFA with an uncoordinated and often inflexible set of rules resulting in conflicting rules, confusion and over inclusion. Our industry would have ground to a standstill without the issuance of dozens of no-action letters, most of which were issued as deadlines approached. A look at some rulemakings affecting the U.S. energy markets in recent months illustrates these problems.[2]

The CFTC finalized its product definition rulemaking in the summer of 2012, with an effective date of October 12, 2012. This effective date triggered compliance obligations relating to products defined as "swaps" under many different rulemakings previously finalized by the CFTC. However, because the CFTC had not yet completed critical rulemakings that would clarify whether certain types of contracts used in the energy markets were "swaps.", market participants, understandably, were unclear as to their responsibilities. Ultimately, and at the last minute before the compliance deadline, the CFTC issued an order delaying the implementation of these compliance obligations to allow the swaps and futures markets to continue operating without disruption until year end.

A few months later, lack of clarity in the swap reporting rulemaking again led to confusion in the energy markets. When the swap data reporting obligations became effective, it was not clear to market participants whether they were required to provide historical trade data relating to certain energy contracts that have been listed and regulated as futures for over a decade. Notwithstanding the fact that this same trade data was already being reported to the CFTC under the existing futures

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ricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

[2] I highlighted similar problems in my testimony before the Committee on February 10, 2011, and its Subcommittee on General Farm Commodities and Risk Management on April 13, 2011, respectively.

rules, it was not clear, and remains unclear, whether this data was also subject to swap data reporting requirements. CME Group has submitted to the CFTC two requests for guidance, consistent with the CFTC's explicit indication in their proposed rulemaking that they would provide such guidance.[3] To date, energy market participants still have not received clarity from the CFTC regarding their record-keeping or reporting obligations under the new swap rules, which for many of them will go into effect on May 29.

We ask the Committee to direct the Agency to re-examine its DFA rulemaking with genuine attention to a cost-benefit criteria and commitment to return to principles-based regulation.

Market Structure

As previously indicated, one of the fundamental purposes of the DFA was to respond to the financial crisis by bringing regulatory oversight to the previously unregulated and opaque swaps market. The DFA accomplished this through two primary changes to the swaps market: (1) centralized clearing, to reduce systemic risk; and (2) reporting and trading on regulated platforms, to provide transparency. These policies mirror, in many ways, the regulatory structure under which the U.S. futures markets have operated for many decades.

The DFA makes clear that futures and swaps are different product classes and should receive similar, but not identical, regulation. Claims that "Futurization" is an improper effort to secure more favorable margin treatment or other regulatory benefits are misplaced. Margin requirements permit the clearing house that is clearing a contract to mitigate the risk attendant to that specific contract. CFTC rules set a floor for the amount of initial margin that clearinghouses must collect. At a well-run and regulated clearing house, like ours, margin is determined by risk management policies and procedures designed to account for the actual risk profile of the product—its underlying volatility and liquidation risk of the contract—not its label as a swap or a future. In fact, many of our futures products require initial margin based on a 2 day volatility measure in excess of the CFTC's regulatory floor.

The example provided by the Lehman bankruptcy is informative. From the time CME decided to liquidate Lehman's futures house positions cleared by CME to complete liquidation, 6 hours elapsed. This was a complex portfolio, across all of CME major product categories, with a margin required on the portfolio approaching $2 billion. We used a variety of market participants to liquidate, and did so within margin cover. In contrast, Lehman's cleared swaps portfolio—which consisted of "vanilla" swaps—was so complex that it took the clearinghouse that liquidated them over 3 weeks to fully liquidate the portfolio.

This example illustrates that whether a swap and a future share an economic profile is not the determinative factor to a clearing house in setting margins. The determinative factor is the overall risk profile of the product. And the liquidity and transparency afforded by that product's market infrastructure is a critical element of the product's risk profile.

It is consistent with the risk mitigation objectives of DFA to ensure that margin requirements be tailored to address the risk characteristics of different contracts. Market participants will continue to use both customizable swaps and standardized futures products. Innovation, competition and customer choice among well-regulated markets is not only a positive development for customers and the public as a whole, but is entirely consistent with the goals of DFA.

Customer Protection

Industry Safeguards

I have previously testified about the rules CME Group, together with the National Futures Association ("NFA") and other U.S. futures exchanges have implemented to strengthen the protection of customer property (and its investment) at the FCM through strict and regular reporting and on-line access to customers' balances at banks and other depositories. They improve our work to mitigate the risk of and early detection of the improper transfer of customer funds and the improper reporting of customer asset balances, and to check compliance with CFTC requirements for the investment of customer funds. Our efforts to enhance our monitoring continue today through the use of an account balance aggregation tool. Timely, including daily, access to this additional information is enabling us to better direct our

[3] In the rule proposal relating to historical data reporting requirements, the Commission stated that it "expects to provide interpretive guidance concerning the determination of the reporting counterparty in situations where a historical swap was executed and submitted for clearing via a platform on which the counterparties to the swap do not know each other's identity." 77 *Fed. Reg.* 35200, 35211, n. 43 (June 12, 2012).

regulatory resources at risk-based reviews of customer balances at clearing members and FCMs and their activity with respect to those balances.

Moreover, the CFTC has recently proposed additional rules on customer protection that include provisions codifying these initiatives, which we strongly support. However, this rulemaking also seeks to fundamentally change the way in which the futures marketplace operates. As we explained in our comment letter, if a proposed "protective" measure is so expensive or its impact on market structure is so severe that customers cannot effectively use futures markets to mitigate risk or discover prices, the reason to implement that measure needs to be re-examined. Among the proposed rules to reevaluate is the rule that would require *at all times* an FCM's residual interest (its own funds) in segregated accounts to exceed the margin deficiencies of its customers. It does not appear that any system currently exists or could be construed in the near future the will permit FCMs to accurately calculate customer margin deficiencies, continuously in real-time. Without access to this data, FCMs will be required to maintain substantial residual interest in segregated accounts or require customers to significantly over-collateralize their accounts. We believe this will be a significant and unnecessary drain on liquidity that will make trading significantly more expensive for customers to hedge. We believe this rule and others could have a very significant impact on certain sectors in the marketplace, particularly smaller FCMs that serve the agricultural community. The industry is conducting an impact analysis of these rules. We have urged the CFTC to allow the industry to complete this impact analysis before proceeding further with the rulemaking process.

Further, CME Group believes that proposed changes to Rule 1.52 threaten the viability of the current regulatory structure. This rule governs the manner in which self-regulatory organizations ("SROs"), such as CME and NFA, conduct their risk-based reviews of FCMs. Among other things, the proposed rule improperly conflates the roles played by an FCM's outside auditor and its regulatory examiners (designated SROs or DSROs), in essence requiring SROs and DSROs to replicate the role of an external auditor. SROs and DSROs are not staffed to play such a role, nor should they be. One of the primary strengths of the current regulatory scheme is that SROs and DSROs play a role distinct from, yet complimentary to, that played by an outside auditor. Rather than simply replicating the work performed by outside auditors, the SROs and DSROs perform limited reviews that focus on particular areas of regulatory concern, including the segregation of customer funds and net capital requirements. This proposal would serve little regulatory purpose while imposing significant costs.

Bankruptcy Code Improvements

We believe that Congress could further enhance customer protections through amendments to the Bankruptcy Code. Potential amendments range from fundamental changes that would facilitate individual segregation of customer property to narrower revisions that would enhance a clearinghouse's ability to promptly transfer positions of non-defaulting customers. While amending the Bankruptcy Code is a significant undertaking, CME Group believes that modification to the bankruptcy regime in light of recent experience would benefit customers and the market as a whole.

Insurance for Futures Study

In the wake of MF Global and Peregrine Financial, some have advocated establishing an insurance scheme to protect futures customers. Any such proposal must be analyzed in light of the costs and potentially limited efficacy of such an approach due the extraordinarily large amount of funds held in U.S. segregation.

The futures industry, led by the Futures Industry Association,[4] is researching various insurance mechanisms in order to provide a quantitative, data-based analysis that will enable policymakers and market participants to determine whether insurance for futures would be viable.

Conclusion

As Congress considers reauthorization of the CFTC, we urge the Committee to continue its strong oversight of the CFTC to ensure that rulemaking is efficient and consistent with the DFA; regulation enhances the safety and soundness of futures and derivatives markets by a principles-based regulatory regime; and the U.S. competitive stance in the global financial marketplace is preserved. We look forward to working with the Committee during this process.

[4] CME Group, the Institute for Financial Markets ("IFM") and the NFA are also sponsors of the study.

The CHAIRMAN. Thank you, Mr. Duffy.

Mr. Sprecher, you may begin when you are ready, sir.

STATEMENT OF JEFFREY C. SPRECHER, FOUNDER, CHAIRMAN, AND CEO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. SPRECHER. Thank you, Chairman Lucas, Ranking Member Peterson, and Committee Members, including my colleagues from Georgia. I am Jeff Sprecher. I am Chairman and Chief Executive Officer of ICE, and I am grateful for the opportunity to comment on the Commodity Exchange Act as this Committee undertakes its reauthorization.

ICE is a leading operator of regulated global marketplaces for futures and OTC derivatives. On December 20 of last year, ICE announced its transaction to acquire NYSE Euronext, which will further expand our reach across commodities and equities markets.

My testimony today focuses on some of the issues that we see in operating these diverse markets.

In 2009 in response to the global financial crisis, the G20 Nations met in Pittsburgh to agree on reforming the world's financial markets. This agreement led Congress to passing the Dodd-Frank Act. Today, the CFTC has passed the majority of applicable rules under Dodd-Frank, and ICE's U.S. businesses have largely implemented these new rules. We continue to support market participants who are doing the same thing.

We are now turning towards rulemakings and implementation in Europe and in Asia, as they finalize their financial reform laws. As we look at the various regimes and work with global regulators, we have concluded that contrary to the G20 goals, global financial reform efforts are not being harmonized and substantial differences remain between regulatory regimes. If regulators fail to harmonize, the effects of uncertainty and the prospect for regulatory arbitrage will be damaging.

The derivatives markets are international, and a majority of companies that operate globally use derivatives to manage price risk and they conduct these transactions with both U.S. and non-U.S. counterparties. The likely outcome will be that regulators deem other country's financial regulatory systems as being non-equivalent, which would lead to those countries erecting barriers to financial markets. It is crucial to understand that if countries erect barriers, markets and market participants will be damaged. Currently in the U.S., commodities markets are the home to global benchmark contracts because Asian and European market participants have direct access to our markets. Over the past year, ICE has been delivering this message to domestic and international regulators, yet regulations continue to diverge, particularly between the U.S. and Europe. We ask the Committee in its oversight role to impress upon the Commodity Futures Trading Commission the importance of working with European and Asian counterparts to harmonize their regulation and avoid creating unintended, unpredictable impacts on our markets and our users.

Note the time for this agreement is closing, because in June, Europe will begin the process of deeming the U.S. equivalent or non-

equivalent under its regulations, so these issues must be solved in the next few months.

In passing the original Commodity Exchange Act, Congress wisely added a sunshine provision to the law to make sure that the CEA has kept pace with rapidly evolving commodities markets. Importantly, this CEA reauthorization marks the third anniversary of the passage of the Dodd-Frank Act. When Dodd-Frank was passed, the financial markets were very different than today. In reviewing the CEA, ICE believes that the Commission should focus on two key areas.

First, given the recent FCM bankruptcies, the Committee should focus on modifications to the bankruptcies provisions of the CEA to ensure that customer funds are protected in future bankruptcies. ICE has been working with other exchanges and market participants on this issue and we look forward to working with you and your staffs to advance this objective.

Second, the market would benefit from a clarification of Dodd-Frank rules on position limits. Of particular concern is Dodd-Frank's definition and limitation on *bona fide* hedging, which is the exemption that is used by end-users. The narrowing of a definition of *bona fide* hedging will likely hurt commercial end-users that markets are here to serve. The support for the *bona fide* hedge exemption methodology that has been relied upon historically would bring greater certainty to our end-users.

ICE appreciates the opportunity to work with Congress and global regulators to address evolving derivatives markets, and Mr. Chairman, thank you for the opportunity to share our views with you. I will be happy to answer your questions as they may arise.

[The prepared statement of Mr. Sprecher follows:]

PREPARED STATEMENT OF JEFFREY C. SPRECHER, FOUNDER, CHAIRMAN, AND CEO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Chairman Lucas, Ranking Member Peterson, I am Jeffrey C. Sprecher, Chairman and Chief Executive Officer of IntercontinentalExchange, Inc., or ICE. I am grateful for the opportunity to comment on the Commodity Exchange Act (CEA) as this Committee undertakes reauthorization.

As background, ICE was established in 2000 as an over-the-counter (OTC) marketplace with the goal of bringing needed transparency and a level playing field for the opaque, fragmented energy market that existed at the time. Since then, ICE has met that objective and expanded its markets through organic growth as a result of innovation. We have acquired futures exchanges and brought competition, new products, technology, and risk management services to a centuries-old business. Today ICE is a leading operator of regulated, global marketplace for futures and OTC derivatives across agricultural and energy commodities, foreign exchange, credit derivatives and equity indexes. Commercial market participants ranging from producers to end-users rely on our liquid, transparent markets to hedge and manage risk.

On December 20th of last year, ICE announced its transaction to acquire NYSE Euronext. As a result of this transaction, which we expect to close this year, ICE's range of products and our global reach will expand even further, adding to our operations in Europe, Asia, North America and South America across the derivatives and equities markets. ICE's businesses are regulated by multiple regulators in multiple jurisdictions, including the United State's Commodities Futures Trading Commission and the Securities and Exchange Commission, among others. My testimony today focuses on some of the issues we see in operating in such diverse markets.

International Harmonization

In 2009, in response to a global financial crisis, the G20 nations met in Pittsburgh to agree on reforming the global financial markets. This agreement led to Congress passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-

Frank Act), which was passed that same year and has been in the implementation process over the past 3 years. Appropriate regulation of derivatives is of utmost importance to the proper functioning of the financial system. ICE believes that increased transparency, risk management and capital sufficiency, coupled with legal and regulatory certainty, are central to reform and to restoring confidence to these vital markets.

Today, given that the CFTC has passed the majority of the applicable rules under Dodd-Frank, ICE's U.S. businesses have largely implemented the new rules, and continue to support market participants in doing the same. We are now turning toward rule-makings and implementation in Europe and Asia as they finalize their financial reform laws. As we look at the various regimes and work with global regulators, we have concluded that, contrary to the G20 goals, global financial reform efforts are not being harmonized and substantial differences remain between regulatory regimes.

If regulators fail to harmonize, the effects of uncertainty and the prospect for regulatory arbitrage will be damaging. Because markets are global and capital flows across borders, no single country or regulatory regime oversees the derivatives market. In order to make long-term business decisions, market participants require certainty that their transactions will not be judged on conflicting standards. The derivatives markets are international: the majority of companies that operate globally use derivatives to manage price risks, and they conduct these transactions with both U.S. and non-U.S. counterparties. The likely outcome will be that regulators deem other countries' financial regulatory systems as "nonequivalent", which would lead to those countries erecting barriers to its financial markets. It is crucial to understand that if countries erect these barriers, WE markets and market participants will be damaged. Currently, the U.S. derivatives markets are home to vital global benchmark contracts in agriculture, energy, financial asset classes. These have become benchmark contracts because Asian and European market participants have direct access to U.S. markets. Importantly, the long-standing global nature of the derivatives markets and the resulting international competition has lead to advances in transparency, risk management, and historically, regulatory cooperation.

Over the past year, ICE has been delivering this message to domestic and international regulators, yet regulations continue to diverge, particularly in the U.S. and Europe. We ask the Committee, in its oversight role, to impress upon the Commodity Futures Trading Commission the importance of working with European and Asian counterparts to harmonize regulation and avoid creating unintended, unpredictable impacts on financial markets and their users. The time for agreement is closing. In June, Europe will begin the process of deeming the U.S. equivalent or nonequivalent under its regulations. These issues must be solved in the next few months.

Commodity Exchange Act Reauthorization

In passing the original Commodity Exchange Act, Congress wisely added a sunshine provision to the law. Every few years, Congress re-examines the CEA to make sure that the law has kept pace with the rapidly evolving derivatives markets. Importantly, this CEA reauthorization marks the third anniversary of the passage of the Dodd-Frank Act. When Dodd-Frank was passed, the derivatives markets were very different than today. Over the past 3 years, these markets have become more standardized, transparent, and key derivative contracts are now subject to mandatory clearing. Last week, the CFTC finalized rules to that will lead to mandatory trading on regulated Swap Execution Facilities. Last year, ICE itself transitioned its OTC energy contracts to regulated futures contracts.

Given these sweeping changes, CEA reauthorization is a key opportunity for Congress to review the law, as well as the oversight of the CFTC, to ensure that the law and the Commission are in step with today's derivatives markets. In reviewing the CEA, ICE believes that the Commission should focus on two key areas. First, given the recent Futures Commission Merchant (FCM) bankruptcies, a focus on modifications to the bankruptcy provisions of the CEA to ensure that customer funds are protected in future FCM bankruptcies. ICE has been working with other exchanges and market participants on this issue and we look forward to working with you and your staff to advance this objective.

Second, the market would benefit from a clarification of Dodd-Frank rules on position limits. As the U.S. District Court for the District of Columbia stated last year, the position limit rules in Dodd-Frank are contradictory. If position limits are applied incorrectly, markets could be constrained in serving a price discovery function. Of particular concern, is the Dodd-Frank Act's limitation of a *bona fide* hedge, which is the exemption used by end-users. The narrow definition of *bona fide* hedge will likely hurt commercial end-users that these markets are intended to serve, and thus

support the *bona fide* hedge exemption relied upon historically would bring greater certainty to end-users in executing their risk management operations.

Conclusion

ICE has always been and continues to be a strong proponent of open, regulated and competitive markets, and appreciates the opportunity to work with Congress and global regulators to address the evolving derivatives markets. We will continue to engage you and your staff on the wide variety of CEA-related issues under the Committee's jurisdiction.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you may have.

Mr. CONAWAY [presiding.] Thank you, Mr. Sprecher.

Mr. Roth for 5 minutes.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Mr. Chairman. My name is Dan Roth and I am the President of National Futures Association.

As we begin this reauthorization process, we at NFA, like all of you, are very focused on customer protection issues. The fact is that for a very long time, the futures industry had an impeccable reputation, and I might add, a well-deserved reputation, for safeguarding the integrity of customer funds. But in the last 2 years, we had first MF Global and then Peregrine, and in both of those instances, customers suffered real losses, hard losses, losses that regulators like me are supposed to prevent.

Clearly, we had to make some dramatic improvements and I wanted to let you know that at NFA, we have been working very closely with the CFTC, with the CME, and other self-regulatory organizations to bring about those changes, and I have highlighted a number of those changes in my written testimony, but in the limited amount of time we have here, if I could focus on just one area, I would like to talk a little bit about something Mr. Duffy mentioned, and that is the daily confirmation process for segregated funds.

At NFA, we have always required FCMs to file daily reports with us showing the amount of customer funds that they are holding. We monitor those reports. We look at them. We are trying to monitor not only compliance with the rules, but also looking for trends or dramatic changes that might be troubling.

In 2012—I should mention, the confirmation process was—we would confirm those balances that we got on the daily reports as part of the annual examination process, and we did that confirmation through the traditional methodology. We would send a written confirmation request to the bank, and then the bank would mail a written response to NFA.

In 2012, we started using an electronic confirmation process, an e-confirmation process, and that is essentially what uncovered the fraud at Peregrine. But even then with the e-confirmation process, that was still being done only as part of the annual examination, and we knew we had to do better, and so we have done better. We have partnered with the CME and together, we have developed and implemented a system that requires the daily confirmation of all seg bank balances. We still have FCMs that file reports daily with the CME and with NFA showing the amount of customer funds

that they are holding, but now we get daily confirmation from the banks regarding those same accounts. We are talking about over 2,300 bank accounts which are being confirmed on a daily basis by NFA and the CME. We then do an automated comparison between what the FCM is saying and what the bank is showing so that we can identify any suspicious deviations.

We are expanding that system further. We are expanding it to cover not just banks, but other depositories holding customer's segregated funds, such as clearinghouses and other clearing FCMs, and that expansion should be done by the end of the third quarter.

Mr. Chairman, I wanted to spend some time on it, because it is a really big deal. This is a huge improvement. This is a giant step in the way we monitor for seg compliance, and we are a better industry because of it.

The one other topic I wanted to discuss orally has to do with, again, a topic Mr. Duffy touched on, which is the customer account insurance. In the wake of MF Global and Peregrine, there have been calls for customer account insurance in the futures industry. Some people think we need some form of insurance to bolster public confidence. Well obviously, public confidence is a very important ingredient. It is essential to having the sort of liquid markets that make efficient markets, and we recognize that. Others, though, are concerned that the cost of the insurance would be so exorbitant that you would actually drain liquidity out of the markets and you would be doing more harm than good. I understand those concerns, too. In our view at NFA, we felt this issue was too important to be decided based on a hunch, that we needed real information and real data, and so we, as Terry has said, we have partnered with the CME and FIA and the Institute for Financial Markets. We have commissioned a consultant with deep expertise in the insurance industry and in the futures industry. He is analyzing several different insurance scenarios, and we have been providing him with very detailed, granular information about the account populations at 11 different FCMs, ranging in size from small to medium to large, and armed with that information, he can then go out and actually get prices from people in the insurance and reinsurance industry so that this Committee can ultimately have real information and make a more informed choice as to whether account insurance would work for this industry or whether it would do more harm than good.

As this process goes forward, Mr. Chairman, we certainly look forward to working with Congress and the Commission and others, and try to continue the improvements that we are making in the regulatory structure here for the futures industry, and I would be happy to answer any questions.

Thank you.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Thank you, Mr. Chairman. My name is Daniel Roth and I am the President of National Futures Association. As Congress begins the reauthorization process, customer protection issues should be front and center in everybody's mind. Customer protection is the heart and soul of what we do at NFA, and for years the futures industry had an impeccable reputation for safeguarding customer funds. Since Con-

gress last considered reauthorization, though, that reputation has taken a serious hit. First at MF Global and then at PFG, customers suffered very real harm from shortfalls in customer segregated funds, the kind of harm that all regulators seek to prevent. Clearly, dramatic improvements had to be made. In the wake of MF Global and PFG, NFA has worked very closely with the CME, other self-regulatory organizations and the CFTC to bring about those improvements. Let me start by highlighting the steps we have already taken.

Daily Confirmation of Segregated Account Balances

For years NFA and other SROs confirmed FCM reports regarding the customer segregated funds held by the FCM through traditional paper confirmations mailed to the banks holding those funds. These confirmations were done as part of the annual examination process. In early 2012 NFA began confirming bank balances electronically through an e-confirm process. That change led to the discovery of the fraud at PFG, but e-confirms were still done as part of the annual examination. We had to find a better way and we did.

We partnered with the CME and developed a process by which NFA and the CME confirm all balances in all customer segregated bank accounts on a daily basis. FCMs file daily reports with NFA and the CME, reflecting the amount of customer funds the FCM is holding. Through a third party vendor, NFA and CME get daily reports from banks for the over 2,000 customer segregated bank accounts maintained by FCMs. We then perform an automated comparison of the reports from the FCMs and the reports from the banks to identify any suspicious discrepancies. In short, Mr. Chairman, the process by which we monitor FCMs for segregated fund compliance is now far ahead of where it was just 1 year ago.

We are working with the CME to expand this system to also obtain daily confirmations from other types of depositories, such as clearing firms and clearinghouses. That expansion should be complete by the fourth quarter of this year.

Customer Account Insurance

In light of the failures of MF Global and PFG there have been renewed calls for some form of customer account insurance. As we begin this discussion, we should bear in mind three points. First, customer account insurance can take many forms. There are alternatives to the SIPC, government sponsored model. Private insurance solutions can take several forms in terms of who is covered and to what extent. Second, public confidence in the markets is critical, but it is a means to an end. The real goal is to ensure that futures markets are effective and efficient and a benefit to the economy. Markets must therefore be liquid and that requires public confidence. However, attempting to bolster public confidence through insurance programs that prove to be cost prohibitive is self-defeating and would damage the liquidity we are trying to foster. Finally, this question is too important to be dismissed out of hand because various forms of insurance might be too expensive.

We need data, not hunches. We need to know what kind of insurance we would be buying and what we would be paying for it. Only then can Congress make an informed decision. With this in mind, NFA has joined with the CME, FIA and the Institute for Financial Markets to commission a detailed analysis of various alternative approaches to customer account insurance. Armed with detailed customer account information from small, medium and large FCMs, the study will calculate the estimated costs of each of the alternatives studied. We hope to have the results of the study in June.

FCM Transparency

One of the lessons we learned from MF Global is that customers should not have to study the footnotes to an FCM financial statement to find out how their segregated funds are invested or other financial information about their FCMs. We had to make it easier for customers to do their due diligence on financial information regarding FCMs. We now require all FCMs to file certain basic financial information with NFA, and that information is then posted on NFA's website for customer review. The information includes data on the FCM's capital requirement, excess capital, segregated funds requirement, excess segregated funds and how the firm invests customer segregated funds. This information is displayed for each FCM and includes historical information in addition to the most current data. The display of FCM financial information on NFA's website began in November 2012 and so far these web pages have received over 15,000 hits.

MF Global Rule

All FCMs maintain excess segregated funds. These are funds deposited by the FCM into customer segregated accounts to act as a buffer in the event of customer defaults. Because these funds belong to the FCM, the FCM is free to withdraw the

excess funds, but after MF Global, NFA and the CME adopted rules to ensure notice to regulators and accountability within the firm. Now all FCMs must provide regulators with immediate notification if they draw down their excess segregated funds by 25% in any given day. Such withdrawals must be approved by the CEO, CFO or a financial principal of the firm and the principal must certify that the firm remains in compliance with segregation requirements. This rule became effective on September 1, 2012.

FCM Internal Controls

NFA, CME and other SROs developed more specific and stringent standards for the internal controls that FCMs must follow to monitor their own compliance with regulatory requirements. NFA has drafted an interpretive notice that contains specific guidance and identifies the required standards in areas such as separation of duties; procedures for complying with customer segregated funds requirements; establishing appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance. NFA will submit the interpretive notice to the CFTC shortly for its review and approval.

Review of NFA Examination Procedures

NFA's Special Committee for the Protection of Customer Funds—consisting of all public directors—commissioned an independent review of NFA's examination procedures in light of the PFG fraud. The study was conducted by a team from the Berkeley Research Group ("BRG") that included former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff fraud. BRG's report was completed in January 2013. The report stated that "NFA's audits were conducted in a competent manner and the auditors dutifully implemented the appropriate modules that were required." The report, however, also included a number of recommendations designed to improve the operations of NFA's regulatory examinations in the areas of hiring, training, supervision, examination process, risk management, and continuing education. NFA has already taken a number of steps to implement BRG's recommendations. A Special Committee appointed by NFA's Board will oversee the timely implementation of these recommendations.

Both the PFG and MF Global bankruptcies highlighted the need for greater customer protections to not only guard against the loss of customer funds but also in the event of an FCM's insolvency. As discussed above, NFA has made and continues to implement changes to enhance the safety of customer segregated funds and guard against a shortfall in customer funds in the event of any future FCM failures.

NFA believes, however, that Congress should consider a number of possible changes to Bankruptcy Code provisions that govern an FCM's liquidation that would likely strengthen customer protections and priorities in the event of a future FCM bankruptcy. We fully recognize that any changes to the Bankruptcy Code regarding FCM insolvency protections will not be easy to achieve. Yet we strongly believe that the two recent FCM failures have highlighted the need for enhanced customer protections that can only be achieved via changes to the Bankruptcy Code.

We are in discussions with all facets of the industry to arrive at a consensus view on changes that should be made. Chief among NFA's concerns in this area is removing the uncertainty over the validity of the CFTC's definition of customer property. Other issues may include reviewing whether it is appropriate that all joint FCM/broker-dealer bankruptcies be administered under SIPA.

Detecting and combating fraud is central to our mission. No system of regulation can ever completely eliminate fraud, but we must always strive for that goal. The process of refining and improving regulatory protections is ongoing and the initiatives outlined above do not mark the end of our efforts. We look forward to working with Congress, the CFTC, SROs and the industry to ensure that customers have justified confidence in the integrity of the U.S. futures markets.

Mr. CONAWAY. Thank you, Mr. Roth.

Mr. Lukken for 5 minutes.

STATEMENT OF HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. LUKKEN. Thank you, Mr. Chairman, Ranking Member Peterson, and other Members of the Committee. I appreciate the opportunity to testify today. My name is Walt Lukken. I am the Presi-

dent and CEO of the Futures Industry Association. FIA is the leading trade association for the futures, options, and over-the-counter cleared derivatives markets. FIA's mission since its inception has been "to protect the public interest through adherence to high standards of professional conduct and financial integrity."

As you know, clearing is an integral part of the futures market structure. Clearing ensures that parties to a transaction are protected from a failure by a counterparty to perform its obligations. The FCMs that FIA represents play a critical role in guaranteeing the transactions and ensuring they are secured with appropriate customer margin to facilitate the clearing process.

As you know, the failures of MF Global and Peregrine Financial Group resulted in severe and unacceptable consequences for futures customers and the markets generally. The entire industry has been working collaboratively to identify and improve procedures required to better protect the integrity of the markets, and much has been accomplished over the last year. FIA formed a customer protection task force in the aftermath of these insolvencies and recommended a number of changes that have been adopted by the regulators. Some of the highlights include the enhancement of FCM record-keeping, reporting, and early warning indicators, including the filing of daily segregation balances with regulators, creating of an automated daily verification, as Mr. Roth has mentioned, for customer segregation balances directly with banks, and other depository institutions, the collection and posting of additional FCM financial information to NFA's online system, Basic, to help customers monitor and assess the health of their FCM, just to name a few.

The Committee may also be interested to know that, as mentioned before, that FIA and CME, the IFM, and NFA have joined together to fund a study of the costs and benefits of various insurance proposals, and we look forward to sharing the findings of this with the Committee when they are available early this summer.

In addition to the efforts undertaken by the industry, the CFTC has recently proposed a set of comprehensive regulations to further enhance customer protection, and we support much of what have been suggested in this rulemaking, including the codification of many of FIA's recommendations. However, the proposed change related to residual interest drastically reinterprets the longstanding application of the statute regarding customer margin collections, and will make trading significantly more expensive for customers hedging their commercial risks. Specifically, this reinterpretation would require FCMs in collecting customer margin to assume all customer margin call deficits are simultaneously not collected, requiring either customers to prepay their margin or firms to fund customer margins on their behalf. When the proposal was released by the Commission, the Commission did not conduct a cost-benefit analysis because it did not have adequate information to determine the costs of this reinterpretation. As such, FIA engaged in its own cost analysis, estimating that this change would require an additional $100 billion in customer margin. Many agricultural customers have expressed strong concerns with this proposal, which will increase the cost of hedging, cause consolidation among small FCMs, and limit execution choices for customers. We believe this

part of the CFTC rule warrants further review before changing the existing interpretation.

Moving to swap clearing, Congress looked to the reliability and stability of the clearing system for futures when it determined to extend clearing for swaps under the Dodd-Frank Act. To date, much of the debate surrounding the implementation of the swap clearing requirement under Dodd-Frank has been focused on what products and entities might be subject to the mandatory clearing requirement, rather than how the operations and mechanics of clearing would work for swaps. Unfortunately, the reality is that the rules being written to facilitate the clearing for swaps are reinventing the already proven clearing process that is familiar and well-tested for futures, thereby creating an overly complicated web of regulations for both swaps and futures. Even those entities in the existing futures clearing environment are being forced to seek temporary relief from the new regulation while they sort through compliance issues. Without such relief, market participants face the reality of either shutting down existing commercial activity, or inadvertently being out of compliance as they seek to implement ambiguous, confusing, or misaligned regulations.

Also of concern is the manner in which the needed relief is being granted. Relief is either commonly provided at the very last minute, causing disruption for customers in both the futures and the swap markets, or causing tremendous resources to be wasted while market participants prepare and wait for a last-minute action.

While the industry appreciates the opportunity to seek temporary relief in these circumstances, what necessitates this relief and the manner in which this relief is granted remains troubling.

With that, Mr. Chairman, I will end my testimony. Thank you very much.

[The prepared statement of Mr. Lukken follows:]

PREPARED STATEMENT OF HON. WALTER L. LUKKEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Chairman Lucas, Ranking Member Peterson, and Members of the Committee, thank you for the opportunity to provide our perspective on matters affecting the derivatives industry and in particular the regulation of our markets by the Commodity Futures Trading Commission (CFTC). As you turn your attention to reauthorizing the CFTC, the Futures Industry Association (FIA) stands ready to assist in any way we can. FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes derivatives clearing firms, traders and exchanges from more than 20 countries. FIA's core constituency consists of futures commission merchants, commonly known as FCMs, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions.

As you know, clearing has long been an integral part of the futures market structure. Clearing ensures that parties to a transaction are protected from a failure by the opposite counterparty to perform their obligations, and the FCMs that FIA represents play a critical role in ensuring that transactions are secured with appropriate margin to facilitate this clearing process.

Improving Customer Protection

I would like to take this opportunity to update the Committee on recent efforts to improve the handling of customer funds, or what is often called margin or collateral. As you know, the failures of MF Global Inc. and Peregrine Financial Group resulted in severe and unacceptable consequences for futures customers and the

markets generally. The entire industry has been working collaboratively to identify and improve procedures required to better protect the integrity of these markets. A number of changes are already being implemented, many of which were recommended by FIA in the aftermath of these insolvencies: [1]

- The National Futures Association (NFA) and the CME Group (CME), the industry's principal self-regulatory organizations, have adopted rules that subject all FCMs to enhanced record-keeping and reporting obligations. For example, chief financial officers or other appropriate senior officers are now required to authorize in writing and promptly notify the FCM's DSRO whenever an FCM seeks to withdraw more than 25 percent of its excess funds from the customer segregated account in any day—these are funds deposited by the FCM into customer segregated accounts to guard against customer defaults.
- NFA and CME have begun building an automated system for the daily monitoring of all customer segregated, secured, and cleared swaps amounts held by FCMs. As part of this project, NFA and CME contracted with AlphaMetrix360, a subsidiary of AlphaMetrix Group, to aggregate the data on customer segregated, secured, and cleared swaps amount accounts. The new system will allow NFA and CME to run an automated comparison of the balances in customer segregated, secured, and cleared swaps accounts at the depositories with the daily reports they receive from FCMs, and then quickly identify any discrepancies.
- NFA is also collecting additional financial information from FCMs and posting that information on its online Background Affiliation Status Information Center (Basic) system, a key step in giving customers the tools they need to monitor the assets they deposit with their FCMs. The new service provides the public with access to specific information about an FCM, such as the firm's adjusted net capital, the amount of funds held in segregated, secured, and cleared swaps accounts, and the types of investments that the FCM is making with those customer funds.
- It is my understanding that NFA is in the process of drafting an interpretive notice that contains specific guidance and identifies the minimum required standards for FCM internal controls such as separation of duties; procedures for complying with customer segregated and secured amount funds requirements; establishing and complying with appropriate risk management and trading practices; restrictions on access to communication and information systems; and monitoring for capital compliance.
- A set of frequently asked questions on customer funds protection [2] has also been developed by FIA, which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets.
- Additionally, FIA, CME Group, NFA, and the Institute for Financial Markets have partnered to fund an evaluation of the costs and benefits of various asset protection insurance proposals. We look forward to sharing these findings with the Committee when available.

In addition to the efforts undertaken by the industry, the CFTC has recently proposed a set of comprehensive regulations to further enhance customer protection. To a significant extent, the proposed rules build upon and codify the recommendations that FIA made and rules that the NFA and CME adopted in early 2012. FIA strongly endorses the regulatory purposes underlying the proposed amendments. We nonetheless submitted an extensive comment letter designed, in substantial part, to assist the Commission in striking an appropriate balance among its several proposals to assure that the producers, processors and commercial market participants that use the derivatives markets to manage the risks of their businesses will be able to continue to have cost-effective access to the markets and a choice of FCMs. In particular, the proposed change related to residual interest drastically re-interprets the long-standing application of the statute and will result in a tremendous drain on liquidity that will make trading significantly more expensive for customers hedging their financial or commercial risks, and will adversely affect the ability of many FCMs to operate effectively. The current interpretation was essential to the performance of the futures industry during the 2008 crisis and its application is not

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[1] See Futures Industry Association, Futures Markets Financial Integrity Task Force—Initial Recommendations for Customer Funds Protection: *http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf.*

[2] See Protection of Customer Funds, Frequently Asked Questions: *http://www.futuresindustry.org/downloads/PCF-FAQs.PDF.*

related to the shortcomings identified after the recent failures. When the proposal was released the Commission did not have adequate information to determine the costs of the modified residual interest requirement.[3] As such, FIA engaged an accounting consultant to sample FCMs on the potential costs of the residual interest proposal; the results show that this change could require an additional $100 billion obligation to the customer funds accounts, beyond the sum required to meet initial margin requirements. Many of the very customers this proposal is designed to benefit have expressed concerns as they rightfully realize this will significantly increase the costs of hedging and likely have the largest impact on small to mid-sized FCMs which could potentially lead to consolidation and fewer choices for them as customers. As previously mentioned, the FIA supports many of the customer protection measures that the Commission has proposed, we simply believe this one in particular warrants further review as to why the existing statutory interpretation should be changed.

The FIA is very engaged in the development of industry and Commission-initiated efforts to proactively address many of the issues presented by these recent failures. While the derivatives industry is strong, and clearing continues to be the gold standard in protecting market participants from the unexpected failure of a counterparty, we have learned that the collateral necessary for a robust clearing system, and the customers who post such margin, are better protected through enhanced disclosures, reporting, and internal controls. Our members commit a substantial amount of their own capital to guarantee customer transactions. We have every incentive to ensure that the integrity of the derivatives clearing system is well-regarded as safe and reliable.

Clearing Under the "Dodd-Frank Act"

Under the "Dodd-Frank Act", Congress determined to extend clearing beyond futures to swaps, and as such the role of the FCM has also expanded. Because FCMs play a critical role in achieving the newly-established clearing regime for swaps, we are happy to offer our thoughts on the implementation of these requirements.

To date, much of the debate surrounding the implementation of the swaps clearing requirements under the "Dodd-Frank Act" has been focused on who, what, when and where, rather than how. Often, public attention to Title VII implementation has been devoted to what products will be subject to the clearing mandate; who will be expected to comply with the mandate; when they will be expected to comply; and where, within the global markets, the products and participants will be regulated—all very important questions, but far less discussion has been devoted to how the mechanics of clearing are being impacted. This is probably a result of the fact that as the legislation was being constructed there were very few questions about how the actual act of clearing swaps would work—I believe most assumed that the process already established for futures would simply be applied to swaps. Certainly, the regulatory policies that have historically existed for clearing futures can largely be applied to swaps, with the occasional exception necessitated by the fact that swaps and futures have evolved in different environments. Unfortunately, the reality is that the rules being written to facilitate the clearing of swaps are in some cases reinventing the already proven clearing process that is familiar and tested for futures, thereby creating an overly-complicated web of regulations for both swaps and futures. Even those who have for many years operated within the existing futures clearing environment are being forced to seek temporary relief from the new regulations while they sort through compliance options. Without such relief, market participants face the reality of either shutting down existing commercial activity or inadvertently being out of compliance as they seek to implement confusing regulations.

Also of concern is the manner in which the needed relief is being granted. Relief is commonly provided at the very last minute causing disruptions for customers in both the futures and the swaps markets and causing tremendous resources to be wasted while market participants prepare and wait.

While the industry appreciates the opportunity to seek temporary relief in these circumstances, what necessitates this relief and the manner in which the relief is granted remain troubling. Let me be clear, we support properly designed and effective clearing rules. Our members provide the majority of the funds that support derivatives clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions. We have every incentive to ensure that the actual process of clearing derivatives—both futures and swaps—is properly regulated.

However, at this critical juncture, when the newly required clearing mandate for swaps is beginning to take effect, we are concerned that so much complexity and

[3] See 77 *FR* 67916.

disorder exists especially given the existence of rules that have long governed the clearing of futures. FCMs stand ready and willing to facilitate the clearing of swaps, just as they have for futures, but the wide-spread confusion as to the mechanics of clearing under these new regulations may be hindering the process.

State of the Derivatives Industry

I want to take some time to update you on the general state of the derivatives industry. As the swaps market developed and Congress, through the "Dodd-Frank Act", determined that certain swaps are now likely suitable for the clearing protections that have long been required for futures, some have claimed that there is regulatory arbitrage occurring, with futures and swaps competing against each other. I believe that most market participants welcome the broadened array of products available in a cleared environment and will continue to use both swaps and futures products to meet their individual risk management needs as appropriate. And as these products continue to evolve, so will their demand. That is the nature of the derivatives industry which has long been dynamic.

In 2012, the total number of futures and options contracts traded on exchanges worldwide dropped by 15.3%. However, overall trading and clearing volumes have risen over the past 10 years. Even before the clearing mandate for certain swaps and swap market participants took effect in March, the volume of swaps submitted voluntarily for clearing was up in January:

- LCH.Clearnet experienced a major surge in interest rate swap clearing, with volume exceeding $55 trillion in notional value in January, an all-time high.
- CME Group also saw all-time highs in interest rate swap clearing, with January volume of more than $250 billion notional cleared and $750 billion in open interest.
- The notional volume of credit default swaps cleared by ICE Clear Credit totaled $400 billion in January.

As the clearing mandate took effect in March for swap dealers, major swap participants and active funds the infrastructure responded relatively well—as noted many of these entities had been engaged in voluntary clearing efforts prior to the March date. It should be noted that the next effective date of June 10 will bring in many more participants and will likely present many more challenges to the new regulatory regime. Given the timing, these implementation challenges will likely become apparent and coincide with the Committee's consideration of the CFTC reauthorization—I encourage you all to continue your long-standing tradition of bipartisan oversight as you focus on these issues absent political pressure.

I am fortunate to represent a wide array of stakeholders in the derivatives industry—all of whom want to see this industry continue to support the risk management needs of its customers in a productive way. This is a goal I know the Members of this Committee share and I look forward to working with you as you consider the CFTC's role in achieving this mutual objective.

Mr. CONAWAY. Thank you, Mr. Lukken.

Now Mr. O'Connor for 5 minutes.

STATEMENT OF STEPHEN O'CONNOR, CHAIRMAN, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Mr. O'CONNOR. Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to testify today.

In the 5 years since the onset of the financial crisis, significant progress has been made in building a more robust financial system and safer, more transparent, over-the-counter derivative markets. ISDA squarely supports these initiatives and regulatory reforms designed to improve systemic resiliency, and ISDA has been working hard alongside regulators to implement those reforms.

However, improvements can and should be made the regulatory reform process. Contrary to Congress' stated intentions, the Dodd-Frank Act contains provisions that could actually increase, rather than decrease, systemic risks. Such provisions include the law's

Section 716, swaps push-out provision, and also the requirement for mandatory initial margin for OTC derivative transactions. The rationale for and value of these provisions are uncertain, but what is certain is that such provisions will impose significant costs and drags on the economy without any clear countervailing benefits.

We also have concerns with regard to the interpretation and implementation of the Act by the CFTC and the SEC. In some cases, sections of the law are being construed differently by the two regulators; in others, regulators are interpreting and implementing the laws in ways that do not reflect the intent of Congress. For example, there are significant risks that the goal of increased regulatory transparency is being undermined by the fragmentation of derivatives trade reporting. U.S. regulators and their international counterparts have failed to reach agreements on the implementation of key regulations, and lack of international coordination and jurisdictional overreach has created barriers to international capital flows and to international commerce.

Here in the United States, the CFTC and the SEC have taken different approaches to the cross-border application of derivative laws, which can seriously impact market liquidity and the competitiveness of U.S. firms in the global economy. The two U.S. regulators also have different interpretations of the law's trade execution requirements, which could lead to bifurcated market practices, and the law's business conduct standards are being applied in a very prescriptive manner, not envisioned by legislators, adding unnecessary costs and complexity to the system. And in some instances, the cost-benefit analysis required under the law is not being appropriately conducted, which could result in the imposition of rules that wind up doing more harm than good. In these and in other areas, there is significant concern that the law will be inconsistently and inappropriately applied.

It is vitally important that we, industry and regulators, focus our resources on those aspects of regulatory reform that address the most important issue: reducing systemic risk. This includes capital, central clearing, and variation margin frameworks as well as regulatory transparency. It is vitally important to avoid enacting measures that harm liquidity or reduce systemic resiliency in the very markets they are trying to protect, resulting in a direct and harmful impact on the economy. This is particularly critical given the slow and uneven growth of the U.S. and the broader global economy.

Dodd-Frank is an important step forward for our country and our markets, and the CFTC deserves our sincere appreciation and support for its efforts in implementing wide-ranging provisions in a relatively short period of time. It is clear, however, that our experience over the past several years has shown that not all of the law's provisions are appropriate and contribute to the overriding goal of a safer financial system, and some efforts by the regulators to implement the law are inconsistent with the intent of Congress, are being interpreted in different ways by different agencies, or impose costs that far exceed any resulting benefits.

In light of these concerns and observations, ISDA respectfully requests this Committee to, first, consistent with H.R. 1256, stress to the CFTC the necessity of applicable, prudent interpretation of the

law, including in the area of margin, and work closely with the industry to adopt financial regulations that ensure the safety of markets, but regulations that do not harm market liquidity or harm market participants, and second, urge the SEC and the CFTC to harmonize their cross-border approach as soon as possible so that U.S. regulators first speak with one voice, and then engage together proactively in the ongoing global debate on international harmonization, since proper global coordination is essential to ensure the competitiveness of the U.S. markets, U.S. businesses, and the U.S. economy.

Thank you.

[The prepared statement of Mr. O'Connor follows:]

PREPARED STATEMENT OF STEPHEN O'CONNOR, CHAIRMAN, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Chairman Lucas, Ranking Member Peterson, and Members of the Committee: Thank you for the opportunity to testify today.

In the nearly 5 years since the onset of the financial crisis, significant progress has been made in building a more robust financial system and a safer, more transparent over-the-counter (OTC) derivatives markets. Rule-making is effectively a two stage process. First, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) created a legal framework for reform, and then the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) have been charged with responsibility for creating market rules, effectively the implementation of the Act. Through this mechanism, a great deal of progress has been made towards a safer more robust financial system.

However, improvements can and should be made at both stages of this process. Contrary to Congress' stated intentions, the Dodd-Frank Act contains provisions that could actually increase, rather than decrease, systemic risk. This includes, for example, the law's Section 716 swaps push-out provision and also the requirement for mandatory initial margin for derivatives transactions. The rationale for, and value of, these provisions are uncertain. What is certain is that such provisions will impose significant costs and drags on the economy, without any clear countervailing benefits.

We also have concerns with regard to stage two, the interpretation and the implementation of the Act by the CFTC and the SEC. In some cases, different sections of the law are being construed differently by the different regulators. In others, regulators are interpreting and implementing the laws in ways that do not reflect the intent of Congress. For example:

- There is a significant risk that the goal of increased regulatory transparency is being undermined by the fragmentation of derivatives trade reporting;
- The CFTC and the SEC have taken different approaches to the cross-border application of derivatives rules, which could seriously impact market liquidity and the competitiveness of U.S. firms in the global economy;
- The two U.S. regulators also have different understandings of the law's trade execution requirements, which could lead to bifurcated market practices;
- The law's business conduct standards are being applied in a very prescriptive manner not envisioned by legislators, adding unnecessary costs and complexity to the system; and
- In some instances, the cost-benefit analysis required under the law is not being appropriately conducted, which could result in the imposition of rules that wind up doing more harm than good.

In these and other areas, there is significant concern that the law will be inconsistently and inappropriately applied. This could increase rather than decrease risk, raise costs and prevent the sound application of risk management practices that are essential to the proper functioning of markets and to a healthy, productive American economy.

I will address each of these points in more detail, but before I do, it's important to state quite clearly: The International Swaps and Derivatives Association squarely supports financial regulatory reform that is designed to build a strong, safe financial system, reduce systemic risk, decrease counterparty credit risk and improve regulatory transparency. This, indeed, is our mission: to foster safe and efficient deriva-

tives markets for all users of derivatives products. ISDA has worked for 25 years on measures such as the significant reduction of credit and legal risk by developing a framework of legal certainty which includes the ISDA Master Agreement and related standardized collateral agreements. The Association has also been a leader in promoting sound risk management practices and processes and has for 12 years been a strong advocate of the appropriate use of central clearinghouses

Today, ISDA has more than 800 members from 60 countries on six continents, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, as well as international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. The Association's broad market representation is further reflected by the number of non-dealer firms on our board of directors and their representation on key ISDA committees.

ISDA believes that the most effective way to achieve the goal of greater systemic resiliency is through a regulatory framework that includes: appropriate capital standards, mandatory clearing requirements where appropriate, robust collateral requirements and mandatory trade reporting obligations. We have worked actively and are engaged constructively with policymakers in the U.S. and around the world on these important initiatives. Great strides have been made in all of these areas.

For example, trade repositories have been established covering derivatives in all major asset classes—interest rates, credit, equities, commodities and foreign exchange. Regulators around the world now have comprehensive access to information about trading activity in the derivatives market. Regulators will now be able to readily identify where risk may be building up in the system as well as detect improper behavior, observe transaction flows and identify trends in liquidity in the OTC markets. However, as discussed in greater detail below, significant work remains to ensure that this information is completely visible to regulators and a major opportunity is not lost.

With regard to clearing of derivatives through central counterparties, nearly ⅔ of the interest rate swap market is already centrally cleared, largely due to voluntary initiatives and commitments by banks to global regulators in advance of the Dodd-Frank Act required mandates. Clearing will increase significantly in the next twelve to twenty-four months as trades between dealers and their clients become subject to mandatory clearing, which began in the U.S. in March 2013.

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Let me turn briefly to what we believe are two of the most significant areas of the Dodd-Frank Act that could benefit from action by Congress: the swaps push-out provision and the initial margin requirements.

Section 716 Swaps Push-Out Provision

The Dodd-Frank Act's Section 716, commonly called the "Swap Push-Out" provision, requires banks to separate and segregate portions of their derivative businesses, including equity derivatives, certain CDS and commodity derivatives transactions, outside of entities that receive Federal assistance, including the Federal deposit insurance program or access to the Federal Reserve's discount window. These activities would have to be conducted in separately capitalized affiliates, legally apart from entities such as FDIC-insured banks. We should also note that, due to a drafting error, certain non-U.S.-based firms with significant U.S. operations and U.S. employees could be harmed further, as they would not be able to take advantage of certain statutory exemptions contained in Section 716.

While the ostensible purpose of Section 716 is to reduce risk, forcing derivatives activities outside of a better-capitalized, better-regulated bank into new standalone subsidiaries could actually increase risk to the system. This perverse outcome has been noted by the FDIC, Federal Reserve, former Treasury Secretary Geithner and even former Federal Reserve Chairman Paul Volcker. Section 716 will also lead to greater inefficiencies and the loss of exposure netting as it requires firms to conduct swaps across multiple legal entities.

There are other disadvantages to Section 716 as well. It will tie up additional capital that might better be used to support investment, and create higher funding and operational costs for the financial institutions that are required to implement it.

Those financial institutions currently include only firms doing business in the U.S., as there is no similar law or regulation in place in any major foreign jurisdiction. These firms will be at a competitive disadvantage to their non-U.S. counterparts. American customers of these firms would therefore face higher costs, or will

seek out lower cost non-U.S. firms to assist with their risk management initiatives and transactions.

Customers will also need to evaluate the strength and capital of each Section 716 subsidiary that they may do business with, rather than that of the parent company, which will also impact these subsidiaries' competitiveness. Section 716 also complicates the ability of financial institutions to net their exposures and to manage their risks most efficiently.

Due to the above noted issues, ISDA has expressed support for H.R. 992, legislation passed by this Committee and the Financial Services Committee.

Initial Margin Requirements

The Dodd-Frank Act adds section 4s(e) to the Commodity Exchange Act to address capital and margin requirements for swap entities.

ISDA and the industry support the intent of global policymakers to develop a regulatory framework that improves the safety of the global over-the-counter derivatives markets, and further recognize the need for robust variation margin requirements, particularly for systemically important firms. That said, we harbor grave concerns regarding Dodd-Frank's initial margin (IM) requirements.

IM is designed to cover the replacement costs if a counterparty defaults. It is an extra payment made between parties in excess of amounts owed, and as such, it improves the situation of the non-defaulting party.

While initial margin has benefits, it is important to understand the very real and very significant costs that it would impose. Depending on how IM requirements are developed and implemented:

- The initial margin requirement has the potential to significantly strain the liquidity and financial resources of the posting party;
- In stressed conditions, the initial margin requirements will result in greatly increased demand for new funds at the worst possible time for market participants; and
- The initial margin requirements could cause market participants to reduce their usage of non-cleared OTC derivatives and: (1) choose less effective means of hedging, (2) leave the underlying risks unhedged, or (3) decide not to undertake the underlying economic activity in the first instance due to increased risk that cannot be effectively hedged.

Perhaps most importantly, we do not believe that initial margin will contribute to the shared goal of reducing systemic risk and increasing systemic resilience. When robust variation margin practices are employed, the additional step of imposing initial margin imposes an extremely high cost on both market participants and on systemic resilience with very little countervailing benefit.

The Lehman and AIG situations highlight the importance of variation margin. AIG did not follow sound variation margin practices, which resulted in dangerous levels of credit risk building up, ultimately leading to its bailout. Lehman, on the other hand, posted daily variation margin, and while its failure caused shocks in many markets, the variation margin prevented outsized losses in the OTC derivatives markets.

While industry and regulators agree on a robust variation margin regime including all appropriate products and counterparties, the further step of moving to mandatory IM does not stand up to any rigorous cost-benefit analysis.

We recognize that it would take Congressional action to amend the Act and the IM requirement. In the absence of such amendment, we believe it imperative that the regulators implement the IM requirement in a prudent way that does not introduce overwhelming costs, reduce liquidity and directly harm the U.S. economy.

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Moving to further comments on implementation, as noted above, there are challenges related to an inconsistent interpretation of the law, and an interpretation that does not reflect the original intent of the legislation.

Swap Data Repositories

Perhaps the most important of these issues is related to fragmentation of trade reporting by OTC derivatives markets participants.

One of the major lessons learned of the financial crisis is the need for regulators and supervisors to have clear and comprehensive access and insights into the level and type of risk exposures at financial institutions and their counterparties. One of the most important achievements of policymakers and market participants in the past 5 years has been the establishment of global trade databases, or swaps data repositories, that accomplish this goal. Such repositories have been built for all

major derivatives asset classes. The level of information they contain is unparalleled in the global financial markets.

This progress is now at risk. Because of current regulatory interpretation regarding collection and reporting of cleared trades, it seems likely that there will not be one central information warehouse that collects all derivatives market data. This data could be splintered into multiple warehouses. If this happens, then regulators would essentially be forced to follow their previous, pre-crisis practices. They would have to go from repository or repository to collect and to attempt to aggregate exposures, just as they used to go from firm to firm for data. Such attempts to aggregate will be near-impossible if fragmentation really takes hold. Systemic risk would not be reduced. Regulatory visibility and the ability to identify where risk is building up in the system would be fatally impaired.

A fantastic opportunity will have been missed. The amount and completeness of information that could be available to regulators is unprecedented in global financial markets. For no other financial instrument, in any asset class, has there ever been a way for authorities to access a complete database of the entire global transaction population.

Cross-Border Application of Rules

Concerns are also growing about the potential application, impact and consistency of the U.S. regulatory framework in other jurisdictions. This was most recently and pointedly evidenced by the April 18 letter from finance officials representing nine of the world's largest countries—imploring Treasury Secretary Lew to limit the cross-border reach of Dodd-Frank Act swaps rules. These issues are raising the prospect that market participants will be subject to duplicative and/or contradictory regulatory mandates from the EU and other non-U.S. jurisdictions that would impose significant costs, fragment market liquidity and potentially create an uneven playing field. As the letter states, "An approach in which jurisdictions require that their own domestic regulatory rules be applied to their firms' derivatives transactions taking place in broadly equivalent regulatory regimes abroad is not sustainable."

ISDA and our members believe that a globally harmonized approach to cross-border regulation is of paramount importance. What they face now is considerable uncertainty. Uncertainty is never a good thing in financial markets, as there are typically only two things to do in face of that uncertainty. One response is to pull back and wait until such time as greater certainty is provided. On a firm level, that means missed opportunity. On a market level, that translates to less efficient, less liquid and more volatile markets, material harm to financing and investing activities and a drag on the economy in general.

The other response is to try to anticipate various possible results. This can lead to costly, duplicative efforts with no guarantee that all that planning will prove effective once the rules are finalized.

Either path runs the risk of undermining the safe, efficient markets that ISDA, regulators and the industry all desire.

To achieve the goal of a globally harmonized framework, the CFTC and SEC should work together to achieve consensus with global regulators. H.R. 1256 would help the U.S. regulators to provide a unified front when addressing the extraterritorial application of U.S. rules and when dealing with non-U.S. regulators. Harmonization of regulatory approaches, particularly on issues with systemic risk implications, and a concerted program of mutual recognition of regulatory regimes by global regulators are essential parts of the solution to ET.

Trade Execution Requirements

The inconsistent interpretation of the law by the CFTC and the SEC is apparent in the recently finalized CFTC swap execution facility (SEF) requirements which mandate initially two, and later three, requests for quotes (RFQs).

To our knowledge, no objective or empirical evidence exists as to why multiple RFQs are beneficial to the market and no research has been done to this effect. In fact, ISDA's members from the buy-side community have expressed concern that a multiple-RFQ model will harm, rather than help, their execution.

For example, the CFTC rule may result in increased transaction costs, and in an ISDA survey of the buy-side, 70 percent of respondents indicated they would migrate to other markets if required to post multiple RFQs. In fact, 76 percent indicated it would have a negative effect on liquidity.

Many buy-side firms have very serious concerns about being forced to request a quote from more than one dealer because that can cause a signaling effect, exposing their investment strategy to multiple market participants. A provision that has been put forth as a benefit for end-users is being soundly rejected by them.

In addition to these issues, the CFTC regulation for SEFs will limit the means by which swaps can be executed to two types of platforms: an electronic order book and an RFQ system.

Business Conduct Rules

Dodd-Frank required the development of Business Conduct rules as a form of customer protection in the swaps market. Regulators have in the past several years developed business conduct rules required of market participants, particularly swap dealers. These rules are extremely detailed and prescriptive and they impose a large compliance burden on market participants that is well outside the scope of what Congress apparently intended.

The rules impose significant additional requirements on swap dealers in respect to their relationships with their customers. Since the majority of external business conduct rules became effective May 1, we have yet to see whether the significant compliance requirements translate into increased customer protection.

To facilitate compliance with these requirements, ISDA has created and managed two industry-spanning protocols directly related to Dodd-Frank. Protocols intend to get the majority of market participants to agree to new transaction terms that reflect the regulatory changes in the law, by adhering to these changes through an electronic market-wide process. The August 2012 Dodd-Frank ISDA Protocol addresses compliance with the CFTC's External Business Conduct Rules; a second protocol facilitates compliance with the CFTC's rules on Swap Trading Relationship Documentation and Clearing Requirements.

Cost-Benefit Analysis

The business conduct standards rules described above, and ISDA's work to fulfill those that have been finalized, clearly illustrate the cost and expense related to certain Dodd-Frank provisions. What is less clear, however, are the benefits that these and other aspects of the law and their regulatory interpretation bring to our country's financial system and the thousands of companies that use OTC derivatives.

An appropriate cost-benefit analysis was both required and desirable prior to finalization of rules; however in a number of instances the CFTC's analysis did not comply with the regulatory standard.

As the Jun. 2012 report by the CFTC Inspector General stated:

> ". . . Generally speaking, it appears CFTC employees did not consider quantifying costs when conducting cost-benefit analyses for the definitions rule. As indicated in the rule's preamble, the costs and benefits associated with coverage under the various definitions (in light of the various regulatory burdens that could eventually be associated with coverage) were not addressed . . ."

The lack of an appropriate cost-benefit analysis makes it especially important that the application and implementation of the final rules be phased in a flexible manner. Doing so would help ensure that rules achieve the purposes for which they are intended and do not impose burdensome costs on the financial system. It would also help regulators to identify and avoid unintended consequences of their actions. And it would encourage regulators to properly allocate limited resources.

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In conclusion, ISDA remains committed to achieving a safer, more efficient and more robust financial system and OTC derivatives markets.

Toward that end, it is vitally important that we, industry and regulators, focus our resources on those aspects of regulatory reform that address the most important issue—reducing systemic risk. This includes appropriate capital, central clearing and variation margin frameworks as well as regulatory transparency.

At the same time, it is vitally important that we seek to avoid burdensome measures that do not pose any clear, tangible benefit, and that divert resources from being allocated more efficiently elsewhere and impede progress in more important areas. Or worse still, enacting measures that harm liquidity or reduce systemic resiliency in the very markets they are trying to protect, resulting in a direct and harmful impact on the economy. This is particularly critical given the slow and uneven growth of the U.S. and the global economy.

Dodd-Frank is an important step forward for our country and our markets. And the CFTC deserves our sincere appreciation and support for its efforts in implementing its wide-ranging provisions in a relatively short period of time. It is clear, however, that our experience over the past several years has shown that not all of the law's provisions are appropriate and contribute to the overriding goal of a safer financial system. Similarly, some efforts by the regulators to implement the law are inconsistent with the intent of Congress, are being interpreted in different ways by various agencies, or impose costs that far exceed any resulting benefits.

In light of these concerns and observations, ISDA respectfully requests this Committee to (1) support the amending of Section 716, which could be done in an effective way through passage of H.R. 992 (2) consistent with H.R. 1256, stress to the CFTC the necessity of a flexible, prudent interpretation of the statutory provisions on margin and work closely with the industry to adopt final regulations that ensure the safety of the markets but do not harm liquidity and market participants; (3) urge the SEC and CFTC to harmonize their cross-border rules as soon as possible so U.S. regulators speak with one voice in the ongoing global debate on extraterritoriality since this is necessary to ensure the competitiveness of U.S. markets and the efficient flow of capital throughout all the global markets in which U.S. businesses operate.

Thank you.

Mr. CONAWAY. Thank you, Mr. O'Connor.

Mr. Dunaway for 5 minutes.

STATEMENT OF WILLIAM J. DUNAWAY, CHIEF FINANCIAL OFFICER, INTL FCSTONE, INC., KANSAS CITY, MO

Mr. DUNAWAY. Chairman Lucas, Ranking Member Peterson, and other Committee Members, thank you for inviting me to testify. I serve as the CFO of both FCStone, LLC, a registered FCM, and INTL Handling, a registered swap dealer. INTL was one of the first to register as a swap dealer under Dodd-Frank, and we were the first non-bank to register. My oral testimony will summarize my written statement submitted to the Committee, which goes into these complex topics in greater detail.

Dating back to 1924, INTL FCStone is now a global firm that services more than 20,000 mostly midsize commercial customers who are producers and end-users of virtually every major traded commodity. The largest market we serve is agriculture. Our customers handle about 20 percent of the grain production in Texas, 40 percent in Kansas, and 50 percent of the grain production in both Iowa and Oklahoma. INTL FCStone supports the Dodd-Frank Act; however, there are rules implementing the Act that may prohibit end-users from using our products to hedge their risk.

Other proposals, if unchanged, could push independent firms like INTL FCStone out of the market, leaving thousands of smaller end-users with nowhere to turn for hedging. In our conversations with the CFTC staff about the capital and margin rules, we have learned that our non-bank swap dealer may be required to hold regulatory capital up to hundreds of times more than that of a bank-affiliated swap dealer for the same portfolio of positions. Other non-bank commodity swap dealers will be in the same disadvantaged position.

There are two reasons for this discrepancy. First, under the new rules, bank-affiliated swap dealers can use internal models to calculate the risk associated with customer positions. Non-banks cannot. Internal models allow for more sophisticated netting of commodity positions to determine market risk capital charges. The CFTC's approach will permit only limited netting for non-bank dealers, forcing non-banks to hold capital against economically offsetting commodity swap positions. This means higher capital requirements overall and relative to those of bank-affiliated swap dealers using internal models.

In addition, the CFTC's approach relies on Basel II, which treats commodity derivatives more harshly than any other type of derivative when calculating risk. As a result, the same derivatives port-

folio that would require a bank-affiliated swap dealer to hold $10 million in regulatory capital would require us to set aside $1 billion in capital. This is entirely unsustainable, and will cause non-bank swap dealers to exit the business. The direct result will be higher costs for end-users, and then for consumers.

Increasing concentration in the industry until only the big banks are left will leave the smaller end-user with no place to go. It is not too late to fix this. The Commodity Exchange Act requires regulators to maintain comparable minimum capital requirements for all swap dealers. We believe the CFTC should revise its proposed capital rules to ensure that the requirements applicable to non-banks and bank-affiliated swap dealers are comparable by altering the non-bank rules to allow for full netting of offsetting commodity swap positions, allow match positions offering offsetting, or permit all swap dealers to use internal models. If the CFTC fails to make these changes, we request this Committee codify one or more of these alternatives as part of the CEA reauthorization.

Turning to our FCM, the CFTC has proposed rules requiring that FCMs residual interest exceed margin deficiencies at all times, and to reduce the margin call collection period to 1 day. These rules will have a substantial negative impact on some customers' ability to hedge their commercial risks, and will severely challenge small and midsize FCMs continued operation. The CFTC should study these issues and conduct a cost-benefit analysis before proceeding.

It is simply not feasible for an FCM to determine whether margin deficiencies are present at all times throughout a day; therefore, FCMs will have to hold margin that assumes the failure of all customers every day. Such a worst case scenario is unheard of and is not applied to any other financial entities. Under the new rule, FCMs will require customers to put up more money at all times, possibly doubling margins and likely resulting in customers being required to prefund their margin.

In addition, we feel the Commission's proposal mandating what amounts to a 1 day margin call collection period for FCM customers as opposed to the current 3 business days is not realistic. Our customers include a large number of farmers and ranchers who meet margin calls by using checks. They may be required to double or triple their margin payments to be able to meet the 1 day payment requirement. Many of our customers also finance their margin calls, requiring more time to arrange wire transfers. Foreign customers have different time zones that make the 1 day deadline impossible. We strongly believe that 2 day deadline is more reasonable and equitable for our customer base.

Finally, as a result of the external business conduct rules now in effect, many of our customers have abandoned OTC derivatives, even though OTC is the most effective hedging tool, because the paperwork requirements are simply too burdensome. Others have asked us to refrain from providing a mid-market mark, because they can either derive this information themselves or prefer immediate execution at market price and cannot even afford seconds delay in their execution. The proposed rule on capital margin allows customers to opt in or opt out of certain protections, including the segregation requirement, and we ask that this same option be extended to some of the business conduct rule disclosures.

INTL FCStone also has some concerns about the extraterritorial application of Title VII of Dodd-Frank, the definition of *eligible contract participant* as it pertains to farmers, and the issue of the futurization of swaps, and I address each of these in my written comments. INTL FCStone is not interested in dismantling Dodd-Frank; in fact, most of the concerns I have outlined here are about the implementation of the rules, not the Act itself. We are simply trying to ensure the final rules function as intended and commercial end-users in the firms like INTL FCStone who serve them do not face greater regulatory burdens than those in the market who speculate or create systemic risk.

Thank you for inviting me to testify today, and I look forward to any questions that you may have.

[The prepared statement of Mr. Dunaway follows:]

PREPARED STATEMENT OF WILLIAM J. DUNAWAY, CHIEF FINANCIAL OFFICER, INTL FCSTONE, INC., KANSAS CITY, MO

Chairman Lucas, Ranking Member Peterson, and other Members of the Committee, thank you for inviting me to testify at this important hearing. I am the Chief Financial Officer ("CFO") of INTL FCStone Inc., a position I have held since the merger of International Assets Holding Corporation and FCStone Group, Inc. in September 2009. In addition, I am the CFO of both, FCStone, LLC, a registered Futures Commission Merchant ("FCM"), and INTL Hanley, LLC, a registered Swap Dealer. Prior to the merger, I was the CFO of FCStone Group, Inc. I began my career more than 19 years ago as a staff accountant with Saul Stone and Company LLC, and since that time, I have served in various capacities, all of which included regulatory accounting and financial reporting, including CFO of Saul Stone and Company LLC, Executive Vice President and Treasurer with responsibility over the regulatory accounting of FCStone, LLC, the successor FCM to Saul Stone and Company LLC.

INTL FCStone Inc. and its affiliates (collectively, "We", "INTL FCStone" or the "Company"), a publicly held, NASDAQ listed company, dates back to 1924 when a door-to-door egg wholesaler formed Saul Stone and Company, which went on to become one of the first clearing members of the Chicago Mercantile Exchange. In June of 2000, Saul Stone was acquired by Farmers Commodities Corporation, which at the time was a cooperative, owned by approximately 550 member cooperatives, and was renamed FCStone LLC. Through organic growth, acquisitions and the 2009 merger between International Asset Holding Corp. and FCStone Group, we have become a global financial services organization with customers in more than 100 countries serviced through a network of 33 offices around the world.

INTL FCStone offers our customers a comprehensive array of products and services, including our proprietary Integrated Risk Management Program, as well as exchange and OTC execution and clearing services, designed to limit risk, reduce costs, and enhance margins and bottom-line results for our customers. We also offer our customers physical trading in select soft commodities including agricultural oils, animal fats and feed ingredients, as well as precious metals. In addition, we provide global payment services in over 130 foreign currencies as well as clearing and execution services in foreign exchange, unlisted American Depository Receipts and foreign common shares, while also providing asset management and investment banking advisory services.

Today, INTL FCStone services more than 20,000 mostly mid-sized commercial customers, including producers, processors and end-users of virtually every major traded commodity whose margins are sensitive to commodity price movements. Although we have become a global company, our largest customer base is serviced from offices in the agricultural heartland, such as West Des Moines, Iowa, Omaha, Nebraska, Minneapolis, Minnesota and Kansas City, Missouri. We are successful because we are a customer-centric organization, focused on acquiring and building long-term relationships with our customers by providing consistent, quality execution and value-added financial solutions. The primary markets we serve include: commercial grains; soft commodities (coffee, sugar, cocoa); food service and dairy (including feed-yards); energy; base and precious metals; renewable fuels; cotton and textiles; forest products and foreign exchange. Our offices are located near the customers we serve and our customers are the constituents of the Members of this

Committee—the farmers, feed yards, grain elevator operators, renewable fuel facilities, energy producers, refiners and wholesalers as well as transporters, who are in involved in the production, processing, transportation and utilization of the commodities that are the backbone of our economy. As an example, we believe our customers handle more than 40% of domestic corn, soybean and wheat production, including 20% of the grain production in Texas, 40% of grain production in Kansas, and 50% of grain production in Iowa and Oklahoma.

We offer our clients sophisticated financial products, but are not a Wall Street firm. Our mid-sized Futures Commission Merchant ("FCM"), FCStone LLC, according to recent industry publications, is the 20th largest FCM based upon customer segregated assets on deposit. However, it is the third largest independent FCM not affiliated with a banking institution or physical commodity business. As the Committee may know, our wholly owned subsidiary INTL Hanley LLC was one of the first to register as a Swap Dealer under the Dodd-Frank regulations. At that time, we were the only organization not affiliated with a bank to register.

Support for Dodd-Frank

INTL FCStone supports the goals of the Dodd-Frank Act and we are deeply committed to safe, efficient OTC derivatives markets that support the health and growth of the real economy. We likewise support the G20's efforts to reduce systemic risk by focusing on improving counterparty credit risk management and transparency in the OTC derivatives markets. Much of the Dodd-Frank Act works toward those goals, and we support those provisions that do so.

However, it is our view that some of the regulations that were drafted to carry out the objectives of Dodd-Frank undermine or do not support the goal of systemic risk reduction. Other changes do not appear mandated by the Act, nor called for by policy concerns. Instead, these regulations seek to impose changes to the market's structure without posing any quantifiable benefit. In addition, they embed an uneven and uncompetitive operating environment for firms doing business in the U.S. compared to our competitors abroad.

We believe these changes will adversely affect the markets' functioning, impose unnecessary costs on us and our customers, and will limit our customers' ability to manage their risks.

Capital and Margin Requirements—Swap Dealer Issues

Ensuring that swap-dealers have an adequate capital base and that customer collateral arrangements do not add to systemic risk are positive and commendable objectives under Dodd-Frank. However, the capital and margin requirements, as proposed,[1] would significantly disadvantage Swap Dealers that, like INTL FCStone, are not affiliated with a bank, in favor of the bank-affiliated Swap Dealers—the very entities that contributed to the financial crisis.

Before I explain this issue in detail, I want to stress to the Committee that the competitive advantage given to the bank-affiliated Swap Dealers under the proposed rules is not modest. In fact, the opposite is true. Our conversations with CFTC staff about the anticipated operation of the rule suggests that our Swap Dealer, INTL Hanley, will be required to hold regulatory capital potentially hundreds of times more than that required for a bank-affiliated Swap Dealer for the same portfolio of positions. Part of this stems from the fact that bank-affiliated Swap Dealers can use internal models to calculate the risk associated with customer positions, while non-banks cannot.[2] The use of internal models is an important tool because these models

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[1] Sections 731 and 764 of the Dodd-Frank Act require regulators to adopt rules setting capital and margin requirements for uncleared swaps for swap entities (Swap Dealers and major swap participants) and security-based swap entities (security-based Swap Dealers and major security-based swap participants). The "Prudential Regulators"—the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Farm Credit Administration and Federal Housing Finance Authority—are required jointly to adopt these rules for the banks and related swap entities and security-based swap entities (Bank Holding Company-affiliated or "Bank Swap Entities") under their jurisdiction, and the Commodity Futures Trading Commission ("CFTC") and the Security and Exchange Commission ("SEC") are required to adopt these rules for other swap entities and security-based swap entities, respectively.

[2] The "standardized approach" for calculating the market risk component of regulatory capital for Commodity Swap Dealers is based largely on the "Standardized Measurement Method" in the Market Risk Amendment. Conceptually, the Standardized Measurement Method applies a market risk charge to an entity's ***net position*** in a financial instrument. In the Proposed Capital Rule, offsetting of equity positions is allowed for positions "in exactly the same instrument," and for single-name credit positions offsetting is allowed for "identical" positions. Similarly, market risk calculations that apply to non-commodity asset classes under the Standardized Measurement Method (*i.e.,* interest rate, equity, and foreign exchange) permit offsetting of "matched"

Continued

generally provide for more sophisticated netting of commodity positions to determine applicable market risk capital charges. As a result of limited netting under the CFTC's "standardized approach," a non-bank Swap Dealer will have to hold market risk capital against economically offsetting commodity swap positions, resulting in a higher capital requirement[3] overall, and relative to the capital requirement for a bank-affiliated Swap Dealer using an internal model.[4] This increased capital requirement would have the perverse effect of actually incentivizing a non-bank affiliated Swap Dealer to not fully offset the risk of an customer OTC transaction and thus incurring potentially unlimited market risk.

Another factor of major concern under the "standardized approach," which is based on European banking standards (*i.e.,* Basel II) , is that commodity derivatives like the ones we offer our agricultural client base are treated more harshly than any other derivatives asset class in terms of calculating risk. Taken in conjunction, the same derivatives portfolio that would require a bank-affiliated Swap Dealer to hold $10 Million in regulatory capital using standard internal models would require us to set aside up to $1 Billion in capital in a worst case scenario. Regulatory capital requirements of this magnitude are wholly unsustainable for a company our size and economically unfeasible for a company of any size. The calculations supporting these estimates are attached to this testimony as *Addendum A.* INTL FCStone submitted these same calculations to the CFTC with our comment letter on this issue.

As I mentioned, INTL FCStone was the first non-bank to register as a Swap Dealer. As other non-banks register, particularly those in the agricultural and energy space, additional market participants will be caught in this position and either squeezed out of the market, or at least seriously disadvantaged relative to the bank-affiliated dealers.

Obviously, this regulatory capital disparity is not a small hurdle for the already disadvantaged independent dealers to overcome. If left unchanged, these capital rules will eventually cause non-bank Swap Dealers to exit the business. The direct result will be higher costs for end-users, and then for consumers. Increasing concentration in the industry until only the big banks are left will leave many customers with no place to go. Serving farmers, ranchers and grain elevators has not been a focus or a profitable business model for the large dealers.

Even larger customers who might be able to access to OTC hedging tools through bank-affiliated dealers will still face higher costs as the big bank dealers will be able to take advantage of decreased market competition. A larger percentage of customers carried through a handful of large, bank affiliated Swap Dealers will increase systemic risk.

The Members of this Committee, obviously, do not see eye-to-eye on every issue. But one thing I think that every Member of this Committee would agree on is that Dodd-Frank was not intended to preclude small commodity producers from hedging, to increase swap concentration at the banks, or to create greater potential for systemic risk. But with the capital and margin rules as proposed, that is the result that will follow.

We believe that this problem can be easily corrected. The Commodity Exchange Act requires the CFTC, the prudential regulators, and the SEC to establish and maintain "comparable" minimum capital requirements for all Swap Dealers. However, the proposed Capital Rules clearly are not "comparable." Pursuant to its mandate under the CEA, we believe that the CFTC should revise its proposed capital rules to ensure that the capital and margin requirements applicable to non-bank Swap Dealers are comparable to those applicable to bank-affiliated Swap Dealers. This can be accomplished by altering the rules to permit the following:

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positions. ***In contrast, the CFTC's "standardized approach," as described in discussions with CFTC Staff, does not provide comparable guidelines for identifying the extent to which commodity positions are offsetting.***

[3] Dealers should depend primarily on spreads between transactions for earnings, not on directional price change speculation. This is an underlying intent of many provisions of Dodd-Frank (*e.g.,* the Volcker Rule). In the ordinary course of their operations, Swap Dealers relying on spreads are incentivized to run flat books, which in turn reduces risk in the market. Based upon our conversations with staff, we understand that the CFTC does not intend to allow Swap Dealers to recognize commodity position offsets as to maturity and delivery location. If this is true, it seems counterproductive from a capital and a risk standpoint. A capital rule that adequately risk-adjusts offsetting positions would properly incentivize Swap Dealers to run flatter portfolios (thereby decreasing systemic risk) because the Swap Dealer would be able to lower its capital requirement by entering into offsetting positions.

[4] We consider it significant that the SEC's proposed rules on capital, margin and collateral segregation for non-bank Security-Based Swap Dealers and non-bank Major Security-Based Swap Participants permit the use internal value-at-risk models. So the CFTC really is the outlier with its capital and margin rules.

- **Full Netting**—Revising the "standardized approach" in the CFTC's proposed capital rules to make clear that it allows full netting of offsetting commodity swap positions, which will create a capital requirements framework that is more similar to the prudential regulators;
- **Matched Position Offsetting**—Alternatively, the CFTC could allow position offsetting for "matched positions," either on a per commodity/per expiry basis, or by using a "maturity ladder" approach to netting, as described in the Basel Committee's Amendment to the Capital Accord to Incorporate Market Risks (the "Market Risk Amendment"), in order to facilitate the netting of commodity swap positions; or
- **Internal Models**—The CFTC could permit all Swap Dealers, including Commodity Swap Dealers, to request approval of, and rely upon, internal models to measure market risk. To the extent that the CFTC currently lacks the resources to review and approve such internal models, it should permit Swap Dealers to certify to the CFTC or the NFA that their models produce reasonable measures of risk, subject to verification by the CFTC when its resources enable it to do so.
- **Flat Book Incentives**—Default risk is reduced when an entity maintains a relatively flat book. The CFTC should incentivize dealers to reduce default risk by decreasing capital requirements for operating a flat book. This incentive can be achieved by revising the Capital Rules to recognize netting for economically offsetting commodity swap positions (whether through the maturity ladder approach, or otherwise). Under the current proposal, dealers get no credit, from a capital perspective, for running a flat book and in fact are penalized.

If the CFTC fails to make these changes, INTL FCStone requests that this Committee consider codifying one or more of these alternatives as part of the CEA reauthorization.

Capital and Margin Requirements for FCMs—Residual Interest/Customer Funds

As I mentioned before, I have spent virtually my entire career working with issues relating to regulatory accounting, FCM capital, and customer segregated assets. In November of 2012, the CFTC proposed new comprehensive regulations relating to residual interest and the handling of customer funds by FCMs. These proposed changes were part of the CFTC's efforts to address customer protection issues that arose during the recent MF Global and Peregrine Financial Group bankruptcies. Customer confidence in the safety of segregated funds and FCM stability are crucial to the continued success of our markets. INTL FCStone supports efforts to enhance customer confidence through appropriate regulation, and fully agree that additional regulation can provide meaningful additional protections and assurances to market participants.

However, certain aspects of the CFTC's proposed rules—specifically, the requirement that FCM's residual interest in futures customer funds exceeds the sum of all of its customers margin deficiencies at all times, and the proposal to require FCMs take a capital charge for margin deficiencies that are outstanding for 1 day or more—will dramatically alter the way that FCMs and their customers have done business for decades These proposals will also have a substantial negative impact on most customers' ability to hedge their commercial risks, and will severely challenge small and mid-sized FCMs' ability to continue to operate.

Residual Interest

The Commission has proposed to add a new Rule 1.20(i)(4), and to amend Rule 1.22(a), to require that "an FCM must be in compliance with its segregation obligations at all times and . . . [i]t is not sufficient for an FCM to be in compliance at the end of a business day, but to fail to meet its segregation obligations on an intraday basis." This proposal represents a massive shift in the current policy, which allows FCMs to "net" excess funds of other customers against the margin deficits of others.

There is also a practical dimension to note. Because it is not feasible for FCMs to determine whether residual interest exceeds the sum of all margin deficiencies at all times throughout a day, the new interpretation suggests that FCMs should model for the failure of ALL customers, EVERY day. Such a worst-case scenario is unheard of, and is not applied to any other financial entities. Basel III does not require banks to hold a dollar for dollar reserve in anticipation of loan losses of ALL customers. CFTC regulations do not require clearinghouses to hold dollar for dollar reserves in anticipation of ALL clearing members failing.

In the end, this new interpretation will result in FCMs requiring customers to put up more money at all times, likely resulting in customers being asked to pre-fund their margin. In addition to requiring customer pre-funding, some have suggested that this rule will likely require an FCM to double a customers' overall margin requirements: in essence requiring customers to fund their potential margin deficiencies. As such, the customer would be required to keep margin funds far in excess of exchange minimum margin requirements. Our mid-sized commercial customers rely upon their lending institutions, such as CoBank, a member of the Farm Credit System, to fund their commercial activities including their hedging activities. A potentially doubling of their funding needs to support their hedging activities would significantly impact the profitability of such customers.

In addition to the negative customer impact, the rule will also put significant financial pressure on FCMs. If the sum of an FCM's customer margin deficits is greater than the residual interest an FCM typically maintains in their customer accounts, then the FCM would have to increase the amount of residual interest it maintains in customer segregated accounts. On "limit up" or "limit down" days in the agricultural exchange traded markets, our firm may be required to deposit up to $400 million to satisfy exchange demands for margin. In order to ensure that our residual interest would be in excess of the sum of all of our customers margin deficiencies in such a situation, we would need to require our customer pre-fund their potential margin deficiencies or in effect require us to pre-fund their potential margin requirements by maintaining our capital in customer segregated accounts. Requiring massive additional injections of our own capital to support the new residual interest requirements will, at some point, become unsustainable for us and others, again leading to the real and substantial risk of increased concentration in an already shrinking market.

One-Day Margin Call

The Commission has also proposed to amend Rule 1.17(c)(5)(viii) to require an FCM to take a capital charge with respect to any margin call that is outstanding more than 1 business day. The rule currently allows an FCM 3 business days to collect margin before taking take a capital charge. INTL FCStone opposes this proposal because it is impractical and will result in substantial negative consequences for agricultural customers and for the FCMs that serve them.

INTL FCStone understands the CFTC's objective in proposing to shorten the time in which an FCM must take a capital charge for accounts that are undermargined. Clearly, margin collection is a critical component of an FCM's risk management program. But it is not realistic to expect that all margin calls can or will be met in one day. There are several reasons for this.

First of all, INTL FCStone's customers include a large number of farmers and ranchers, many of whom meet margin calls by using checks because of the expense and impracticality of wire transfers in their circumstances. Check-paying customers are likely to have to double or triple their margin payments in order to make sure that they can meet the 1 day requirement. This would be very costly for many farmers and ranchers.

Second, many of our customers finance their margin calls, which can require additional time to arrange for delivery of margin call funds due to routine banking procedures. Finally, foreign customers often have considerable difficulty meeting margin calls in 1 business day due to time zone differences and varying bank holidays. In some countries customers face regulatory restrictions or formalized processes in connection with any transfers of funds out of their country. This can often impact such customers' ability to meet margin calls in one day and, in some cases, make it legally impossible.

Combined Impact

These proposals, taken together, will result in very substantial costs for FCMs and their customers. For many small and medium-sized FCMs, the costs of obtaining the required additional capital to cover increased margins—either in the form of general credit or permanent capital—could be insurmountable. In order to lower some of these costs or meet these requirements, FCMs would have to require customers to prefund some or all of their potential margin obligations, increasing costs to the end-users and ultimately may have the unintended consequence of giving smaller commercial customers no alternative to hedge their commodity price risk.

The increased financial requirements for FCMs will negatively impact the ability of non-bank FCMs to compete effectively, leading to a greater concentration of customers at the remaining FCMs and potentially increasing systemic risk. At the same time, neither of these proposals brings greater transparency to protect customer funds, which is what brought down MF Global and Peregrine.

Before making these significant changes, the CFTC should conduct a more thorough study and then conduct a cost-benefit analysis of the affects the proposals would have on FCMs, their customers and the markets. Should the CFTC proceed in a rulemaking that that will shorten the time period in which an FCM must take a capital charge for under-margined accounts, we strongly believe that a 2 day deadline is more reasonable and equitable. Increasing the time to meet a margin call by an extra day takes into account the challenges and cost considerations facing many key market participants, such as the agricultural clients that make up a significant portion of INTL FCStone's customer base. From our experience, making the margin call deadline 2 business days would take care of about 90% of the situations where the customer faces a delay in meeting a margin call.

Customer Issues

External Business Conduct Requirements

I would like to briefly touch on another set of rules that are having a negative impact on customers of INTL Hanley, our registered swap dealer: namely, the External Business Conduct Rules that went into effect on May 1st of this year. As this Committee is well aware, these Rules generally attempt to enhance protections for counterparties of Swap Dealers and major swap participants through due diligence, disclosure, fair dealing and anti-fraud requirements. These External Business Conduct Rules require the Swap Dealer to deliver pre-trade, product risk disclosures and a "mid-market mark" for the transaction. Substantial information gathering about our customers is also required to satisfy new "know your customer" and suitability requirements. As a result, all of our customers have been required to complete extensive new account forms, and amend their swap documentation so that we, in turn, can comply with these new rules.

Although these requirements may seem innocuous and un-burdensome to the regulators, a substantial number of our customers have abandoned OTC derivatives altogether because the paperwork requirements are simply too burdensome. Others have asked us to refrain from providing a mid-market mark because they can either derive this information themselves, or prefer immediate execution at the market price and cannot afford even seconds delay in execution.

The proposed rules on capital and margin allow customers to opt-in or opt-out of certain protections, including, most significantly, the requirement that collateral be segregated. More than anything else, segregation of customer funds and prompt transfer of those funds to customers in the event of a bankruptcy is a core protection embedded in the Commodity Exchange Act. Because there is an existing regulatory recognition that customers can make informed choices about whether to opt-in or opt-out of certain protections, we believe that giving customers the right to opt-out of certain Business Conduct Rule disclosures—such as receiving a mid-market mark—would be highly beneficial.

Eligible Contract Participant Rules

Even prior to Dodd-Frank, CFTC rules limited participation in the OTC markets to transactions between "Eligible Contract Participants" ("ECPs"), *i.e.,* entities with $10 million in total assets or with a net worth of at least $1 million, who are engaged in hedging qualify as ECPs. However, Dodd-Frank amended the standard for individuals to qualify as ECPs by replacing the "total assets" test with an "amounts invested on a discretionary basis test." The term "amounts invested on a discretionary basis" is not defined in the Dodd-Frank Act, and it is unclear from the legislative history what Congress intended by this amendment. At this point, it is not clear whether a farmer's ownership interests in legal entities that hold farm and related assets (which may include the farmer's residence) would constitute "amounts invested on a discretionary basis" under the new ECP definition for individuals.

INTL FCStone would urge the CFTC and the SEC to use their broad rulemaking authority to provide guidance on the meaning of the phrase "amounts invested on a discretionary basis," and we request that such guidance interpret the phrase broadly to permit individuals with significant farming operations to be deemed ECPs and, therefore, permitted to use OTC swaps.

Absent such regulatory guidance, we request that this Committee include a definition of the phrase "amounts invested on a discretionary basis" in the CEA reauthorization bill, and that such definition be broad enough to capture individuals with significant farming operations.

Extraterritorial Application of Dodd Frank

Another issue of concern to most market participants is the international reach of Title VII of the Dodd-Frank Act. As everyone here knows, the CFTC has issued proposed rules that would essentially grant the broadest possible extraterritorial

reach to U.S. swaps regulations. According to the CFTC's proposed rules and interpretive guidance, any swap between a U.S. person and a non-U.S. person will generally be subjected to U.S. swap regulation. This presents obvious conflicts with foreign regulations. For example, a cross-border swap cannot be cleared in both a U.S.-registered clearinghouse and separately in a different clearinghouse registered in the European Union.

Although its latest guidance is a move in the right direction, throughout the regulatory process, the CFTC has consistently insisted on a broad interpretation of the definition of a "U.S. person" and of the activities that would be deemed to have "a direct and significant connection with activities in, or effect on, commerce of the United States." The result is a complex and confusing regulatory scheme that threatens to expose U.S. Swap Dealers and FCMs to considerable regulatory risk and would effectively extend the CFTC's reach into any jurisdiction around the world.

This issue is of great concern to INTL FCStone because our largest geographic area of growth for our OTC swaps is Brazil. Brazil is a fast-growing, but still developing market that desperately needs good hedging tools. INTL FCStone can provide these hedging tools and we can bring the business from Brazil and other countries into the U.S., so long as the Dodd-Frank rules do not put us at a disadvantage. But, if local agriculture producers in Brazil have to comply with Dodd-Frank requirements if they hedge with us and do not have any comparable requirements or burdens if they hedge with a non-U.S. firm, they will go with the non-U.S. firm and we will lose the business.

Other U.S. market participants share our general views on the cross-border topic, but INTL FCStone wants the Committee to be aware that the cross-border issue is not one that is only of concern to the Wall Street firms and the other large players.

The Securities and Exchange Commission's ("SEC") recent proposal is a significant improvement over the CFTC's, especially with respect to the broad view taken by the SEC on the issue of substituted compliance. By basing its determination of equivalency on outcomes, rather than requiring a rule-by-rule comparison of the regulations, as stipulated by the CFTC, the SEC is, I hope, moving us toward a workable solution where non-U.S. rules that attempt to address the same issues and get to the same end point should be deemed comparable.

Bottom line—subjecting swaps transactions to multiple, and potentially conflicting rules and requirements is simply unworkable. It is imperative that the U.S. regulators work together to promulgate one set of clear, simple and workable cross-border rules before firms are expected to comply. In addition, U.S. firms need enough lead time to digest and comprehend the rules so that we can plan for the scope of Dodd-Frank's impact on our global businesses.

"Futurization of Swaps"

I want to briefly address an issue that has been called the "Futurization of Swaps" because I understand that at least one House Subcommittee has held a hearing on this issue and the CFTC held a staff roundtable to discuss it, so I know it is a matter that at least some in Washington are reviewing. Of course, the "Futurization of Swaps" refers to the post-Dodd-Frank Act evolution of end-users bypassing swaps transactions in favor of futures.

We have been told by a number of our customers that they have determined that they will no longer use "vanilla" or "look-alike" OTC instruments, and instead will rely exclusively on exchange traded futures. It is important to note, however, that this decision has not been the result of a considered decision about which instrument serves as the most cost-effective risk management tool, but instead, is wholly the result of the regulatory burdens associated with swaps as opposed to futures.

For instance, we have a number of customers who have told us that the extensive new reporting and record-keeping requirements for swaps (both cleared and uncleared) are the factor that has lead them to exit the OTC markets, although that was never the intent of Congress in enacting Dodd-Frank. Although exchange-traded futures are often an appropriate and suitable risk management tool, there are other instances where futures may not be as beneficial from the customer's perspective

In our experience, for farmers and others in the agriculture space, vanilla OTC in fact may be the most cost-effective and practical hedging vehicle available to them based on the ability to offer customized credit arrangements, or because there is greater liquidity in OTC markets. But, due to concerns over the burdens associated with record-keeping requirements and the likelihood of increased costs of using swaps, some of our customers have taken a short-sighted view and have fled the OTC markets for futures. Others have decided not to hedge at all. This trend runs

counter to the intention of Dodd-Frank to allow end-users a continued ability to access the OTC markets.

Conclusion

INTL FCStone is not interested in dismantling Dodd-Frank. In fact, most of the concerns expressed in this testimony are about the implementation of rules, not the Dodd-Frank Act itself. We are simply trying to ensure that the final rules function as intended and that the commercial end-users, and the firms like INTL FCStone, who serve them do not face the same regulatory burden as those in the markets who speculate and create systemic risk.

Firms like INTL FCStone and our customers did not contribute to the financial crisis and we support common-sense reforms that strengthen and bring more transparency to these markets, but we are now being asked to bear additional regulatory burdens that actually put us at a competitive disadvantage to the very firms that caused the financial crisis. This is unfair and, quite frankly, is not good policy. But, we will continue to work with the regulators throughout this process to ensure that firms like INTL FCStone will be here well into the foreseeable future to help our customers manage their risk. And we will continue to advocate for our customers in seeking regulations that are drafted in such a way that they continue to allow even the smallest end-users to have access to hedge against market risk.

These are challenging times for our industry, not only due to the regulatory changes described above, but also due to fundamental shifts in the business model that underlies the futures industry. With depressed futures volumes, historically low interest rates, and extremely competitive pricing, FCMs are under tremendous strain financially. Many of us are concerned that the business is reaching a point where it cannot absorb additional costs without a substantial shift in the model—whether that is considerable consolidation among FCMs or some firms leaving the business altogether. This type of risk concentration in a few firms is not, in my opinion, what was intended by Dodd-Frank, and it will make the clearing system—and our broader economy—more vulnerable to catastrophic losses. So as our regulators consider the pending rules and this body continues to execute its oversight mandate, I urge you to consider both the immediate and the long-term consequences that these rules bring for the small and mid-sized commodity producers, processors and end-users that are so important to a strong U.S. economy.

Thank you for inviting me to testify today. INTL FCStone greatly appreciates the ongoing work and support that the Committee has provided during some very trying times for our nation, and I look forward to answering any questions that you may have.

ADDENDUM A: CAPITAL COST OF ALTERNATIVE APPROACHES TO NETTING OF COMMODITY SWAP POSITIONS

The necessity of the revisions to the Proposed Capital Rule recommended by INTL FCStone is evident when an analysis of the various capital requirement approaches is conducted based on a hypothetical portfolio. Below we apply the "standardized approach" to a hypothetical commodity swap portfolio held by a swap dealer. This analysis illustrates how the Proposed Capital Rule's failure expressly to permit the netting of commodity positions results in significantly higher capital costs for Commodity Swap Dealers as compared to all other swap dealers.

As demonstrated above, the commodity position market risk charges under the "standardized approach" are not "comparable" to the rules of the banking regulators. This lack of comparability is inconsistent with the CFTC's statutory mandate under Section 731 of the Dodd-Frank Act. In addition, the Proposed Capital Rule's disregard for netting of commodity swap positions under the "standardized approach" is inconsistent with the fundamental goal of a capital regime, which is to incentivize prudent risk management by a swap dealer. Keeping all other factors equal, maintaining a flatter portfolio should yield lower risk capital charges.

The table below compares the impact of these alternative approaches to netting of commodity positions under existing approaches to market risk, including (i) gross calculation with absolutely no offsets, (ii) the standardized measurement method with offsetting of the exact same commodity, month, strike, and put/call, (iii) the standardized measurement method with offsetting in the same expiry, (iv) the maturity ladder approach with offsetting in the same expiry, and (v) the internal models based approach.

For purposes of illustrating the impact of these alternative approaches, we have set a hypothetical baseline of $20 Million (the minimum capital requirement) as the standardized approach with offsetting by commodity and expiry. The percentages in the illustration below are representative of the actual percentage differences seen

in our portfolio in applying the different calculation methods. However, as noted, the dollar amounts are for illustration purposes only.

The only variable changed between Rows 1–3 is the offsetting used with the calculation of the 3% supplemental charge. Row 4 uses paragraphs 7 through 11 of the Market Risk Amendment of which paragraphs 8 through 10 prescribe application of the Maturity Ladder Approach. Row 5 represents an internal models approach using Historical Value at Risk with a 99% confidence interval, 3 year look-back and a 10 day time horizon.

Row	Market Risk Capital Calculation Approach	Total Market Risk Capital Charge	Percent as compared to the Row 3 "Standardized Approach"
1	"Standardized Approach" (Gross Calculation with absolutely no offsets)	$536,688,787.53	2,683%
2	"Standardized Approach" (offsetting exact same (commodity, month, strike, put/call))	$112,939,994.78	565%
3	"Standardized Approach" (offsetting within same commodity and expiry)	$20,000,000.00	100%
4	Total for Maturity Ladder Approach with offsetting in same expiry	$17,738,970.37	89%
5	Internal Models-Based Approach (HVaR, 99% CI, 3 year Lookback, 10 day time horizon)	$3,863,209.48	19%

As depicted in the table above, the differences between the capital costs associated with the various approaches are astronomical and, unless the Proposed Capital Rule is clarified/revised, the effects on the competitive balance between Commodity Swap Dealers and all other swap dealers would be substantial. While the Internal-Based Models Approach best corresponds an entity's capital charge to its market risk, in the event that an internal model is not appropriate for a given entity, interpreting or modifying the standardized approach under the Proposed Capital Rule to permit netting by commodity and expiry or, alternatively, through application of the Maturity Ladder approach, is a much better alternative and will allow the market to maintain some semblance of competitive balance.

Additionally, the table depicts the sizeable differences between approaches permitting different types of offsets. The approaches using offsets that more accurately gauge an entity's market risk result in capital charges that are more reasonable and are closer to the capital charges that result from using a models-based approach. See *Appendix A* for an illustration of the differences in the calculations used above.

APPENDIX A

The purpose of this Appendix is to provide a detailed illustration of the netting of offsetting exposures described in the comment letter. For the sole purpose of this illustration, we have put together the below hypothetical portfolio which contains both OTC and centrally-cleared corn swaps, swaptions, futures and futures options. This is not the same portfolio used for the calculations noted in the comment letter, but rather a much smaller and single commodity portfolio.

For simplicity, this illustration only covers the market risk charges applicable to 15% directional risk on the net position and the 3% of "gross" to cover forward gap, interest rate and basis risk. The Maturity Ladder Approach (iv) and Internal Models (VaR) (v) are excluded from this illustration. The initial offsetting allowed under the Maturity Ladder Approach is the same as reflected in (iii) below although the resulting charges would be slightly less due to lower charges (1.5%) for offsetting exposures within a broader "Time Band".

Corn

Position	OTC	Delta
A	Long 50 December 2013 swaps	250,000
B	Long 100 December 2013 5.50 puts	(164,379)
C	Long 250 December 2013 6.50 calls	518,800
Position	**Central Clearing Counterparty**	**Delta**
D	Short 150 December 2013 futures	(750,000)
E	Short 100 December 2013 5.50 puts	(164,384)
F	Short 25 March 2013 6.91 puts	59,762

Corn—Continued

Position	Central Clearing Counterparty	Delta
G	Short 25 March 2013 6.91 calls	(65,199)
H	Short 25 July 2013 6.92 puts	57,717
I	Short 25 July 2013 6.92 calls	(65,199)

Definitions of fields used in the below illustrations:

Underlying Group—the underlying commodity upon which the position is based.

Positions Included—the positions from the above portfolio that are included in each line. This really helps to illustrate how the netting described is working.

Contract Month—the delivery month of the underlying on which the position is based.

Option Type—Call, Put or, in the case of swaps and futures, N/A for the position shown.

Strike—The strike price for the position shown.

Delta—the underlying equivalent size of the position expressed here, not as futures equivalents, but notional quantity (*i.e.,* Notional Delta). In this illustration using corn, the delta is expressed in bushels. To derive the futures contract equivalent size, simply divide the number shown by 5000.

Spot Price—in this case, the spot price of corn used in the calculations as prescribed by the proposed rules.

Delta Notional—derived by multiplying Delta * Spot Price. This is the notional value of the based upon the delta as prescribed to do in the *Amendment to the Capital Accord to incorporate market risks* page 31 under Delta-plus method.

15% Net Charge—this calculation only applies to the net remaining position and is the capital charge for directional risk. It is derived by multiplying to total net Delta Notional by 15%.

3% Gross Charge—this value is derived by multiplying the absolute value of Delta Notional by 3% per line item. This is the only charge which will vary between the examples below and is dependent upon what is allowed to offset/net.

(i) Standardized Approach with *no* offsetting—Same methodology used in Row 1 of the comment letter.

Underlying Group	Positions included	Contract Month (MMM–YY)	Option Type	Strike	Delta	Spot Price	Delta Notional	15% Net Charge	3% Gross Charge
Corn									
	A	Dec-13	N/A	0	250,000.00	5.9975	$1,499,375.00		$44,831.35
	C	Dec-13	Call	6.5	518,800.17	5.9975	$3,111,504.00		$93,345.12
	B	Dec-13	Put	5.5	−164,379.00	5.9975	$(985,863.08)		$29,575.89
	D	Dec-13	N/A	0	−750,000.00	5.9975	$(4,498,125.00)		$134,943.75
	E	Dec-13	Put	5.5	164,383.79	5.9975	$985,891.79		$29,576.75
	F	Mar-13	Put	6.91	59,761.61	5.9975	$358,420.27		$10,752.61
	G	Mar-13	Call	6.91	−65,198.86	5.9975	$(391,030.18)		$11,730.91
	I	Jul-13	Call	6.92	−67,119.50	5.9975	$(402,549.20)		$12,076.48
	H	Jul-13	Put	6.92	57,716.57	5.9975	$346,155.12		$10,384.65
Corn Total			**Net Total**		3,131.62	5.9975	$18,781.89	$2,817.28	$377,217.50

(ii) Standardized Approach offsetting exact same Commodity, Month, Strike, Put/Call—Same methodology used in Row 2 of the comment letter.

Underlying Group	Positions included	Contract Month (MMM–YY)	Option Type	Strike	Delta	Spot Price	Delta Notional	15% Net Charge	3% Gross Charge
Corn									
	F	Mar-13	Put	6.91	59,761.61	5.9975	$358,420.27		$10,752.61
	G		Call	6.91	−65,198.86	5.9975	$(391,030.18)		$11,730.91
	H	Jul-13	Put	6.92	57,716.57	5.9975	$346,155.12		$10,384.65
	I		Call	6.92	−67,119.50	5.9975	$(402,549.20)		$12,076.48
	A, D	Dec-13	N/A	0	−500,833.15	5.9975	$(3,003,746.82)		$90,112.40
	B		Put	5.5	4.79	5.9975	$28.71		$0.86
	C		Call	6.5	518,800.17	5.9975	$3,111,504.00		$93,345.12
Corn Total			**Net Total**		3,131.62	5.9975	$18,781.89	$2,817.28	$228,403.03

(iii) Standardized Approach offsetting within same commodity and expiry—Same methodology used in Row 3 of the comment letter

Underlying Group	Positions included	Contract Month (MMM–YY)	Option Type	Strike	Delta	Spot Price	Delta Notional	15% Net Charge	3% Gross Charge
Corn									
	F, G	Mar-13			−5,437.25	5.9975	$(32,609.91)		$978.30
	H, I	Jul-13			−9,402.93	5.9975	$(56,394.09)		$1,691.82
	A, B, C, D, E	Dec-13			17,971.80	5.9975	$107,785.89		$3,233.58
Corn Total			**Net Total**		3,131.62	5.9975	$18,781.89	$2,817.28	$5,903.70

Mr. CONAWAY. I thank the witnesses, and recognize Mr. Neugebauer, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Duffy, you mentioned that industry had taken a lot of steps to make sure that customers' segregated funds were protected, and could you kind of just elaborate on how you think we are today *versus* where we were, say, 2 years ago prior to MF Global and——

Mr. DUFFY. Sure, I would be happy to. Mr. Roth elaborated on a couple of the new methodologies that we are deploying to shore up the system, but where we are at is whether we are asking the CEO or the CFO to sign off on the movement of certain segregated funds, a couple of things that Mr. Roth highlighted, but what is still missing and what is missing in a lot of things in legislation is teeth in anything. I am a proponent of regulation to an extent. I am a proponent of regulation that makes sense on a global basis. What I think we are also missing is the deterrent for people not to go down the paths that someone did like at MF Global. I think that we have shored up the system. People have said to me is there a crisis of confidence in your market participants? I spoke at the Kansas Grain and Feed Association. There wasn't a crisis of confidence in the market, there was a crisis of confidence in what was the lack of not being done to a certain individual that went in and used their money for their own purposes.

This is where the problems lie, sir. I think that the old saying is "Don't throw the baby out with the bath water." We have good systems in place in our industry. We have added three or four more to shore that up. What we need to do is put teeth into these things and make people make certain they don't go down this path.

Mr. NEUGEBAUER. Just to kind of move forward on that, in one of the proposals that is out there is an insurance program, and I was thinking this morning—and also looking at your testimony, and you mentioned that you were opposed to the user fees that the—or the fee that the President proposed in his budget. Do you worry that if you put these user fees on and you implement an insurance program, that you drive the transactional cost up for some of the end-users? And we have already seen a decline in activity. Are we driving some additional people out of the markets?

Mr. DUFFY. I think there is no question that is true. I am not a proponent of insurance. I supported the study to Mr. Roth's comments. I think it is the right thing to do. We should never make a knee-jerk reaction when it comes to something like this, so the study was a good idea. The problem is it should be voluntary, not mandatory. I think if people want to have their costs go up, which they will—you have to realize, sir, we put $100 million fund in place at CME. I couldn't get it insured. I had to self-insure that fund because the cost of the insurance would be a lot more than it is worth, so can you imagine trying to insure $158 billions of customer segregated funds, what that would do to the consumer or to the risk offsets that people are trying to do at FCStone or places? They wouldn't be able to afford it. So I don't think Congress should mandate it. I think we have good rules in place, and I don't think insurance is a bad idea, but it is up for the individual if they want to acquire it to acquire it, and Congress should not mandatorily put it in place.

Mr. NEUGEBAUER. Thank you.

Mr. Sprecher, I understand that the EU could, as early as June, make a determination whether or not the U.S. regulatory standards are equivalent to theirs. Should that determination be not equivalent, what would be the ramifications on EU clients doing business regularly in the U.S. markets, and *vice versa?*

Mr. SPRECHER. Thank you for the question. The concern that I have is that if the EU were to make such a determination, and you rightfully pointed out that they may do that as soon as June, they would deny access for European customers to U.S. markets. As a market operator and sitting next to another great market operator, we enjoy sitting in the United States and having the world come to us. We enjoy having the world's agricultural markets in the United States. My company has a contract called World Sugar, which is largely produced outside the U.S. and largely consumed outside the U.S., but yet trades in U.S. markets. I think if we start denying access or if other countries decide to deny access of global market participants to the U.S., it will have broad repercussions on keeping these markets here and regulated in the U.S.

Mr. NEUGEBAUER. Well, the—issue is extremely important to our—isn't it?

Mr. SPRECHER. Absolutely important to our market and our domestic market participants. We know—and the United States has benefitted from the globalization of commodities. We are at the center of that, and it would be sad to see the world get balkanized as the result of the lack of regulatory harmonization.

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

Mr. CONAWAY. Thank you, Mr. Neugebauer.

The Ranking Member for 5 minutes.

Mr. PETERSON. Thank you, Mr. Chairman.

Mr. Dunaway, I was reading your testimony here, and I guess I need more clarification or information here about this issue with the capital margin requirements. I don't understand what is going on here, why it is the businesses under the bank, the capital margin requirements are less than they are if they are not, and that is one issue. And then is this why people are pushing this swap push-out bill, because the more they can get under the bank, the less capital they have to come up with? Is that—I have been kind of mystified why there has been all this push for this swap push-out bill.

Mr. DUNAWAY. Well, I can certainly address the first part of your question. I am not quite as familiar with the second half, but with regards to the regulatory capital requirement for a non-bank swap dealer, it really comes down to the fact that the banks already have internal models that have been approved by the regulators and the CFTC is willing to rely on——

Mr. PETERSON. What regulator?

Mr. DUNAWAY. Either the SEC or the Prudential Regulators have approved their models.

Mr. PETERSON. And so the CFTC has gone along with that?

Mr. DUNAWAY. They have accepted the internal models that those banks, but however——

Mr. PETERSON. But they are trying to put a different model on people that are outside?

Mr. DUNAWAY. They are not accepting—at this point, they are not approving any other internal model, so they are taking a standardized——

Mr. PETERSON. So you don't know what they are doing, or what?

Mr. DUNAWAY. I do know what they are doing, and it is laid out in our comment letter that we made to the CFTC. They are taking a page out of the Basel II regulations and creating a standardized approach, but the real downfall of that is it takes a complete gross position for non-bank affiliates. We are taking a market risk, even if we have economically offsetting positions.

Mr. PETERSON. So you have had discussions, obviously, with the CFTC staff, I guess?

Mr. DUNAWAY. Yes, we have.

Mr. PETERSON. What is their explanation for this? I mean, it doesn't seem to make any sense. Why are they doing this?

Mr. DUNAWAY. We have—the beginning of January, we submitted our comment letter, which I believe has been provided to the Committee, with the calculations, and we followed that up with discussions with both CFTC staff and some of the Commissioners. I don't have a good answer as to why they are doing it. I know that we have not received any direct feedback addressing our concerns, other than that they understand the concern, but we haven't seen any tangible evidence of rule changes being proposed.

Mr. PETERSON. Okay. But they have not actually finalized this, and so if nothing changes, you are going to have to put up significantly more capital than the banks.

Mr. DUNAWAY. If the rules are incorporated, yes, as they are currently stated.

Mr. PETERSON. I guess the way this was proposed, 90 percent of the swaps that are out there are going to be allowed to remain under the banks, and about ten percent would have been pushed out into a separate entity, the reason being that the banks have government money, taxpayer money behind them and these swaps that we are pushing out have nothing to do with the banking activity. They are different. So there is a bill to allow 99 percent of the swaps to be pushed out, so there will be hardly anything left in the bank. I was trying to figure out why they were doing this. Well maybe it is because of this, that they are going to have to—if they don't allow it under the banks, they are going to have to put up significantly more capital in this new entity that they create to hold those ten percent swaps that are pushed out. But you haven't run into that or nobody——

Mr. DUNAWAY. I am not familiar if they push it out, if they can still use the internal model or not, but I would assume that they would still have the benefit of utilizing the internal model, otherwise I am not sure. You can see the dramatic effect it has on our capital requirements. Even the large banks, I don't think that they could economically handle or——

Mr. PETERSON. I mean, that would be even more questionable that they would allow—if they did have to set up the separate entities and ten percent of the swaps were pushed out, if they allowed the banks to use that other definition and not you, that would be even worse.

Mr. DUNAWAY. I would agree.

Mr. PETERSON. You know, it doesn't make any sense. So I guess my staff would like to follow up with you and also with the Commission and try to figure out what is going on here.

Mr. DUNAWAY. Certainly. I would appreciate that. Thank you.

Mr. PETERSON. It doesn't seem to make any sense to me.

I yield back.

Mr. CONAWAY. The gentleman yields back.

I recognize myself for 5 minutes.

The Committee last Congress, and this Congress, have passed a cost-benefit bill that would basically encapsulate what the President asked all agencies to do with respect to determining what the costs are of a particular proposed rule. We have been particularly disappointed in the way the CFTC has done that. Can you give us some real world examples, anybody on the panel, of where the CFTC did do a cost-benefit analysis and either got it right or got it wrong with respect to the implementation that you are now going through? So Mr. Sprecher, Mr. Duffy, any of you can give us some examples of where that is—either lined up with what the CFTC said, or is out of line?

Mr. SPRECHER. Well, the most obvious example that affects both the CME Group and ICE has been the position limit rules which came out and ultimately are the subject of court matter over this very issue. Our customers every day want certainty about position limits. People are—as you well know, our mutual constituents want certainty so that they can make informed decisions, going forward, as part of reinvigorating the economy is making forward decisions, and unfortunately, this whole position limit area is tied up in courts over this very issue, and we are in the unfortunate position of not being able to help our customers with any kind of guidance on how they might want to hedge their future risks.

Mr. CONAWAY. So Mr. Duffy?

Mr. DUFFY. Yes, if I could add, I was going to mention position limits but I am glad Jeff did, because we are both affected by it. But one of the things—I will try to give you the other side of the equation of what I think they got right, and that is on the margin issue as it relates to futures *versus* swaps, 1 day *versus* 5 days. They have historical backgrounds and data to show that futures should be margin 1 day. They also have historical data to show that swaps have been margin 5 days, hence Mr. Sprecher's clearinghouse in London at ICE Trust for credit default swaps. So to say that a swap is identical to a future is just flat wrong, and it should not be margin in the same respect because there are certain participants who can participate in the default. There are certain ones who can't. There are 12½ to 20 million contracts a day traded in the regulated futures market where people can participate in default. There are 2,000 transactions a day in the over-the-counter swaps market where a handful of participants can participate. I think that is where they got it right, if you want to look at where they got it right.

Mr. CONAWAY. Okay. Mr. O'Connor, can you give us your thoughts on the importance of harmonization with respect to the SEC and the CFTC, as well as the world regulatory scheme?

Mr. O'CONNOR. Yes. I think a useful example might be the impact of the CFTC's reach outside of the U.S. jurisdiction, so the

CFTC is fairly unique in that it requires swaps dealers to register and there is a reluctance on the part of overseas banks to register with the CFTC, and in fact, on the part of their own regulators as well to have that happen. So what has happened is that many, many international banks have now stopped trading with U.S. banks in the swap markets, since to do so would trigger a requirement for them to register with the CFTC, and there might be some perceived actual burden associated with such registration.

So what that means is that liquidity has been harmed in that U.S. banks can no longer access liquidity provided by the overseas banks and *vice versa,* and the overseas banks, in addition to not trading with U.S. banks, are not trading with their U.S. clients either, so U.S. corporations and investment firms that used to trade with offshore banks now have seen that liquidity dry up as well, so that is an example.

Mr. CONAWAY. Is there a way to quantify that in terms of—I understand the overall concepts, but is there a way to quantify the lack of liquidity or the increase in costs as a result of lack of liquidity that we can point to specifically with hard data?

Mr. O'CONNOR. Not one that springs to mind immediately, but certainly we can try to do some work and get that to you.

Mr. CONAWAY. All right. Mr. Roth, you mentioned the study that some of you are conducting. What is the timing for when that is supposed to be done? I think Mr. Lukken said this summer, but is that what your expectations are?

Mr. ROTH. Yes, I am always more optimistic. We are in the process of—the consultant has all the data that he needs. He needs to provide that data to the insurance companies and then get responses back from insurance companies to his requests for estimates for cost. So it is going to be a little bit out of his control. It is going to depend on how long those insurance companies take to get back to him, but we were hoping within the next 6 weeks we would have a response.

Mr. CONAWAY. All right, thank you. I will yield back.

Mr. Scott for 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. It is good to have all of you here and Mr. Sprecher, good to have you here up from Atlanta, Georgia.

Mr. Sprecher, let me start with you. You have been working with the CFTC and the SEC for quite some time on what we call portfolio margining regime for credit default swaps. Can you give us a brief update on the progress of that?

Mr. SPRECHER. Sure. Thank you for the question.

First, let me say that I think it is the nature of my testimony and hearings like this in general to point out failings of the agencies because we want to correct them, but we very much appreciate that both SEC and CFTC have been given a tall mandate to implement Dodd-Frank in a short period of time. And one of the areas that is a tall mandate is how to cooperate on this so-called portfolio margining. The CFTC largely has its work done and we thank them for that. We have now turned to the SEC and are trying to work through their process. They obviously have a different priority set, different time table on the things they are working on on Dodd-Frank, so we have tried to raise the priority level of this

issue with them. We have also asked many of you to help us raise that priority issue.

There is a critical deadline coming up in June 10 where more of our mutual constituents are going to be required to do clearing, and we are advocating very hard and strongly with the SEC that they finish their work in this area by June 10, or if they cannot finish their work, at least provide some kind of interim relief that would not make it expensive for end-users to start clearing, which they are going to be required to do by law. I have some hope from our recent conversations, including in the past 24 hours, that the SEC understands that deadline and is making efforts to try to make sure that our mutual constituents will see some relief.

Mr. DAVID SCOTT of Georgia. That June deadline is very important for that as well for the joint rulemaking, which is what I would like to talk to you for a minute now. You are somewhat caught in the middle of that between the CFTC and the SEC. Can you tell us, is that harmonization possible? Where could you pinpoint the problem as to why we can't get the SEC and the CFTC to harmonize? That is critical, and like you said, June is just a few days away when Europe will be making their decisions.

Mr. SPRECHER. Yes. Both agencies come from two different perspectives. One, an agency that is very used to overseeing farmers and ranchers and commodity traders, and another that is overseeing individual shareholders and securities investors. They have had different regimes, as many of you know, and a lot of history with their regimes and they both bring their own biases and backgrounds to the discussion on how to harmonize. Frankly, they are trying to find the best of both worlds. Securities law and just the size and breadth of the SEC is large and complicated, and so it was not surprising to us to see the CFTC be able to get its work done quickly. But the SEC is a very complicated process that is embedded in past history. I am hopeful that they understand the issue. A lot of end-users and our mutual constituents have been in to inform them how important getting this right is, and I do think that that has had an impact on them to raise the priority on this issue.

Mr. DAVID SCOTT of Georgia. In your estimation, do you think it is possible that they can come together and coordinate and harmonize?

Mr. SPRECHER. I think it is a minimum they will provide some interim ability is my hope. I think the process of harmonizing is going to take significantly more time, however.

Mr. DAVID SCOTT of Georgia. And I want to ask you one more quick question.

You mentioned the importance, in your estimation, of what you referred to as *bona fide* hedging.

Mr. SPRECHER. Yes.

Mr. DAVID SCOTT of Georgia. And how that would hurt commercial end-users. Could you tell us how that would be the case?

Mr. SPRECHER. Sure. You know, in custom and practice over the last many years, we have had at the Exchange many *bona fide* hedgers. These are farmers, ranchers, industrial companies that are looking to specifically hedge risk. The definition—some of the definitions that have been proposed are very, very specific on how one would consider a hedge and go way beyond the history of how

we have been looking at this in the past. For example, my father-in-law, who is a farmer, is right now planting his corn. He is going to hedge his corn risk in some way on CME markets. He has no idea exactly how much corn he is going to end up with at the end of the year. His hedge will not be a perfect hedge. It will, by nature, be an imperfect hedge. He has to make a guesstimate as to how many sunshine days they are going to have, how his crop might do, how the yields will be this year. If we hold him to a standard where he has to be specific up front, it is almost an impossibility and if you go to very complex industrial companies that are hedging foreign exchange risks because they are global, they are hedging interest rate risk because they borrow, they are hedging commodity risk because of the inputs, they don't have perfect information and they often buy more contracts than they need or less contracts than they need and we understand that at the exchange level. We work with these people day in and day out. We challenge them on what they do and we think that process historically has worked very well.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Sprecher.

Mr. SPRECHER. Thank you.

Mr. CONAWAY. Mr. Scott for 5 minutes.

Mr. AUSTIN SCOTT of Georgia. Thank you, Mr. Chairman, and the gentleman Mr. Neugebauer asked most of my questions about the European Union, which is what I wanted to concentrate on, and the potential for two different sets of rules.

One of my primary concerns with what I see coming out is the effect on liquidity, whether it is an increased transaction cost, which means you have fewer transactions, or one set of rules for the U.S. and one set of rules for the European Union. If the European Union is going to give us an answer in June, which is 1 month from now, what do you expect to happen between now and the end of June from U.S. regulatory agencies, and what do you anticipate the liquidity challenges, not only for the U.S. but for the world, would be if we end up with the EU saying we will not accept the rules from the U.S.?

Mr. SPRECHER. Thank you for the question, Congressman Scott.

We hope that, given the short time that you indicate, the CFTC engages on this on a meaningful level, and if it cannot work with the EU in such a short period of time, that the two of them agree to come up with a different deadline.

I think all of us in the room have seen our end-users have to make last minute decisions or seek last minute relief, and it is agonizing and it is imperfect. For my own company, we are having to make decisions do we break apart the liquidity and contracts and launch U.S. versions and separate European versions, because the two regulatory regimes may not come together. We can't do that overnight. We would have to give a lot of conversation with the global market participants on why we would be looking at splitting markets and how it is going to impact them, and if that is what regulators are asking us to do, we ourselves need a lot of time. So the deadlines are frightening in their immediacy, and we really hope that the CFTC will engage at a very meaningful level with Europe. The relationship between the U.S. and Europe is one that

you would hope that we would be able to come to much commonality.

Mr. DUFFY. If I could add a little bit. We are obviously concerned about the overreaching potential of what the U.S. Government and what is going to be retaliated back on U.S. participants in foreign markets. You know, one of the examples is right now Europe is proposing a 2 day margin for their products and then there is—so people are saying well what does that mean? If we don't accept that here in the U.S., will they start to put different restrictions on U.S. participants in foreign markets? Well, what they fail to recognize is in the United States, we do interday margin, so we do margin on a real time basis every—we don't do it once a day. We do it twice a day, sometimes three times a day because we do mark to market every 12 hours, and more if needed. They don't do that in Europe. What they do is they only do it on a basis of what market conditions predict. So they are trying to get commonality across the platforms, and this is one of the reasons how they are going to bring it out. Well we already have an answer for that. We do it and we do it even more than you do it today.

The other issue on the tax, which is something you raised which is a concern of mine. First of all, Great Britain, to their credit, have already said they will not accept a Tobin Tax on users fees as the rest of the European Union is proposing it. What they also failed to admit is they are going to have another vote after the elections in November and codify that at the end of the year. So we will see how that vote goes first. So the worst thing this Congress could do is react on a knee-jerk reaction to compare what Europe is going to do prior to us and then us doing it first. So that is a big concern we have in our industry.

Mr. AUSTIN SCOTT of Georgia. I don't believe it will be the Congress that has a knee-jerk reaction. It might be an agency or an Administration.

Just real quick—I am almost out of time. What percentage of the global markets trade through our U.S. entities?

Mr. SPRECHER. Well, my company, which as you know is based in Atlanta, Georgia, has more than 50 percent of our revenues come from entities outside the United States.

Mr. AUSTIN SCOTT of Georgia. I think that, again, gets back to one of our primary concerns in that we want those foreign businesses doing business in the United States. It is good for the United States and it is good for our economy.

With that, Mr. Chairman, I am down to about 20 seconds here. I yield the remainder of my time to you.

Mr. CONAWAY. The gentleman yields back. Thank you very much.

Mr. Costa for 5 minutes.

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

Mr. O'Connor, your testimony was somewhat critical on business conduct standards in Dodd-Frank, which were designed to provide customer protection in the swap market. Do you believe that we should have some sort of customer protection, or should we go back to pre-2008?

Mr. O'CONNOR. I absolutely believe there should be customer protection. I think the main point that I was attempting to make was that the approach has been ultra prescriptive rather than prin-

ciple-based, and that has led to an enormous challenge from an implementation perspective.

Mr. COSTA. I think you also have to remember, we were reacting to a crisis. We had a meltdown. I mean, some argue that, economists, we were this close to a worldwide depression.

Your testimony also bemoans the possibility of multiple swap data repositories, and we had a lot of debate, as you know, on Dodd-Frank. The Committee heard similar complaints from other organizations like yours and private companies that sought a government mandate to a single swap data repository, always for the benefit of, one would argue, the regulators. This Committee rejected that approach in letting the market decide whether or not a single or multiple repositories would be best. Well the single repository is such a great idea and multiple repositories are so bad, why are you seemingly afraid of letting the market come to the conclusion by itself?

Mr. O'CONNOR. My point—and I am almost wearing a regulator hat here, is that the idea behind the data repositories is to provide one database where regulators can go to look at behavior in the market and all transactions from all market participants, and I think that, as I said in my written testimony, that would give regulators an unprecedented tool in global markets, and no other market anywhere in the world has there been the chance to create something that would give regulators tools to see what every counterparty was doing in every market. And as a single model, if that is split up into ten repositories, then that is an opportunity lost is the point I am trying to make.

Mr. COSTA. All right, before my time expires, Mr. Duffy and Mr. Sprecher, in your testimony—or in the testimony, Mr. O'Connor expressed worries about fragmentation of derivatives trade reporting. Each of your companies, I am told, has your own swap data repository, and the CFTC has been sued by another swap data repository for approving rules governing each of your SDRs. Do you agree with Mr. O'Connor's view that fragmentation—on the fragmentation of swap reporting?

Mr. DUFFY. I will say this, that if the swap is being cleared at Mr. Sprecher's clearinghouse or mine, the cost to the participants are a lot less. If you have—and second of all, the regulator already gets a copy of each and every swap, so he doesn't have to worry about going to one place. He gets a copy of the swap transaction from the SDRs.

Second, the costs associated with duplication of having a swap cleared at IntercontinentalExchange or at CME Group and then sent to one central swap depository is going to cost the participants multiples of that. So we are already doing that.

Mr. COSTA. Mr. Sprecher, quickly before my time expires.

Mr. SPRECHER. Yes, and in fact, CME Group and ICE every day arrange for Large Trader Reports to go to the CFTC to show the entire positions in our clearinghouse, and so this is really just an augmentation of what exists today.

Mr. COSTA. Let me ask you my final question here. You have all kind of expressed your concerns about what is going on here with the implementation of the regulatory scheme of Dodd-Frank. I don't know that I have really clearly heard you say what concerns

you about what the Europeans are doing right now because I have some interaction with my colleagues there and what are your concerns about what is going on there?

Mr. LUKKEN. Just quickly, one of the issues that we are dealing with that has been resolved in the United States is how swaps are segregated here in the United States using the LSOC methodology. In Europe, that is exponentially more complex, given that Europeans through a mirror have to give a choice of both omnibus segregation for swaps and individually segregated accounts for swaps. That is being interpreted by several jurisdictions within Europe differently, so companies that we represent have to come in and build multiple systems in order to account for each of those different interpretations. We are working with ESMA in Paris to help to consolidate that, to make it one comprehensive guidance on how that is going to be built for the Europeans, and that is just beginning. We are about a year behind where we are with Dodd-Frank in Europe, but we are starting to focus our attention——

Mr. COSTA. How would you describe the—well——

Mr. CONAWAY. Nice try, Mr. Costa. The gentleman's time has expired.

Mr. COSTA. Thank you, Mr. Chairman.

Mr. CONAWAY. Mr. Fincher for 5 minutes.

Mr. FINCHER. Thank you, Mr. Chairman, and I thank the panel for being here today.

Listening to the comments from you all and then some of my colleagues on the—here today, just thinking about who is going to regulate the regulators, who is going to oversee the overseers. You know, how big can it get? How out of control can it get? I was listening to the Ranking Member, my friend who is very knowledgeable about these issues, and him being reluctant from Mr. Dunaway's testimony about how cloudy a lot of these rules still are.

I guess my point—and Mr. Duffy, I am going to let you comment on this—we are going to be placed at a terrible disadvantage. We are seventh generation farmers. I come from a family farm background. We farm about 12,000 acres of corn and cotton, soybeans, and wheat. I know firsthand, from having to deal with Cargill Bungees selling your product and then them having to go in the market and take a position on that market that I may deliver in September, December, March, June, whatever the month may be. When you start really pressing down on them with more regulations, more margin requirements, then they come back to me and say Mr. Fincher, we need more capital. We need a higher risk protection, and my bottom line starts to decrease. Mr. Scott and I have a credit valuation adjustment bill that is a study, and my fear is we are going to open the door to the European institutions on having the advantage over us because just the credit valuation is a prime example. They are delaying or not going to enforce it and we are.

Mr. Duffy, would you comment on some of that?

Mr. DUFFY. I would be happy to try to comment on that. I think you are absolutely right. I think that especially when you look at London, London is truly a one-trick financial institution. That is what it does. It is going to do everything in its power to capture financial services business, and if anybody thinks that excludes ag-

ricultural derivative trading or anything else of that nature, they are sadly mistaken. They already trade those products throughout Europe today. I said this before and I will say it again. If we become an importer of those types of goods and services in this country it will be a shame, because what will happen when you become an importer of those products, you become an importer of that price and you will be determining what they do.

Mr. Sprecher gave a great example about World Sugar. It trades here in the United States. We set it, we don't even use it. That is a huge advantage that we have and we should never want to give that up, sir. I think that our financial markets, as long as they have the proper oversight, should be free to operate in the global capacity that we do, and that is critically important for you as a farmer, or a banker, or any other—mortgage or reinsurer.

Mr. FINCHER. We are so fortunate. I mean, money loves a safe place and capital, it loves a safe place. And thinking about MF Global, Mr. Corzine, and the things that happened there and farmers and ranchers losing money all across the country, I have a news flash for everybody. I don't care how many laws you pass in Congress, bad actors are still going to go bad things, and you are going to tighten down the market to the point that no one can do business and we have no room for opportunity, and we are going to lose the market share. I feel that is what is going to happen from my small perspective.

One last question. I have a minute left. Explain why moving to a 1 day margin is so unreasonable for many customers, Mr. Duffy.

Mr. DUFFY. Moving to a 1 day margin? You know, again, margin at the CME Group is based on the evaluation of the risk of the portfolio, so we really don't measure it. Our risk department is taught not to measure it in days, it is taught to measure in risk. What is the cost of the position, and that is the way we do things to protect the system. Fortunately, the government has come up with a system that either 1 day, 2 days, 5 days or 10 days on how they decide the collection for the regulatory floor. I think that is important, because whether you are a farmer, rancher, or a reinsurer, capital is tight but yet you still need to risk your portfolio. I don't care that insurance rates are next to zero. What happens if they go to five percent overnight and you don't have your portfolio risk and you are stuck with a bunch of mortgages at zero? You are going to have a real big problem. So people have to make sure they have the ability to do risk management, and at the same time, they can't tie all their capital up in margin, which is completely unnecessary to the system.

Mr. FINCHER. Absolutely. Well my time is almost up. I appreciate the comments. Thank you. I yield back.

Mr. CONAWAY. The gentleman yields back.

Mr. Davis for 5 minutes.

Mr. DAVIS. First of all, thank you, Mr. Chairman, and thank you to each and every one of you. I apologize, I had to leave and I am coming back, so if there is anything redundant, please forgive us.

I would like to ask you kind of an open-ended question, starting with Mr. Duffy. Is there anything that—any questions that you haven't had asked yet that you think are very imperative that this Committee needs to understand so that we can move forward in

ensuring that this regulatory environment does not stop what you guys are doing on a regular basis?

Mr. DUFFY. I don't know if there has been not a question asked, Mr. Davis, but what is important for this Committee that oversees the regulator is to make sure that they are enacting what was in the spirit of the Dodd-Frank law, and not to come up with some interpretations that had nothing to do with the law that puts us at what Mr. Fincher said is a complete competitive disadvantage, because that is exactly the path we are going to go down if we continue to have the law interpreted by the regulator that was not voted on by the Congress.

Mr. DAVIS. Thank you, Mr. Duffy. I appreciate your comments and I could not agree more. Is there anybody else on the panel that would like to address this issue?

Mr. LUKKEN. I would just mention—and we would like to leave this thought for the Committee is the amount of work that has gone on since MF Global and since Peregrine to try to restore customer confidence. Many of these panelists have talked about this today, all of the different changes that have gone on, whether it is the automatic verification system that Mr. Roth has talked about where we are getting daily confirmations directly with the bank to verify that the money is there that the FCMs are holding, that is huge. That is unprecedented, and these guys are way ahead of the curve with other industries in this area. Whether it is all the changes, the Corzine rule that the CME and the NFA have adopted where if a firm is going to move customer money, anything above 25 percent, that they have to get the CFO or the CEO to sign off on that, I mean, that is accountability, the controls that have been put into place. So I just wanted to make sure this Committee understand the enormous amount of work that the self-regulatory organizations and the industry and the CFTC and the rulemaking it is currently contemplating are doing to restore customer confidence, and we just want to make sure that the Committee understands that fully.

Mr. DAVIS. Thank you, sir.

Mr. ROTH. Congressman, if I could—I am sorry. Just one comment I would make as far as an issue that we haven't talked about. Our goal is obviously to prevent FCM insolvencies. When they do happen, at some point we need to look at the experience with MF Global and with Peregrine and identify changes regarding the bankruptcy proceedings to make sure that customers receive the priority that Congress intended. I know that is a very complicated question. We have ongoing discussions with basically everybody here at the table, trying to make sure we come up with a solution to those issues. I think we have to look at the bankruptcy proceedings themselves. There may be a way to do this without—by just amending the Commodity Exchange Act. We need to explore that. I think bankruptcy issues, at some point we have to get our arms around that a little bit better.

Mr. DAVIS. Thank you, Mr. Roth.

Mr. O'Connor?

Mr. O'CONNOR. Thank you. I wanted to sort of drill into a little bit on the international aspect here. I think that is one thing that has been consistent in all of the testimonies, and the point I would

like to make is while the CFTC has a tool through the no action letter to make changes and—relief, and ISDA knows this, because we submitted 17 no action letters which were almost entirely granted, and by the way, we appreciate the work of the CFTC staff in granting that, but it does tax resources both at the regulator and the industry to have to go through that motion. The point, though, is that the Europeans don't have such a mechanism and they have a very, very rigid process for—to get to regulation that to change is like turning around an oil tanker. So, people shouldn't underestimate the seriousness of potential conflict that might be out there.

Mr. DAVIS. Thank you, Mr. O'Connor. Anybody else? Mr. Dunaway?

Mr. DUNAWAY. Sure, I will just add one thing real quick. One thing I want to make sure the Committee understands is just the sheer burden that is being placed on smaller OTC participants, the smaller farmers, small commercial entities that are really being pushed out of the OTC markets. You know, we are fully supportive of clearing of swaps on the very clearinghouses, but the sheer burden of the paperwork and the disclosures and the hoops that we are making the smaller participant jump through really ends up pushing them to products that don't fully hedge their risks. They are going to exchange rate of product which we are fully happy to offer them, but it won't particularly hedge their individual commodities. There is an extreme burden that is pushing a lot of the smaller farmers, a lot of the smaller commercial companies to really hedge themselves ineffectively or not at all.

Mr. DAVIS. Thank you, Mr. Dunaway, and thank you all very much for your time today, and your insight. I yield back.

Mr. CONAWAY. The gentleman yields back.

Mr. LaMalfa for 5 minutes.

Mr. LAMALFA. Thank you, Mr. Chairman. I apologize. I had to step out of the room for a few minutes here. Some of our western folks are with us today. Did we get a chance to talk a little bit about the no action letters in any of our questions from the Committee here? I had one directed for Mr. Duffy here, if we—if that hasn't been covered. I don't want to be redundant here.

The point about numerous no action letters being issued at last moments for market participants in having to comply with the new regulation, many of them having been done just since last summer on the ones that we know about that are public. Would you be able to elaborate a little bit on how these last minute no action letters are being a barrier or very harmful to what you are trying to do as you make business decisions as well as in the marketplace?

Mr. DUFFY. The best thing I could say to that, Congressman, is being around the markets for 33 years like I have, the worst thing you could ever have—there is enough uncertainty that you have in your everyday business, but when you have uncertainty in the way the rules are, how you are supposed to comply, you absolutely have no chance to do your risk management business. And when we are going to the final hour of the deadline without the rules being understood or disseminated properly and then a no action letter comes out at the 11th hour, these are harmful for risk management, for farmers, for bankers, for reinsurers as I have said earlier, across the board no matter what it applies to. So these no action

letters, which have been numerous, are actually coming out at the 11th hour, as I said, and it is the worst thing that could happen is uncertainty, because uncertainty will chase people away from the marketplace and it will do what your colleague said. They will go to other markets in different jurisdictions that don't present this type of uncertainty. This is critically important. So whatever the rules are, I am a big believer—when I saw Sarbanes-Oxley and a lot of people said they couldn't comply with 404, well now they are complying with 404, but you have to give people time to understand the rules and to comply with them. You cannot issue a no action letter at the 11th hour.

Mr. LAMALFA. How do you think that this is a justified way of doing business, and why do you think this is this way and it continues to be that pattern?

Mr. DUFFY. If I ran the CME Group like that, we wouldn't be in business.

Mr. LAMALFA. Thank you very much. Yes, that is the thing. Anybody in business has to make a commitment one way or the other with their time, their resources, making long-term commitments. You have to have predictability. You have to know ahead of time what the ground rules are going to be on taxation, anything else, otherwise you are on an incomplete playing field that there is no way to know if the bottom line is going to be met with the rules that are coming at you at the last minute.

So I thank the entire panel for your testimony here today, and hopefully we can make better policy out of this through this Committee. So thank you so much.

I yield back, Mr. Chairman.

Mr. CONAWAY. The gentleman yields back.

Mr. Gibbs for 5 minutes.

Mr. GIBBS. Thank you, Mr. Chairman. I just wanted to mention on the no action letters it is kind of what the EPA does with guidance letters.

First of all, I want to thank you all for being here. I am going to kind of pick off Mr. Fincher a little bit, because I am a farmer/producer too, and I am really concerned. Sitting here listening to your testimony, there is kind of a common theme with all these new regulations and more regulatory enhancement, concern about liquidity in the market, confidence in the market for price discovery, and if people don't have confidence, we lose liquidity and we lose price discovery and we lose a risk management tool for our farmers out there, and that is my top concern.

So going on that a little bit, it seems to me that we look to MF Global and some other things that—moving forward on segregation of funds, keeping that separate in your daily reporting, that is an area that I believe it looks like to me that CFTC should really be focused on to make sure that there is a firewall there and there is accountability. Some of these other things, the transaction tax and increased margin that would put a lot of producers out of the market, am I correct in my hypothesis, I guess, on this? You are all shaking your heads, so I guess I am.

Mr. DUFFY. Good comment, sir. I think you are absolutely spot on. You have basically touched on everything that you are talking about. Confidence is of extreme importance, whether you are refer-

ring to MF Global or anything else. If the participants don't have confidence in the system or the marketplace, they won't participate, so at the CME Group, we spend over $40 million a year—and I don't think there is anybody else in our industry that can even match that number—on just regulatory issues to show that we have compliance. I just spent the last 14 to 16 months on the road in the middle of the country talking to farmers and ranchers and others about the confidence in the marketplace, the tools that we put into place. I think that is one of the things that they want to see. So we are actually showing them what we are doing.

Mr. GIBBS. Just, Mr. Duffy, to go on with that, since we have had the crisis of MF Global and others, what are you seeing with customer funds coming back, participation in the market——

Mr. DUFFY. Yes, we are up a couple percent year over year, and our overall volume, our agricultural products are actually doing quite well, so I am seeing the farmer come back and hedging in their products again. And again, as I said earlier, I don't believe it was a crisis in the CME Group or anything else. I think it was a crisis in the system how it failed them and allowed somebody to touch their customer segregated property, which they did not believe could ever possibly happen. So, now that we have hopefully shored that up a little bit, the participants are back in the marketplace, sir.

Mr. GIBBS. That is good. Do you want to add Mr. Roth?

Mr. ROTH. Congressman, I just wanted to add that since we have implemented this system for the daily confirmation of seg balances, it officially became active February 15. I should also mention that all of the data that we receive is always available to the CFTC as well, so that we can have a third set of eyes looking at that. We always make all of our data, regulatory data immediately available to the CFTC, and so they can see the same stuff that we see and I think it is a huge improvement from where we were just a year ago.

Mr. GIBBS. Just to follow up, another question about the Bankruptcy Code. You know, the first in line if there is a bankruptcy, we see funds that people from the segregated firms fail, segregated accounts. Specifically can you provide any insight how that Code should be amended to make sure that our producers are protected?

Mr. ROTH. Yes, I can just mention an issue that the CFTC has always defined customer property under the bankruptcy rules—under its bankruptcy rules, it has defined customer property and in the event of a shortfall in seg funds, customer property has always been defined to include all of the assets of the FCM until the customers have been made whole. That is a great definition. That is exactly the way it should be. It is the way it has been for a long time. There was in a proceeding maybe 10 years ago a district court opinion which was ultimately rendered moot because the matter was settled, but that court decision rendered—created some doubt as to the validity of the CFTC's definition, and that is a doubt I don't think we should have to live with. I think that cloud should be removed and we should figure out a way to make very clear——

Mr. GIBBS. I am just about out of time. Just a quick question. MF Global, our producers out there and getting reimbursed, what is the status, Mr. Duffy?

Mr. DUFFY. I will be happy to take shot. Right now, the best estimates are that 4D, which are U.S. clients trading on U.S. markets, have roughly 99¢ on the dollar back, and then there is another, what are called 30.7, which are U.S. clients trading on foreign markets, which have around 97¢ on the dollar back, so we are seeing most of the property returned to the participants that it was taken from. Now obviously there are shortfalls on the broker/dealer side, but again, in our world, because of some of the steps that we were able to take, along with our colleagues down the line here, we were able to get the money back.

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

Mr. CONAWAY. The gentleman's time has expired.

Gentlemen, I appreciate each of you coming today and helping us with your perspectives on how well the CFTC is doing and not doing, both the good and the bad. We have several hearings yet to be held with the Subcommittee, and we will look forward to additional comments.

I ask unanimous consent to enter into the record letters from the Institute of International Bankers, from SIFMA, and the American Bankers Association on this issue.

[The information referred to is located on p. 59.]

Mr. CONAWAY. Again, thank you, gentlemen, for your time this morning, and we are adjourned.

[Whereupon, at 11:49 a.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED LETTERS BY HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

May 21, 2013

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Lucas and Ranking Member Peterson:

In connection with the Agriculture Committee's hearing on "The Future of the CFTC: Market Perspectives" and given the role of the CFTC with respect to swaps regulation under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), the Institute of International Bankers (IIB) would like restate our support for a number of important issues. We recognize and applaud the Committee's efforts to address these issues in legislation approved by the Committee earlier in the year, and in the previous Congress.

The IIB represents internationally headquartered financial institutions from over 35 countries around the world, and its members are extensively involved in activities regulated by the CFTC, including in particular swaps activities that are subject to the requirements of Title VII. Indeed, IIB members constitute approximately ½ of the firms that are currently registered as swap dealers under Title VII.

As the Committee initiates its CFTC reauthorization process, we believe whether through standalone legislation or as part of reauthorization, that it is important that the Committee provide: (i) certainty with respect to the application of the requirements of Title VII to cross-border swaps activities, including the effective and efficient coordination and harmonization of U.S. rules with those of other countries; and (ii) national treatment for the U.S. operations of foreign banks *vis-à-vis* U.S.-headquartered banks in connection with their swaps activities in the United States.

Cross-Border Swaps Activities—Certainty in the Coordination of U.S. and International Rules

(1) A substantial majority of swaps transactions are effected between counterparties in different countries. Ensuring proper alignment of U.S. rules with those of other countries therefore is crucial to maintaining the vitality of the U.S. swaps market.

Substituted compliance is an important component of harmonizing U.S. swaps rules with the rules of other jurisdictions. Reflecting the strong U.S. commitment to the principles agreed to by the G20 leaders in 2009, DFA Sec. 752 directs the CFTC to consult and coordinate with its regulatory counterparts outside the United States in order to promote effective and consistent global regulation of swaps. The cross-border dimensions of swaps regulation are also addressed in DFA Sec. 722(d), which establishes a general prohibition against the application of Title VII's requirements to swaps activities outside the United States, except with respect to activities that have a "direct and significant connection with activities in, or effect on, commerce of the United States" or as may be necessary to avoid evasion of Title VII.

Unfortunately, efforts to this point to achieve an appropriate cross-border harmonization of Title VII's requirements with those of other countries have born little fruit. As a result, there remains considerable uncertainty regarding the cross-border application of Title VII's requirements, which in turn has given rise to significant concerns regarding the prospect of fragmenting and disrupting the international swaps market.

Mutual recognition of each other's rules through substituted compliance is an important means to accommodate the rules of different countries in a manner that fosters coordination and avoids unnecessary duplication or conflict. Consistent with international comity principles, permitting a financial institution to comply with equivalent rules of another jurisdiction in connection with its cross-border swaps activities best achieves the purposes underlying DFA Sections 752 and 722(d).

At this stage of Title VII's implementation, there exists a very real potential for conflict between U.S. rules and those of other countries. Absent a satisfactory resolution of these conflicts, many global swap dealers will face the unten-

able position of violating one country's rules or laws in order to comply with another's. **We appreciate the Committee's efforts on this issue in approving H.R. 1256, *the Swap Jurisdiction Certainty Act.* We believe it is essential to make it explicitly clear that reliance on broadly equivalent rules of other countries is an integral part of the cross-border swaps regulatory regime intended under Title VII.**

Ensuring National Treatment

(2) DFA Sec. 716, also known as the "swap push-out rule", contains an acknowledged oversight that results in unequal treatment for uninsured U.S. branches and agencies of foreign banks compared to that of U.S. banks. Sec. 716 sets forth a general prohibition against "Federal assistance" (including access to the discount window) for swap entities, but includes certain grandfather and transitional provisions that permit the phased-in implementation of the prohibition with respect to insured depository institutions as well as safe harbor provisions that allow insured depository institutions to continue to engage in swap activities related to their *bona fide* hedging and traditional bank activities. The uninsured branches and agencies of foreign banks are not afforded the benefit of these provisions. Senators Dodd and Lincoln recognized that this exclusion was unintentional and acknowledged that there was a need "to ensure that uninsured U.S. branches and agencies of foreign banks are treated the same as insured depository institution."[1]

Uninsured U.S. branches and agencies are licensed by a Federal or state banking authority and subject to the same type of safety and soundness examination and oversight as U.S. banks. Based on the policy of national treatment, uninsured branches and agencies are afforded equivalent treatment to U.S. banks, including access to the Federal Reserve's discount window. Access to the discount window is an important tool for maintaining a sound and orderly financial system, and the branches and agencies of U.S. banks are provided access to similar facilities in other countries.

Based on the disparate treatment to which they are subject under Sec. 716, the uninsured U.S. branches and agencies of foreign banks are facing the prospect of having to "push-out" all their existing swap positions and ongoing swap activities to a registered swap affiliate by the July 16, 2013 effective date—an impossible compliance task and one that places these uninsured branches and agencies at a substantial competitive disadvantage *vis-à-vis* insured depository institutions that benefit from the grandfather, transitional and safe harbor provisions. **The resulting disparity is wholly at odds with the longstanding U.S. policy of national treatment; the legislation approved by the Committee H.R. 992 would address this unintended oversight.**

(3) *The definition of a "Swap Dealer" under Sec. 1(a)(49) of the CEA* (as modified by the DFA) provides an exclusion for insured depository institutions, specifying that in "no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer." Similar to the unintended omission of uninsured U.S. branches and agencies of foreign banks in DFA Sec. 716, this exclusion is provided only for insured depository institutions and results in unequal treatment for those uninsured branches and agencies that generally enter into swaps transactions only in connection with their lending activities.[2]

This exclusion permits small U.S. banks the ability to enter into interest rate swaps in connection with their lending activities without having to register as swap dealers, thereby providing them a competitive advantage over the similarly-situated uninsured U.S. branches and agencies of foreign banks, which are denied this parity of treatment. In the last Congress, the Committee approved legislation that addressed this issue. **We would urge the Committee to address this important national treatment issue as part of the CFTC reauthorization process.**

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[1] 156 *Cong. Rec.* S5903–S5904 (daily ed. July 15, 2010) (colloquy between Senator Dodd, Chairman of the Senate Banking Committee, and Senator Lincoln, Chairman of the Senate Agriculture Committee and sponsor of Sec. 716).

[2] For those insured depository institutions that generally enter into swaps transactions with customers only in connection with their lending activities, the exclusion ensures that such ordinary course banking activities will not result in their having to register as a swap dealer. At the same time, swap transactions conducted by an insured depository institution outside the context of its ordinary banking activities may result in it having to register as a swap dealer.

We thank you for your attention to and efforts on these important issues, and are happy to provide additional information at your request.

Sincerely,

SARAH A. MILLER,
Chief Executive Officer,
Institute of International Bankers.

May 14, 2013

ANANDA RADHAKRISHNAN,
Director of Division of Clearing and Risk,
Commodity Futures Trading Commission,
Washington, D.C.

Re: Request for Relief with respect to Rule 39.13(g)(2)(ii)

Dear Mr. Radhakrishnan:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") is writing to request that the Commodities Futures Trading Commission (the "**Commission**") take prompt action to provide relief from the terms of Rule 39.13(g)(2)(ii). In particular, we are writing to support the requests made on behalf of Bloomberg L.P. ("**Bloomberg**") in a letter dated March 11, 2013, and a Motion for Stay dated April 24, 2013, for relief from the 5 day minimum liquidation time required for the calculation of initial margin requirements for swaps (other than swaps on agricultural commodities, energy commodities and metals) cleared on derivatives clearing organizations ("**DCOs**"). We understand that, notwithstanding the related legal actions recently filed on behalf of Bloomberg in District Court for the District of Columbia, such requests remain pending with the Commission.

We are aware of the extensive attention given to this issue by the Commission and its staff, including the Commission's consideration of comments received on the rule as initially proposed and your solicitation of public input through the Public Roundtable on Futurization of Swaps (the "**Roundtable**") held on January 31, 2013. We take this opportunity to offer the perspective of our buy-side member firms and to highlight several important market developments.

Background

Rule 39.13(g) provides that DCOs shall employ models that will generate margin requirements adequate to cover the DCOs' potential future exposure to a clearing customer's position based on price movements between the last collection of variation margin and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's positions. Under the final rule the models must assume, unless an exception is granted, that it will take at least 1 day to liquidate futures and options ("**Futures**") and agricultural commodity, energy commodity and metal swaps ("**Commodity Swaps**") and that it will take at least 5 days to liquidate all other cleared swaps ("**Non-commodity Swaps**"). In the preamble to the final rule, the Commission explained that these "bright-line" minimum liquidation times would provide certainty to the market, ensure that margin requirements would be established for the "thousands of swaps that are going to be cleared" and prevent a potential "race to the bottom" by competing DCOs.

AMG believes that the minimum liquidation time of 5 days for Non-commodity Swaps (a) is arbitrary and overly conservative, (b) is based on a fundamentally flawed assumption as to a difference in liquidity between futures and swaps, (c) creates an artificial economic incentive for market participants to use futures rather than swaps and (d) is contrary to Congress's goal of promoting trading of swaps on swap execution facilities ("**SEFs**"). We strongly believe that the minimum liquidation time for Noncommodity Swaps should be the same as for Futures and Com-

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[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds. In their role as asset managers, AMG member firms, on behalf of their clients, engage in transactions that will be classified as "security-based swaps" and "swaps" under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

modity Swaps—*i.e.,* 1 day—with DCOs using their reasonable and prudent judgment to set higher liquidation times for particular types or classes of transactions where warranted by their specific liquidity characteristics as evidenced by quantitative analyses derived from sources such as swap data repository data.

The 5 Day Minimum Liquidation Time for Non-Commodity Swaps Is Arbitrary and Overly Conservative

Nowhere in the adopting release for the final or proposed rules does the Commission explain why the minimum liquidation time for Non-commodity Swaps should be five times that for Commodity Swaps and Futures. Initial margin set by a DCO for a particular transaction is intended to cover the potential future exposure of the DCO during the maximum period between the last collection of variation margin and the time within which the DCO estimates that it would be able to liquidate a defaulting clearing member's position(s) in such transaction. Thus, the appropriate liquidation time for a particular transaction will be affected by a number of factors, including: the trading volume, open interest, and predictable relationships with highly liquid products of such transaction. In adopting a one-size-fits-all 5 day liquidation time for Non-commodity Swaps, the Commission relied on a flawed assumption, which we discuss below, that Non-commodity Swaps categorically take five times longer than Futures and Commodity Swaps to liquidate. This belief is not supported and fails to adequately take into account the wider range of options available for closing out swap transactions as compared to Futures.

Moreover, a 5 day liquidation time for Non-commodity Swaps is overly conservative. The Commission does not provide any data or analysis of the liquidity in the interest rate, credit default, foreign exchange or equity index swap markets to support the 5 day liquidation time for Non-commodity Swaps.

The Commission's Assumption About the Difference in Liquidity Between Futures and Commodity Swaps, on the One Hand, and Non-Commodity Swaps, on the Other Hand, Is Fundamentally Flawed

The Commission's assumption that Non-commodity Swaps are categorically five times less liquid than Futures and Commodity Swaps is fundamentally flawed. Many swap contracts have become highly standardized and fungible; conversely, new swap futures offerings have customized terms. This convergence makes prior distinctions between futures and swaps no longer relevant.[2]

Standardization of over-the-counter swap terms has been underway for some time and is currently accelerating in response to the new regulatory developments under the Dodd-Frank Act such as the implementation of mandated central clearing and exchange trading. For example, the standardization of auction settlement and contract terms of credit default swaps began in 2009 under ISDA's "big bang" protocol. More recently, interest rate swaps ("**IRS**") are becoming standardized as well. AMG, working in collaboration with ISDA, has introduced Market Agreed Coupon Contracts ("**MAC Contracts**") which are IRS contracts with pre-defined, market-agreed terms, including start and end dates and fixed coupon rates.[3] Similarly, trueEX LLC ("**trueEX**"), a Designated Contract Market ("**DCM**") launched in 2012, plans to list for trading on its electronic trading platform U.S. dollar denominated Standard Coupon & Standard Maturity Interest Rate Swap contracts ("**SCSM Contracts**") with standardized coupons, maturities, roll dates and other terms. In both cases, these standardized specifications are intended to create fungible, liquid contracts regardless of the date acquired and are highly similar to swap futures contracts offered on futures exchanges.

Despite having highly similar, or in some case indistinguishable, trading and liquidity characteristics, the arbitrarily longer liquidation time mandated for Non-commodity Swaps by Rule 39.13(g)(2)(ii) puts them at a significant competitive disadvantage and creates an artificial economic incentive for market participants to use futures rather than swaps, which could result in unintended and unjustifiable

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[2] In its Final Rule defining "swap" and "security-based swap," the Commission described a comment received from the CME that the CFTC should "clarify that nothing in the release was intended to limit a DCM's ability to list for trading a futures contract regardless of whether it could be viewed as a swap if traded over-the-counter or on a SEF, since futures and swaps are indistinguishable in material economic effects." The Commission declined to provide the requested clarification noting that prior distinctions between swaps and futures (such as the presence or absence of clearing) may no longer be relevant, and as result it is difficult to distinguish between the two instruments on a blanket basis. *Further Definition of "Swap," "Security-Based Swap," and "Security-based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement record-keeping,* 77 FED. REG. 48208, 48303 (Aug. 13, 2012).

[3] See SIFMA website: *http://www.sifma.org/services/standard-forms-and-documentation/swaps/*.

regulatory arbitrage. For example, in December 2012, Eris Exchange launched "Eris Standards," swap futures contracts with quarterly effective dates, pre-determined fixed rates, and cash settlement upon maturity, but as described in a press release, these swap futures contracts "are expected to offer margin savings of 40–80% compared to cleared OTC interest rate swaps."[4] In contrast, without relief from the Commission, the MAC Contracts—which also have quarterly effective dates, predetermined fixed rates and more flexible means of settlement, including cash unwind—would be required to use a 5 day liquidation time under Rule 39.13(g)(2)(ii).

AMG believes that these deliverable swap futures contracts and MAC swap contracts are similar instruments and would require substantially similar time periods to liquidate in the case of a customer default. Accordingly, we strongly believe that the minimum margin requirements for these instruments should be the same. Also, we do not believe there is any basis whatsoever to increase the margin requirements or minimum liquidation times for Futures. As expressed in our prior comment letters, we also continue to believe that the Commission should not require minimum liquidation times that exceed 1 day for cleared swaps, whether Commodity Swaps or Non-commodity Swaps.[5]

Rule 39.13(g)(2)(ii) Is Contrary to Congress's Goal of Promoting Trading of Swaps on SEFs

By creating incentives favoring futures trading over swap trading, Regulation 39.13(g)(2)(ii) runs counter to Congress's explicit goals "to promote the trading of swaps on swap execution facilities and to promote pre-trade price transparency in the swaps market."[6] A nearly identical concern led the Commission to abandon its originally proposed bright-line distinction between 1 day and 5 day minimum liquidation times for swaps executed on DCMs and SEFs, respectively. In the preamble to the final rule, the Commission noted that "requiring different minimum liquidation times for cleared swaps that are executed on a DCM and similar cleared swaps that are executed on a SEF could have negative consequences."[7] The Commission acknowledged the comments of multiple parties that this distinction, among other things, would put SEFs at a competitive disadvantage to DCMs, potentially create detrimental arbitrage between standardized swaps traded on a SEF and contracts with the same terms and conditions traded on a DCM and undermine the goal of the Dodd-Frank Act to promote trading of swaps on SEFs.[8] In response to such comments, the Commission determined not to mandate different minimum liquidation times for cleared swaps based on whether they are executed on a DCM or a SEF.[9] We believe that the same logic should be applied such that minimum liquidation times for cleared swaps executed on a DCM or a SEF should be no higher than that for exchange-traded futures.

By arbitrarily setting the liquidation time for Non-commodity Swaps at 5 days, as compared to 1 day for Futures, Rule 39.13(g)(2)(ii) increases the margin required for Noncommodity Swaps relative to Futures and creates an artificial economic incentive for market participants to favor Futures, even though the trading and liquidity characteristics of the two instruments may be the same. Surely, it could not have been Congress' intent in adopting Title VII of the Dodd-Frank Act for the Commission to create a market structure that would move liquidity away from swaps and into Futures.[10] However, Rule 39.13(g)(2)(ii) puts SEFs at a competitive disadvantage to DCMs, and creates a detrimental arbitrage between Non-commodity Swaps and futures contracts with the same terms and conditions. It is critical to

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[4] *Eris Exchange to Launch New, Margin-Efficient Interest Rate Swap Futures* (Press Release, Dec. 5, 2012) avail at *http://www.prnewswire.com/news-releases/eris-exchange-to-launch-new-margin-efficientinterest-rate-swap-futures-182180261.html*.

[5] *See* SIFMA AMG Letter to the Commission on Risk Management Requirements for Derivatives Clearing Organizations (Jun. 3, 2011), available at *http://sifma.org/workarea/downloadasset.aspx?id=25861* ("In the context of cleared transactions, we believe that a 1 day liquidation period for swaps executed on either a DCM or SEF and a 2 day liquidation period for all other swaps is sufficient for this purpose . . .").

[6] Commodity Exchange Act § 5h(a)(1)(e).

[7] *Derivatives Clearing Organization General Provisions and Core Principles,* 76 FED. REG. 69334, 69367 (Nov. 8, 2011).

[8] *Id.* at 69366.

[9] *Id.* ("The Commission is persuaded by the views expressed by numerous commenters that requiring different minimum liquidation times for cleared swaps that are executed on a DCM and equivalent cleared swaps that are executed on a SEF could have negative consequences.")

[10] Indeed, post-implementation of rules adopted by the Commission under the Dodd-Frank Act, the cleared swaps markets may provide more protections to participants than the Futures market, For example, the Commission's collateral segregation model for cleared swaps (complete legal segregation), once implemented, will be more protective than the model for Futures, as the MF Global and Peregrine collapses have shown.

our members' interests as swap market participants that SEFs be robust and vibrant trading platforms and not disadvantaged by external costs that arise solely due to regulatory status. However, if the minimum liquidation times established by the Commission under Rule 39.13(g)(2)(ii) remain unchanged, the Congressional goal of promoting trading of swaps on SEFS will be undermined.

Relief Requested

Accordingly, we encourage the Commission to provide relief in the form of a stay of Rule 39.13(g)(2)(ii) that would immediately adjust the minimum liquidation time for all cleared Non-commodity Swaps, whether executed on a SEF or DCM, to a 1 day liquidation time, conditioned on the obligation of the relevant DCO to use its reasonable and prudent judgment to set higher liquidation times for particular types or classes of transactions where warranted by their specific liquidity characteristics, as evidenced by quantitative analysis derived from sources such as swap data repository data. We respectfully request that the Commission act expeditiously to do so, in view of the importance of relief before the June 10, 2013 mandatory clearing date for category 2 participants, as Bloomberg has explained in its Motion for Stay. Relief before June 10 is necessary to give market participants more certainty and provide a greater incentive for participants to clear their Non-commodity Swap trades.

Based on the foregoing, we respectfully request that the Commission grant the relief described in this letter. We appreciate the Commission's consideration of this request, and stand ready to provide any additional information or assistance that the Commission might find useful. Should you have any questions, please do not hesitate to call Tim Cameron at [**Redacted**] or Matt Nevins at [**Redacted**].

Sincerely,

TIMOTHY W. CAMERON, ESQ.,
Managing Director, Asset Management Group,
Securities Industry and Financial Markets Association;

MATTHEW J. NEVINS, ESQ.,
Managing Director and Associate General Counsel, Asset Management Group,
Securities Industry and Financial Markets Association.

CC:

Hon. GARY GENSLER, *Chairman,* Commodity Futures Trading Commission;
Hon. JILL E. SOMMERS, *Commissioner,* Commodity Futures Trading Commission;
Hon. BART CHILTON, *Commissioner,* Commodity Futures Trading Commission;
Hon. SCOTT O'MALIA, *Commissioner,* Commodity Futures Trading Commission;
Hon. MARK WETJEN, *Commissioner,* Commodity Futures Trading Commission.

Certification Pursuant to CFTC Regulation 140.99(c)(3)

As required by CFTC Regulation 140.99(c)(3), we hereby (i) certify that the material facts set forth in the attached letter dated May 14, 2013 are true and complete to the best of our knowledge; and (ii) undertake to advise the CFTC, prior to the issuance of a response thereto, if any material representation contained therein ceases to be true and complete.

Sincerely,

TIMOTHY W. CAMERON, ESQ.,
Managing Director, Asset Management Group,
Securities Industry and Financial Markets Association;

MATTHEW J. NEVINS, ESQ.,
Managing Director and Associate General Counsel, Asset Management Group,
Securities Industry and Financial Markets Association.

May 21, 2013

Hon. FRANK D. LUCAS,
Chairman,
House Committee on Agriculture,
Washington, D.C.;

Hon. COLLIN C. PETERSON,
Ranking Minority Member,
House Committee on Agriculture,
Washington, D.C.

Dear Chairman Lucas and Ranking Member Peterson:

The American Bankers Association (ABA) appreciates the opportunity to participate in the comprehensive review of the Commodity Exchange Act (CEA) and Commodity Futures Trading Commission (CFTC) regulatory oversight. As noted in your request, this reauthorization comes at a challenging time. Not only has the CFTC remained responsible for oversight of the futures markets, but also it has proposed and finalized dozens of rules to implement the new regulatory framework required by the Dodd-Frank Act.

ABA encourages the Committee to address the following issues related to the new swaps regulations during the reauthorization: implementation transition, cross-border jurisdiction, eligible contract participant (ECP) definition, and risk-based measurement for the clearing exemption.

Implementation Transition

New swaps regulations must be implemented carefully so that they do not unnecessarily interfere with bank or bank customer risk management. The vast majority of banks use swaps to hedge or mitigate risk from their ordinary business activities, including lending. Hedging and mitigating risk are not only good business practices generally, but are important tools that banks use to comply with regulatory requirements to prudently manage risks associated with their assets and liabilities.

Some banks also give customers the option of using swaps to hedge and mitigate their loan risk from changes in interest rate or currency exchange rates. Farmers and energy companies may want to hedge against price changes in commodities. Swaps can be used for all of these purposes.

If banks cannot afford to continue using swaps to hedge risk because the regulations are too burdensome or are not implemented in a way that ensures a smooth transition, it will affect their ability to provide long-term, fixed rate financing. Customers may find long-term business planning difficult and may hesitate to borrow if they are only able to get short-term loans or loans with variable interest rates. They may also defer other business plans if they do not have a cost-effective way to hedge and mitigate their foreign currency, commodity price, or other risks.

The new regulatory framework for the swaps markets is not yet complete. Banks, bank customers, and other market participants need clarity as the new regulations are implemented. ABA believes that clear rules and interpretive guidance as well as appropriate no-action relief will ensure a smooth transition for swaps markets.

Cross-Border Jurisdiction

Banks operating globally also need clarity about the jurisdictional scope of the U.S. regulatory requirements. Although Title VII of the Dodd-Frank Act includes provisions that generally limit its extraterritorial reach, the language does not clearly delineate a standard for determining which cross-border activities should be subject to U.S. jurisdiction. Nor does it address the competitive imbalances that might arise if swaps regulations apply differently to banks depending on the country where they are headquartered.

The CFTC has issued proposed guidance and an exemptive order to address the applicability of Title VII regulations to cross-border swaps transactions. The Securities and Exchange Commission (SEC) has indicated that it will issue a proposed rule addressing security-based swaps transactions. In the meantime, banks operating globally are uncertain about which U.S. regulatory requirements may or may not apply to some of their derivatives activities and whether the jurisdictional scope may differ depending on whether the bank is headquartered in the United States or in another country.

ABA supports the goal of promoting consistency between the cross-border application of all Title VII rules. Market participants that engage in swaps and security-based swaps need clarity and would benefit from consistency between CFTC and SEC rules.

Eligible Contract Participant Definition

ABA has previously asked the CFTC for rulemaking, interpretive guidance, or exemptive relief on the eligible contract participant (ECP) definition. The ECP definition is a key component of the new regulatory framework for the swaps markets, since it will be illegal to enter over-the-counter (OTC) swaps with non-ECPs. Many

swaps will still be OTC transactions because they are exempt from clearing or they are customized to meet individual customer needs, so banks and their customers need clarity about which individuals or entities will be ECPs.

Following ABA's request, the CFTC staff subsequently issued helpful interpretations and no-action relief on some issues related to the ECP definition. However the no-action relief only addressed interest rate swaps. Furthermore, the Commission has not yet taken formal action and the no-action relief will expire no later than June 30, 2013.

Absent formal Commission action, banks and their customers will be left wondering whether they will be able to engage in certain swaps transactions or, if they do, whether the swaps will be subject to rescission or possibly a private right of action once the no-action relief expires. The uncertainty is already having an impact on loan negotiations. Since it takes months to negotiate and close a loan, many of the loans currently being negotiated will not close until after the staff no-action relief expires. As a result, loan officers remain uncertain whether many of their customers will be able to use swaps to hedge commercial risk. This affects the customers' ability to repay the loan and the banks' ability to lend to those customers.

ABA believes that it is important that the CFTC act expeditiously to provide clarity and legal certainty to ensure the transition to the new regulatory regime does not unduly disrupt the lending markets. Absent clarity, banks will be unnecessarily discouraged from offering swaps to customers if it is unclear whether those customers will qualify as ECPs. The result will be decreased lending—especially to individual entrepreneurs and small and mid-size businesses—at a time when our country needs access to credit to ensure sustained economic recovery.

Risk-Based Measurement for Clearing Exemption

Many banks use swaps to hedge or mitigate risk the same way that other commercial end-users do, but they were not automatically exempted from the swaps clearing requirements even though other end-users were. This is incongruous considering that banks are already subject to comprehensive regulatory oversight.

Banks are required to have internal risk management practices and are subject to regular supervision by bank regulators. They are also subject to legal lending limits that cap the exposure that a bank may have to any individual or entity. As a result of the Dodd-Frank Act, legal lending limits will now explicitly include swap transactions in the measurement of credit exposure to another person.

The CFTC was required to consider an exemption from swaps clearing requirements for certain banks that use swaps to hedge or mitigate risk. Even though the CFTC's exemptive authority was not limited to institutions of a certain asset size, the Commission adopted a final rule exempting banks with total assets of $10 billion or less from the clearing requirements.

ABA asserts that a risk-based measurement for the end-user clearing exemption for banks would be more appropriate. For example, even banks with $30 billion or less in assets account for only 0.09 percent of the notional value of the bank swaps market as of December 2012. Rather than a $10 billion asset threshold or any other arbitrary asset threshold, a more appropriate measurement for the exemption might be in proportion with size of swaps portfolio and risk to the market. Swaps activity of this magnitude simply does not pose any significant risk to the safety and soundness of swap entities or to U.S. financial stability.

Conclusion

Thank you for your consideration of these issues that the ABA believes are essential to successfully functioning swaps markets. Please feel free to contact Edwin Elfmann at [**Redacted**] or Diana Preston at [**Redacted**] if you have any questions or need additional information.

Sincerely,

JAMES C. BALLENTINE,
Executive Vice President, Congressional Relations & Political Affairs,
American Bankers Association.

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