COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

HARMONIZING GLOBAL DERIVATIVES REFORM: IMPACT ON U.S. COMPETITIVENESS AND MARKET STABILITY

STATEMENT OF JOHN M. DAMGARD, PRESIDENT
FUTURES INDUSTRY ASSOCIATION

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Chairman Conaway, Ranking Member Boswell, members of the Subcommittee, I am John Damgard, president of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today.

When Congress was considering the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), many in the financial services industry — and in Congress — cautioned that the extraterritorial reach of the regulatory structure being established would unnecessarily interfere with the regulatory programs being established in the European Union and Asia and would inhibit the ability of U.S. market participants to compete internationally. As we approach the effective date of the Dodd-Frank Act, and the regulatory regime contemplated by the Commodity Futures Trading Commission (Commission) in its proposed rules has come into focus, there is increasing evidence that last year's hypothetical fears will be this year's reality.

Concern Over the Extraterritorial Scope of the Commission's Rules is Increasing

In March, the UK Financial Services Authority (FSA) filed a comment letter with the Commission objecting to the Commission's proposed rules prohibiting registered derivatives clearing organizations (DCOs) from setting minimum capital requirements for swap clearing members higher than $50 million. While acknowledging that minimum capital requirements may help assure fair and open access to clearing organizations, FSA warned that "impos[ing] them on clearing arrangements for products that have complex or unique characteristics could lead to increased risk to the system in the short to medium term." FSA has a direct interest in the Commission's rules affecting DCOs, since two registered DCOs active in clearing swaps — LCH.Clearnet Ltd. and ICE Clear Europe — are located in London and are subject to regulation by FSA as recognized clearing houses. Therefore, the Commission's requirements for DCOs may conflict with FSA's.

Earlier this month, Paula Dejmek, a member of the cabinet of Michael Barnier, the European Commission's internal market and services commissioner, speaking at a conference of the Association for Financial Markets, observed:

> We are aware of the extraterritorial application of the Dodd-Frank Act. We are not happy with it and this is something we are discussing with our U.S. counterparts, hoping to find mutually convenient solutions. . . . The issue of regulatory convergence is extremely important. . . . We have important questions to address, notably with regard to the mutual open access to each other's market operators and infrastructures.

International regulators are not the only authorities troubled by the extraterritorial reach of the Dodd-Frank Act. Just last week, Senators Schumer and Gillibrand joined 16 members of the New York House of Representatives both Democrats and Republicans, including Congressman Gibson and eight members of the House Financial Services Committee, to express their fears that the Commission's proposed rules imposing margin requirements on uncleared derivatives transactions between non-U.S. subsidiaries of U.S. entities and non-U.S. counterparties:

> will inevitably result in significant competitive disadvantages for U.S. firms operating globally. . . . [A]bsent harmonization between new rules here and abroad, disparate treatment of U.S. firms will only encourage participants in derivatives markets to do business with non-U.S. firms. Accordingly, it is important to strike a balance between implementing the new safeguards and harming the competitiveness of U.S. financial institutions vis-à-vis their international counterparts. . . . Congress . . . included provisions in Dodd-Frank that instruct regulators . . . to impose regulations extraterritorially beyond the U.S. only if there is a 'direct and significant' connection with U.S. activities or commerce. These provisions are intended to protect . . . the competitiveness of U.S. institutions, which is necessary for a healthy banking system.

We do not underestimate the challenges facing the Commission, and we recognize that the Commission and its staff are working hard to comply with the very tight timeframes set out in the Dodd-Frank Act. It is perhaps understandable, therefore, that the Commission has not considered fully, and provided guidance on, the intended extraterritorial scope of the Dodd-Frank Act. As the above examples indicate, however, the Commission cannot wait any longer.

Guidance on the Extraterritorial Scope of the Commission's Rules is Essential

Many provisions of the Dodd-Frank Act do not require implementing rules and will become effective in less than two months. The failure of the Commission to provide clear guidance on the extraterritorial scope of the Dodd-Frank Act prior to its effective date, and the resultant legal and regulatory uncertainty to which market facilities and participants both here and abroad will be exposed, will require such participants to incur significant costs to comply with the Dodd-Frank Act or assume the regulatory risk that they will be found to be in violation of one or more provisions of the Dodd-Frank Act and, perhaps, ordered to cease business activities until they are in compliance. No market facility or participant can afford to take this risk.

One example that I would like to highlight for you today that directly affects many FIA members are the provisions of the Dodd-Frank Act requiring any clearing organization, wherever located, that clears swaps for participants located in the U.S. to be registered with the Commission as a DCO and the concomitant obligation of any clearing member clearing swaps on behalf of U.S. participant to be registered as an FCM.

Section 725 of the Dodd-Frank Act provides that it is unlawful for any clearing organization "directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a derivatives clearing organization with respect to . . . a swap," unless that clearing organization is registered with the Commission as a DCO. On its face, therefore, this section requires a foreign clearing organization to be registered as a DCO if it cleared just one swap for or on behalf of a U.S. participant. This is the case even if the Commission has not determined that the swap is required to be cleared.

Section 724 of the Dodd-Frank Act provides that it is unlawful for any person to accept any money or securities "from, for, or on behalf of a swaps customer" to margin a cleared swap, unless that person is registered with the Commission as an FCM. Consequently, a clearing member of a foreign clearing organization that clears swaps, directly or indirectly, on behalf of one or more U.S. swap participants is required to be registered with the Commission.

Requiring the registration of such foreign DCOs threatens to: (i) severely strain the Commission's resources; (ii) impose substantial financial and operational burdens on FCMs, subjecting FCMs to duplicative and conflicting laws and regulatory requirements; (iii) restrict competition among clearing organizations and FCMs; and (iv) enhance rather than reduce systemic risk.

In his testimony before the House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies in March, Chairman Gensler stated that the Commission currently oversees 14 registered DCOs and anticipates that the Dodd-Frank Act will result in an additional six or seven clearing organizations applying for registration as a DCO. Consequently, the Commission is requesting a 30 additional staff, in addition to the current staff of 40, "to address the significant increase in the number of DCOs, the more complex nature of the swaps markets and the Congressional mandate that we annually examine systemically important DCOs."

Providing appropriate exemptions from registration to foreign clearing organizations whose activities do not have "a direct and significant connection with activities in, or effect on, commerce of" the U.S. would relieve the Commission of the cost of overseeing such foreign clearing organizations and free staff to focus on transactions that more directly affect U.S. market participants. An exemption would also permit such clearing organization to offer clearing services to U.S. participants without having to incur the costs of applying for registration and, thereafter, meeting duplicative and potentially conflicting regulatory requirements of the Commission and its home country regulator.

Importantly for our member firms, an exemption from registration as a DCO would relieve U.S. FCMs of the difficult choice of complying with multiple financial and operational requirements attendant to membership in clearing organizations around the globe or choosing not to offer the broad range of swaps clearing services to customers. Moreover, such firms may have to become registered in the home jurisdiction of the foreign DCO and, potentially, become subject to taxation in multiple jurisdictions.

As the Subcommittee is aware, one of the principal purposes of the Dodd-Frank Act is to encourage competition among clearing organizations and clearing members. Requiring each foreign clearing organization that clears swaps for or on behalf of U.S. participants to become registered as a DCO and each clearing member that, directly or indirectly, clears for U.S. participants to become registered as an FCM will almost certainly restrict rather than encourage competition. Requiring U.S. FCMs to become registered with multiple foreign DCOs may also enhance systemic risk, by exposing such FCMs to the risks of being members of clearing organizations that are subject to different regulatory regimes and bankruptcy laws.

As noted earlier, two of the more active swaps clearing organizations registered with the Commission, ICE Clear Europe and LCH.Clearnet Ltd., are located outside of the U.S., and we fully expect that other foreign clearing organizations will elect or be required to be registered with the Commission as DCOs. Certainly, any foreign clearing organization that elects to apply for registration as a DCO should be permitted to apply. However, we do not believe every foreign clearing organization that clears swaps, directly or indirectly, for or on behalf of U.S. participants should be required to be registered simply because it offers clearing services to U.S. participants.

A Successful Model for the Regulation of Foreign DCOs

This does not need to be result. We agree with the New York congressional delegation that the Dodd-Frank Act should not apply to activities outside of the U.S., *i.e.*, clearing on a foreign clearing organization, unless such clearing activities have "a direct and significant connection with activities in, or effect on, commerce of" the U.S. We believe the Commission has authority to interpret this provision to exclude from its jurisdiction certain entities and transactions that do not have a significant impact on that do not have a significant impact on U.S. commerce. Moreover, the Commission has specific authority under the Dodd-Frank Act to exempt a foreign clearing organization from registration as a DCO, subject to appropriate conditions, if the Commission determines that the foreign clearing organization is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of such organization.

The Commission's Part 30 rules, which govern the offer and sale of foreign futures and options transactions to U.S. participants, is a tested, successful model for the regulation of international transactions that could serve as a starting point for exempting foreign clearing organizations and other market participants from the Commission's registration requirements. The Commission's Part 30 rules were first promulgated nearly 24 years ago in 1987. Under these rules, foreign clearing organizations are not required to be registered

with the Commission to clear futures contracts executed on foreign exchanges on behalf of U.S. participants. In addition, a foreign clearing member is not required to be registered with the Commission as an FCM, if the foreign clearing carries only a customer omnibus account on behalf of a U.S. FCM and does not carry an account directly for a U.S. customer.

These rules assure that the accounts of U.S. participants are carried by U.S. FCMs, subject to the Commission's rules regarding the protection of foreign futures and options customer funds, as well as the Commission's sales practice and other requirements to which FCMs are subject. Customers that trade on non-U.S. markets also receive prescribed risk disclosure, which assures that they understand the additional risks of trading outside of the U.S.

Further, the Commission's Part 30 rules provide that a foreign clearing member may deal directly with FCMs and their affiliates without having to be registered with the Commission as FCMs. Having determined that a foreign clearing member is not required to be registered as an FCM to carry a US FCM's customer omnibus account, the Commission concluded that registration would not be required to clear the US FCM's proprietary accounts. The Commission concluded that US FCMs are able to assess the risks of trading on foreign markets.

Finally, under the Part 30 rules, the Commission has granted exemptions from registration to non-U.S. firms that deal with U.S. customers and that the Commission determines are subject to comparable regulation in their home country.

When I appeared before you in February, I noted:

> Because Congress gave the regulatory agencies, including the Commission, broad discretion in adopting rules to implement provisions of the Dodd-Frank Act, it is essential that the Committee on Agriculture, as the committee of jurisdiction with respect to matters relating to the [Commodity Exchange Act], monitor carefully the Commission's implementation of the Dodd-Frank Act and provide additional guidance when appropriate.

FIA urges the Subcommittee to encourage the Commission to exercise its interpretative and exemptive authority broadly in order to facilitate U.S. FCM participation in the development of international cleared swaps markets. The Commission must act now; if it waits until the end of the rulemaking process, it will be too late.

Exemptive Relief Will Facilitate Coordination Among International Regulators

By granting appropriate exemptive relief, we believe the Commission will facilitate greater coordination among international regulators and the establishment of consistent standards with respect to the regulation of swaps. The need for such coordination has been brought into sharp relief with reports that the European Parliament is considering amendments to

the European Union's European Market Infrastructure Regulation ("EMIR"), which would effectively prohibit a third-country clearing organization from providing clearing services to EU entities, unless the clearing organization was authorized by each EU member state. Moreover, a third party clearing organization could be authorized only if the European Commission recognized that the legal and supervisory arrangements of its home jurisdiction were "equivalent" to those contained within EMIR.

If the European Parliament adopts these amendments, it would be extremely difficult, if not impossible, for US DCOs to offer their clearing services to entities within the EU. The "balkanization" of derivatives clearing in this way benefits no one, dening market participants access to clearing, reducing competition and increasing global systemic risk. Yet, the Commission's ability to challenge these amendments will be severely constrained if the Dodd-Frank Act is interpreted to require EU clearing organizations to be registered here to offer clearing services to US participants.

The Commission has been a leader in developing standards for mutual recognition among international regulators for more than 20 years. The Dodd-Frank Act should not be interpreted in a manner that requires the Commission to surrender this leadership role.

Position Limit Rules Must be Harmonized

In their letter to Chairman Gensler, the New York delegation noted;

> [A]bsent harmonization between new rules here and abroad, disparate treatment of U.S. firms will only encourage participants in derivatives markets to do business with non-U.S. firms. Accordingly, it is important to strike a balance between implementing the new safeguards and harming the competitiveness of U.S. financial institutions vis-à-vis their international counterparts.

I would like to take a moment to address one aspect of the Commission's proposed rules with respect to which the lack of international harmonization threatens to place U.S. markets and market participants at a severe competitive disadvantage, *i.e.*, position limits. FIA fully supports a robust large trader reporting system across markets. It is important that the Commission and other regulatory agencies and self-regulatory organizations know the identity of market participants with meaningful positions. However, we cannot support the proposed position limit rules.

FIA filed extensive comments in response to the proposed rules in which we argued, among other things, that the proposed rules do not satisfy the statutory prerequisites for establishing position limits. Specifically, in publishing the proposed rules for comment, the Commission cited no evidence for concluding that position limits are "necessary to diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation, or that the levels proposed by the Commission are "appropriate."

We also expressed concern over the public policy considerations of imposing significant new restrictions on the ability of market participants to trade listed and over-the-counter derivatives without adequate factual support for those restrictions. The price discovery and risk-shifting functions of the U.S. derivatives markets are too important to U.S. and international commerce to be the subject of a position limit experiment based upon unsupported claims about price volatility caused by speculative positions.

Equally important, we are concerned that the proposed rules could cause non-U.S. participants that currently use U.S. futures and derivatives markets to trade and manage their commercial or financial risks will shift their trading activities to locations outside of the U.S., which do not have position limits. As the Subcommittee will recall, the Dodd-Frank Act requires the Commission, within 12 months of adopting any position limits to "conduct a study of the effects (if any) of the position limits imposed . . . on the movement of transactions from exchanges in the United States to trading venues outside the United States." Our fear is that, without the necessary factual predicate, the Commission cannot assure Congress or market participants that the position limits it sets will not adversely cause the price discovery and risk allocation functions that U.S. futures exchanges perform so well to shift to foreign boards of trade.

The Commission's Rules Should Be Published for Additional Comment

FIA has previously expressed to the Subcommittee its concern that the pace and order in which the Commission has proposed rules to implement the Dodd-Frank Act were such that meaningful analysis and comment difficult was difficult, if not impossible. Earlier this month, the Commission announced that it would reopen the comment period on many of the proposed rules for an additional 30 days. We appreciate the Commission's action. However, we are disappointed that the Commission did not share its views on the many thousands of comments it has received to date and, more importantly, how the Commission sees these various rule proposals fitting together to form a comprehensive and coherent regulatory structure.

Chairman Gensler has correctly observed that the numerous rules the Commission has proposed form a mosaic, and he has suggested that this 30-day comment period will allow commenters to see the entire mosaic at once. Mosaics, however, are nothing more than chips of colored stone until they have been creatively assembled to make a work of art. We suggest that the Commission's proposals are still just chips waiting for the Commission to assemble them into a comprehensive regulatory structure. The industry and the public deserve an opportunity analyze and comment on the Commission's vision of its regulatory mosaic before it is set in concrete. We, therefore, recommend that, once the Commission has determined how these various proposed rules will fit together, it provide an additional 60-day comment period before promulgating final rules. We think a 60-day comment period would be well within the timetable set by the G-20.

Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you may have.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: John M. Damgard

Organization you represent (if any): Futures Industry Association

1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source:_____ **Amount:**_____

Source:_____ **Amount:**_____

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:**

Source:_____ **Amount:**_____

Source:_____ **Amount:**_____

Please check here if this form is NOT applicable to you: XX

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* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.

Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823
202.466.5460
202.296.3184 fax
www.futuresindustry.org

John M. Damgard is President of the Futures Industry Association (FIA) and founder, past president and a member of the board of the Institute for Financial Markets (IFM). FIA is the non-profit trade association that represents the commodity futures and options industry. The FIA membership is composed of the 40 largest brokerage firms and over 130 law firms, accounting firms, banks, insurance companies, pension funds, commodity pool operators, commodity trading advisors, domestic and international exchanges, international firms and other market users. We estimate that FIA members are responsible for over 90% of the customer business transacted on U.S. futures markets. Incorporated in 1989, the IFM's mission is to be the preeminent non-profit educational resource for the financial services industry.

Prior to joining the FIA in 1982, Mr. Damgard directed the Washington office of ACLI International, a leading commodity merchant firm active in cash and futures markets worldwide. He served as Deputy Assistant and Acting Assistant Secretary of Agriculture and was responsible for the major marketing and regulatory functions at the USDA. Prior to his service at the Department of Agriculture, Mr. Damgard served on the White House staff as Assistant to the Vice President during the Nixon/Ford Administrations and previously was active in banking, farming and manufacturing in Illinois.

Mr. Damgard was born and raised in Ottawa, Illinois. He was educated at Deerfield Academy in Massachusetts, Knox College in Illinois and University of Virginia. Mr. Damgard is active in community and political affairs. He currently serves as a special advisor to the Managed Funds Association. He has appeared on numerous radio and television programs to discuss public policy issues related to the domestic and international financial markets. Also, he has been a frequent witness before Congress regarding a variety of legislative issues and before the Commodity Futures Trading Commission regarding regulatory policies.