HEARING TO REVIEW PROPOSED LEGISLATION BY THE U.S. DEPARTMENT OF THE TREASURY REGARDING THE REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS

HEARINGS

BEFORE THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 17, 22, 2009

Serial No. 111–29

Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

53–020 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON AGRICULTURE

COLLIN C. PETERSON, Minnesota, *Chairman*

TIM HOLDEN, Pennsylvania, *Vice Chairman*
MIKE MCINTYRE, North Carolina
LEONARD L. BOSWELL, Iowa
JOE BACA, California
DENNIS A. CARDOZA, California
DAVID SCOTT, Georgia
JIM MARSHALL, Georgia
STEPHANIE HERSETH SANDLIN, South Dakota
HENRY CUELLAR, Texas
JIM COSTA, California
BRAD ELLSWORTH, Indiana
TIMOTHY J. WALZ, Minnesota
STEVE KAGEN, Wisconsin
KURT SCHRADER, Oregon
DEBORAH L. HALVORSON, Illinois
KATHLEEN A. DAHLKEMPER, Pennsylvania
ERIC J.J. MASSA, New York
BOBBY BRIGHT, Alabama
BETSY MARKEY, Colorado
FRANK KRATOVIL, JR., Maryland
MARK H. SCHAUER, Michigan
LARRY KISSELL, North Carolina
JOHN A. BOCCIERI, Ohio
SCOTT MURPHY, New York
EARL POMEROY, North Dakota
TRAVIS W. CHILDERS, Mississippi
WALT MINNICK, Idaho

FRANK D. LUCAS, Oklahoma, *Ranking Minority Member*
BOB GOODLATTE, Virginia
JERRY MORAN, Kansas
TIMOTHY V. JOHNSON, Illinois
SAM GRAVES, Missouri
MIKE ROGERS, Alabama
STEVE KING, Iowa
RANDY NEUGEBAUER, Texas
K. MICHAEL CONAWAY, Texas
JEFF FORTENBERRY, Nebraska
JEAN SCHMIDT, Ohio
ADRIAN SMITH, Nebraska
ROBERT E. LATTA, Ohio
DAVID P. ROE, Tennessee
BLAINE LUETKEMEYER, Missouri
GLENN THOMPSON, Pennsylvania
BILL CASSIDY, Louisiana
CYNTHIA M. LUMMIS, Wyoming

PROFESSIONAL STAFF

ROBERT L. LAREW, *Chief of Staff*
ANDREW W. BAKER, *Chief Counsel*
APRIL SLAYTON, *Communications Director*
NICOLE SCOTT, *Minority Staff Director*

CONTENTS

	Page
Thursday, September 17, 2009	
Boswell, Hon. Leonard L., a Representative in Congress from Iowa, submitted material	99
Lucas, Hon. Frank D., a Representative in Congress from Oklahoma, opening statement	3
Peterson, Hon. Collin C., a Representative in Congress from Minnesota, opening statement	1
Prepared statement	2
WITNESSES	
Hixson, Jon, Director of Federal Government Relations, Cargill, Incorporated, Washington, D.C.	4
Prepared statement	6
English, Hon. Glenn, CEO, National Rural Electric Cooperatives Association, Washington, D.C.	8
Prepared statement	10
Schryver, David, Executive Vice President, American Public Gas Association, Washington, D.C.	11
Prepared statement	13
Hirst, Richard B., Senior Vice President and General Counsel, Delta Air Lines, Minneapolis, MN; on behalf of Air Transport Association	19
Prepared statement	21
O'Connor, Gary N., Chief Product Officer, International Derivatives Clearing Group, LLC, New York, NY	50
Prepared statement	51
Damgard, John M., President, Futures Industry Association, Washington, D.C.	55
Prepared statement	56
Duffy, Hon. Terrence A., Executive Chairman, CME Group Inc., Chicago, IL	60
Prepared statement	61
Pickel, Robert G., Executive Director and CEO, International Swaps and Derivatives Association, New York, NY	71
Prepared statement	72
Supplemental material	121
Short, Johnathan H., Senior Vice President and General Counsel, IntercontinentalExchange, Inc., Atlanta, GA	77
Prepared statement	79
Supplemental material	122
Budofsky, Daniel N., Partner, Davis Polk & Wardwell LLP, New York, NY; on behalf of Securities Industry and Financial Markets Association	82
Prepared statement	84
SUBMITTED MATERIAL	
3M Company, submitted statement	150
Keating, Frank, President and CEO, American Council of Life Insurers, submitted statement	102
Menezes, Mark W., David T. McIndoe, R. Michael Sweeney, Jr., Hunton & Williams LLP; on behalf of Working Group of Commercial Energy Firms, submitted report	103
National Association of Manufacturers, submitted statement	152

Page

National Association of Real Estate Investment Trusts; The Real Estate Roundtable; and International Council of Shopping Centers, joint submitted statement 153
Plank, Roger, President, Apache Corporation, submitted statement 123
Rathert, Terry W., Founder, Executive Vice President, and Chief Financial Officer, Newfield Exploration Company, submitted statement 145

Tuesday, September 22, 2009

Lucas, Hon. Frank D., a Representative in Congress from Oklahoma, opening statement 156
Peterson, Hon. Collin C., a Representative in Congress from Minnesota, opening statement 155

WITNESSES

Gensler, Hon. Gary, Chairman, Commodity Futures Trading Commission, Washington, D.C. 157
    Prepared statement 159
Schapiro, Hon. Mary L., Chairman, U.S. Securities and Exchange Commission, Washington, D.C. 163
    Prepared statement 165

SUBMITTED MATERIAL

Independent Petroleum Association of America, submitted statement 201

HEARING TO REVIEW PROPOSED LEGISLATION BY THE U.S. DEPARTMENT OF THE TREASURY REGARDING THE REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS

THURSDAY, SEPTEMBER 17, 2009

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

The Committee met, pursuant to call, at 10:34 a.m., in Room 1300, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] presiding.

Members present: Representatives Peterson, Holden, Boswell, Scott, Marshall, Herseth Sandlin, Ellsworth, Walz, Kagen, Schrader, Dahlkemper, Bright, Kratovil, Schauer, Kissell, Boccieri, Murphy, Pomeroy, Minnick, Lucas, Goodlatte, Moran, Neugebauer, Schmidt, Smith, Latta, Roe, Luetkemeyer, Thompson, Cassidy, and Lummis.

Staff present: Adam Durand, Scott Kuschmider, Clark Ogilvie, James Ryder, Debbie Smith, Tamara Hinton, Kevin Kramp, Josh Mathis, Mary Nowak, Nicole Scott, Jamie Mitchell, and Sangina Wright.

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

The CHAIRMAN. The Committee will come to order. This hearing of the Committee on Agriculture to review proposed legislation by the U.S. Department of the Treasury regarding the regulation of over-the-counter derivatives markets will come to order.

I welcome everyone to today's hearing to review the legislative language put forth by the U.S. Department of the Treasury last month regarding the regulation of the over-the-counter derivatives. We are beginning an important period in our attempts to bring much-needed transparency and more effective oversight to our financial markets, particularly for unregulated swaps and derivatives.

Before the August district work period, House Financial Services Committee Chairman Frank and I released a concept paper outlining our shared principles on what over-the-counter derivative legislation should entail. We put out the concept paper before August so that Members could have plenty of time to review it, critique it, develop ideas, suggestions, thoughts, and comments in preparation of dealing with these issues this fall.

With that said, I hope the Members of this Committee have come armed with good questions today for our industry stakeholders.

Earlier this year, the White House presented broad reform proposals touching many sectors of the financial system. Included in those proposals were provisions to regulate the market for over-the-counter derivatives. Our Committee examined these principles in July. And when Secretary Geithner appeared before a joint hearing with the House Financial Services Committee, we heard their general views at that time. Secretary Geithner's testimony that day was informative, and I was encouraged by his willingness to work with our two Committees in a bipartisan manner as we move forward.

Following Secretary Geithner's appearance, Treasury has filled in some of the blanks on their regulatory reform principles with legislative language. And that is the subject of today's hearing.

I am pleased to note that several of Treasury's proposals are similar in concept to legislation that our Committee has already passed this year, including mandatory clearing of all standardized over-the-counter products and setting capital and margin requirements for dealers.

Treasury's language expands on some of these principles, and while I do have some outstanding concerns, such as the fair treatment for end-users in any regulatory overhaul, I think their ideas represent a decent beginning in the debate over legislation that gives the American people the confidence that our markets are being overseen and monitored by strong, effective regulators.

This morning, we will hear from two panels of industry stakeholders representing exchanges, traders, and end-users. Next week, Commodity Futures Trading Commission Chairman Gary Gensler will appear before the Committee for the first time, and he will be joined by Securities and Exchange Commission Chairman Mary Schapiro.

I look forward to hearing today's witnesses give their thoughts on the central clearing model for OTC derivatives, along with issues like OTC product standardization, dealer regulation, and their thoughts on joint rulemaking between agencies of jurisdiction.

Again, I thank today's witnesses for being here. I look forward to their testimony.

[The prepared statement of Mr. Peterson follows:]

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

Good morning, and welcome to today's hearing to review legislative language put forth by the U.S. Department of the Treasury last month regarding the regulation of over-the-counter derivatives.

We are beginning an important period in our attempts to bring much-needed transparency and more effective oversight of our financial markets, particularly for unregulated swaps and derivatives.

Before the August District Work Period, House Financial Services Committee Chairman Frank and I released a concept paper outlining our shared principles on what over-the-counter derivative legislation should entail.

We put out the concept paper before August so that Members could have plenty of time to review it, critique it and develop ideas, suggestions, thoughts and comments in preparation of dealing with these issues this fall. With that said, I hope the Members of this Committee have come armed with some good questions today for our industry stakeholders.

Earlier this year, the White House presented broad reform proposals touching many sectors of the financial system.

Included in those proposals were provisions to regulate the market for over-the-counter derivatives. Our Committee examined these principles in July, when Secretary Geithner appeared before a joint hearing with the House Financial Services Committee.

Secretary Geithner's testimony that day was informative, and I was encouraged by his willingness to work with our two Committees in a bipartisan manner as we move forward. Following Secretary Geithner's appearance, Treasury has filled in some of the blanks on their regulatory reform principles with legislative language, and that is the subject of today's hearing.

I am pleased to note that several of Treasury's proposals are similar in concept to legislation that our Committee has already passed this year, including mandated clearing of all standardized over-the-counter products, and setting capital and margin requirements for dealers. Treasury's language expands on some of these principles; and while I do have some outstanding concerns, such as the fair treatment for end-users in any regulatory overhaul, I think their ideas represents a decent beginning in the debate over legislation that gives the American people the confidence that our markets are being overseen and monitored by strong, effective regulators.

This morning we will hear from a two panels of industry stakeholders representing exchanges, traders, and end-users. Next week, Commodity Futures Trading Commission Chairman Gary Gensler will appear before this Committee for the first time, and he will be joined by Securities and Exchange Commission Chairman Mary Schapiro. I look forward to hearing today's witnesses give their thoughts on the central clearing model for OTC derivatives, along with issues like OTC product standardization, dealer regulation, and their thoughts on joint rulemaking between the agencies of jurisdiction.

I thank today's witnesses for being here and I look forward to their testimony. At this time, I would like to yield to my friend and colleague from Oklahoma, the Ranking Member of the Committee, Mr. Lucas, for his opening statement.

The CHAIRMAN. And, at this time, I would like to yield to my friend and colleague from Oklahoma, the Ranking Member of the Committee, Mr. Lucas, for an opening statement.

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

Mr. LUCAS. Thank you, Mr. Chairman. And I want to thank you for calling this series of important and timely hearings on the Administration's proposal to regulate the over-the-counter derivatives market.

I congratulate the Chairman on both the structure of the hearings and on the diverse and highly impacted list of witnesses. I hope they will be able to answer some of the many questions I, and my colleagues on the Committee, will have about the August 11 proposal.

At a time when all of America is being cost-conscious, the Administration, once again, proves perhaps they don't quite get that. Regardless of whether you think the economy is improving or not, the Administration's proposal to regulate the over-the-counter derivatives markets will do nothing but increase costs.

The Administration's proposals pile more regulations and requirements on legitimate business activity—activity that is aimed at controlling cost and managing risks. The increase in regulation will increase the cost of doing business, and that increase will be passed along to consumers.

With all of the focus on unlocking the credit markets, this proposal, in my opinion, goes in the wrong direction. It takes capital—capital that otherwise would be used for research and development, payroll, and other employee benefits—and parks it over at a clearinghouse where it will collect dust.

I am concerned that the increase in cost will reduce, if not eliminate, the risk-management activity, which would only translate into higher price and volatility for consumers. Those businesses that decide that the new regulatory regime is too costly will go without mitigating the risk or move its very legitimate and necessary over-the-counter financial activities out of the country. In either scenario, the government loses any ability to oversee the activity, and we lose more jobs.

Why do we need the requirement to move transactions into regulated exchanges? Where is the systematic risk that this proposal is solving? Why do we need to go beyond increasing transparency to government regulators? Instead of mandates and prohibitions, we should encourage people to trade and clear in healthy, liquid, American markets.

Mr. Chairman, over the next few days, I hope to learn the answers to some of these questions. I look forward to hearing our witnesses today, and I thank you very much for calling this series of hearings.

The CHAIRMAN. I thank the gentleman.

And when this whole system collapses again, I hope people will remember the statement, because I am afraid we are heading in the same direction.

So, anyway, I want to recognize John Riley, who left our Committee, went over to the CFTC. I don't think we have publicly recognized him. Where is John? There he is.

[Applause.]

The CHAIRMAN. We miss him. He did a great job for many, many years on the Committee, and he is doing good work now over at the CFTC. And we look forward to working together with that agency as we move forward.

We welcome the witnesses to the Committee. Our first panel of witnesses: Mr. Jon Hixson, the Director of Federal Government relations for Cargill; Hon. Glenn English, President of the NRECA and a former distinguished Member of this Committee and Subcommittee Chairman, who has worked on these issues for a long time when he was here; Mr. Dave Schryver, Executive Vice President of the American Public Gas Association; and Mr. Ben Hirst, the Senior Vice President and General Counsel for Delta Air Lines.

So welcome, all, to the Committee. Thank you for making yourself available.

And, Mr. Hixson, you can begin.

Your full statements will be made part of the record, and feel free to summarize. We are going to try to limit the testimony to 5 minutes so we will have time for questions.

STATEMENT OF JON HIXSON, DIRECTOR OF FEDERAL GOVERNMENT RELATIONS, CARGILL, INCORPORATED, WASHINGTON, D.C.

Mr. HIXSON. Thank you, Mr. Chairman. My name is John Hixson, Director of Federal Government Relations at Cargill. I am testifying on behalf of Cargill, Incorporated, and I thank the Committee for the opportunity to testify today.

Cargill previously testified before this Committee, in February of this year, calling for better reporting and transparency as well as enforceable position limits. We continue to support those views and appreciate the opportunity to discuss the Treasury Department's proposal today.

Cargill is an extensive end-user of derivatives on both regulated exchanges as well as the over-the-counter markets. Cargill's activity in offering risk-management products and services to commercial customers and producers in the agriculture and energy markets can be highlighted with the following OTC examples:

We offer customized hedges to help bakeries manage the price volatility of their flour so that their retail prices for baked goods can be as stable as possible. We issue critical hedges to help regional New England heating oil distributors manage price spikes and volatility on their purchases so they can offer families stable prices throughout the winter season. And we offer customized hedges to help a restaurant chain maintain stable prices on chicken so the company can offer consistent prices and value to their retail customers when selling chicken sandwiches.

Under the Treasury Department's proposal, it is highly likely that Cargill would be forced to greatly reduce, if not eliminate, offering our customers risk-management solutions like those described above. Under the proposal, the risk-management products that would remain in the market would dramatically increase in borrowing and working capital required for hedging. As a result, we expect prudent hedging of commodity, interest rate, and foreign exchange risk by end-users to decline significantly. With less hedging, end-users will be faced with more price risk exposure and volatility.

We support the objectives of the Treasury Department's proposal, which includes a recognition that traditional end-user hedging in the OTC markets can and should occur. However, we are concerned that several of the restrictions in the legislation could have many negative unintended consequences.

Hedging is a valuable activity that is backed by an offsetting position. Such hedging does not create systemic risk and should be exempted from mandatory margining and clearing requirements. The Treasury Department's proposal includes language to define legitimate hedging and exempt it. We support this view.

However, the definition and available exemptions need to be clarified. The exemption from clearing should not be linked to the eligibility requirements set by a clearing organization. This would help avoid a conflict of interest. The exemption for margining should recognize the inherently balanced nature of hedges; for example, the offsetting position.

We recommend that hedges recognized under the exemption meet a common sense definition. For example, that definition could include a three-part test like improved documentation, better transparency, and a measure to ensure the effectiveness of the hedge. The exemption should not be tied to accounting practices, which may not always account for *bona fide* hedging activity such as hedge on a physical commodity. In addition, the definition of the term *major swap participant* should be structured to exempt entities seeking to maintain an effective hedge.

The Treasury proposal calls for higher capital charges for OTC products that are not cleared. In addition, the bill calls for capital and margin requirements for non-bank dealers that could be higher than for bank dealers. This requirement could make non-bank dealers uncompetitive against bank dealers. Non-bank dealers who are involved in hedging transactions have an important role to play in serving customers in many commodity markets. No non-bank dealer in the commodities markets required a taxpayer bailout or caused systemic risk due to offering commodity hedging products for their customers.

We recommend that the transparency and market oversight proposals move forward, but that the regulatory agencies study this segment of the market prior to developing appropriate capital and regulatory guidelines.

Much has happened in the last 18 months across the financial and commodities markets. The U.S. Treasury Department's proposal calls for improved regulation, accountability, and transparency that will be helpful in preventing the build-up of systemic risk and allowing regulators to appropriately monitor speculative activity. However, actions that dramatically increase the cost of managing risk may ultimately have the unintended consequence of deterring prudent hedging. This could leave U.S. businesses overexposed to volatile market conditions.

We appreciate the opportunity to testify before the Committee and look forward to working with you as this legislation continues to develop. Thank you.

[The prepared statement of Mr. Hixson follows:]

PREPARED STATEMENT OF JON HIXSON, DIRECTOR OF FEDERAL GOVERNMENT RELATIONS, CARGILL, INCORPORATED, WASHINGTON, D.C.

My name is Jon Hixson, Director of Federal Government Relations at Cargill. I am testifying on behalf of Cargill, Incorporated and want to thank you for the opportunity to testify.

Cargill is an international provider of food, agricultural, and risk management products and services. As a merchandiser and processor of commodities, the company relies heavily upon efficient, competitive, and well-functioning futures markets and over-the-counter (OTC) markets.

Cargill is an extensive end-user of derivatives products on both regulated exchanges and in OTC markets, and is also active in offering risk management products and services to commercial customers and producers in the agriculture and energy markets.

Examples of OTC Products

Cargill's activity in offering risk management products and services to commercial customers and producers in the agriculture and energy markets can be highlighted with the following OTC examples:

—Customized hedges to help bakeries manage price volatility, so that their retail prices for baked goods can be as stable as possible for consumers and grocery stores.

—Hedges to help regional New England heating oil distributors avoid price spikes and volatility, so that they can offer individual households stable prices throughout the winter season.

—Customized hedges to help a restaurant chain receive stable prices on chicken, so that the company can offer consistent prices and value for their retail customers when selling chicken sandwiches.

Under the Treasury Department's proposal, it is highly likely that Cargill would be forced to greatly reduce, if not eliminate, offering our customers the risk management solutions described above. Under the proposal, the risk management products that would remain in the market would dramatically increase the borrowing and working capital required for hedging.

In addition, we would expect prudent hedging to decline significantly in those situations where Cargill, like other end-users, manages its own commodity, interest rate, and foreign exchange risks, due to the imposition of mandatory margining and the drain on working capital. With less hedging, end-users will be faced with more price risk exposure and volatility.

We appreciate the Treasury Department's proposal and continue to support its stated objectives. The proposal includes recognition that traditional end-user hedging in the OTC markets can and should occur. However, we are concerned that several of the restrictions in the legislation could have many unintended negative consequences.

Exceptions to Central Clearing and Margining Need to Be Clearly Defined

Exceptions to clearing and margining requirements need to be clearly defined for hedgers. Hedging is a valuable economic activity which is backed by an offsetting position. Such hedging does not create systemic risk and should be exempted from the mandatory margining and clearing requirements. The Treasury Department's proposal includes language to define legitimate hedging activity and to exempt it from certain requirements. However, this definition and available exemptions need to be clarified.

—The exemption from clearing should not be linked to the eligibility requirements set by the clearing organization. This would help avoid a conflict of interest.

—The exemption from margining should recognize the inherently balanced nature of hedges, *i.e.,* the offsetting position, and should include an exemption for this category of end-users.

- ◦ The exemption should not be tied to accounting practices, which may not always account for *bona fide* hedging activity.
- ◦ Effective guidelines that improve documentation, transparency and ensure hedge effectiveness can be established as an appropriate alternative in defining this exemption.

—The definition of the term Major Swap Participant should be structured to exempt entities seeking to maintain an effective hedge.

Capital Charges and Treatment of Non-Bank Dealers

The proposed legislation calls for higher capital charges for OTC products that are not cleared by a registered derivatives clearing organization than those applicable to swaps that are centrally cleared. In addition, the bill calls for capital and margin requirements for non-bank dealers that could be higher than for bank dealers. This action could make non-bank dealers uncompetitive against bank dealers and is without sound justification for this disparate treatment.

—Non-bank dealers who are involved in hedging transactions have an important role to play in serving customers in many commodity markets. Since no such non-bank dealer in the commodities markets required a taxpayer bailout or caused systemic risk due to offering commodity hedging products to their customers, we recommend that the transparency and oversight proposals move forward, but that regulatory agencies study this segment of the market and develop capital and regulatory guidelines only to the extent appropriate for this type of hedging transaction.

Cargill has previously testified this year before the House Agriculture Committee, calling for better reporting and transparency, as well as enforceable position limits. We continue to support those views, and would like to call to the Committee's attention a few regulatory steps taken in this area since we last testified.

—Commitments of Traders (COT) Report—On September 4, 2009, the Commodity Futures Trading Commission (CFTC) issued its first new COT that covers the major agriculture and energy contracts. The COT reports currently break traders into two broad categories: commercial and noncommercial. The new reports will break the data into four categories of traders: Producer/Merchant/Processor/User; Swap Dealers; Managed Money; and Other Reportables.

—OTC Reporting and Transparency—The CFTC continues to collect data on OTC transactions through its Special Call authority. The CFTC will begin publishing this data, which highlights index fund activity, on a quarterly basis with a goal of eventually releasing this data on a monthly basis.

Conclusion

Much has happened in the last 18 months across the financial and commodities markets. The U.S. Treasury Department's proposal calls for improved regulation, accountability, and transparency that will be helpful in preventing the build-up of systemic risk and allowing regulators to appropriately monitor speculative activity.

However, it is critically important that Congress and regulators take actions that focus on the areas of concern, while encouraging prudent risk management.

Actions that dramatically increase the cost of managing risk may ultimately have the unintended consequence of deterring prudent hedging, and leaving U.S. businesses over-exposed to volatile market conditions.

We appreciate the opportunity to testify before the Committee, appreciate the work of the Chairman, the Ranking Member, and all Members of this Committee, and look forward to working together as this legislation continues to develop.

Thank you.

The CHAIRMAN. Thank you, Mr. Hixson.

Mr. English, welcome to the Committee.

STATEMENT OF HON. GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVES ASSOCIATION, WASHINGTON, D.C.

Mr. ENGLISH. Thank you very much, Mr. Chairman. I appreciate it. And, certainly, it is a pleasure to be back in the Committee and have an opportunity to testify on this issue. Thanks for inviting us.

I am Glenn English, Chief Executive Officer of the National Rural Electric Cooperatives Association. And, as I think most of you know, we are a not-for-profit, owned by our membership, consumer-owned. And while we serve about 12 percent of the population of the country, some 42 million people, those people are scattered out over 70 percent of the land mass of the United States. We maintain about 42 percent of the infrastructure of this country.

And so, as we look at the particular issue that we have before us, Mr. Chairman, I am sure some of the Members of the Committee are probably wondering what in the world we are doing here. This is a little different situation than they normally find us being engaged and involved in.

But what it really comes down to is that hedging is becoming a much more important factor for us in managing risk for our memberships. And this world is becoming a good deal riskier, as you deal with any kind of production of energy and power, and as we move forward in dealing with the challenges of climate change. And whether it is coming through the Clean Air Act in the EPA or whether it is through legislation that passes the Congress, either way, it is going to be more costly and more risky. And hedging is going to play an even more important role, as we move forward in the future, in trying to maintain those risks, trying to keep those electric bills down and as affordable as we can possibly keep them.

Now, we have, in the past, been engaged from time to time through a couple of organizations that we have to manage risk for electric cooperatives, most of it on the fuel side through the Alliance of Cooperative Energy Services Power Marketing, known as ACES Power Marketing. That is a group that we established and electric cooperatives own, and many of our generation and transmission organizations participate, and even some of the distribution cooperatives participate through this organization. And also through financing to help meet the financial needs of electric cooperatives through the National Rural Utilities Cooperative Finance Corporation; this is one that we use in conjunction with the Rural Utilities Service. So this helps us meet the infrastructure needs. Both of those organizations use hedging to a great extent to try to minimize the risks that they are facing.

Now, the Treasury Department's proposal, while the thrust of the effort we don't really have an objection to, the problem we come down to is the cost and what it is going to mean as far as electric bills. The point that I am trying to make here, Mr. Chairman, is we kind of find ourselves between a rock and a hard spot on this particular issue.

You know, we have no problem as far as additional scrutiny is concerned. We want to see transactions being open and clear. We want to see efforts made to deal with any kind of manipulation that might be ongoing. But, as we deal with this, we find ourselves in kind of a difficult situation from the standpoint that we are very small, and much of this is focused and addressed toward big traders with a lot of money. And we just don't have that many trades, and we are not of that size or that magnitude.

Now, as far as trading on the exchanges themselves, of course, we do have some trades that we do on exchanges. But, quite frankly, when you come to the issue of margins and having margin calls, that requires a huge amount of money. Now, most of you are familiar with your electric cooperatives back home. You don't have that kind of resources; you don't have that kind of money. We have equity, but we certainly don't have the cash on hand.

And so, as you move forward looking at issues like natural gas and other fuels, dealing with issues like carbon, if you get into the issue of carbon being traded on the exchanges, that becomes a much more expensive proposition for us, requiring a good deal of money. And that means we will have to go out and borrow that money. And that means that we have to show that cost. That cost will be reflected, then, as far as electric bills for the membership, for your constituents.

And that is where our problem is with this particular issue. So, as we move forward here, we are hopeful, Mr. Chairman, that the Committee will search for a way for people like us, who need increasingly to hedge—legitimate hedges, not speculation, but legitimate hedges—that we can do that in such a way that we can keep the costs down, that we are not subject to the volatility of the marketplace as far as margin calls are concerned, as it affects people like us.

And, if we can do that, that means that we can, obviously, continue to protect your constituents and protect their electric bills, and help minimize what we think are going to be increases, in some cases substantial increases, in electric bills.

So, Mr. Chairman, I want to thank you again for having us here and giving us the opportunity to talk about this. I hope that we will come back and focus a little bit on making sure that folks that are not big traders, but, instead, have a need for a market, whether it is through the derivatives, through over-the-counter markets, or whether it comes back through the exchanges, that we can have a way in which we can do that affordably, and that whatever legislation moves forward from this body is one that takes that into account and continues to make that possible. Because that will make a big difference in electric bills for the future, as far as members of electric cooperatives and, I suggest, other utilities as well.

Thank you, Mr. Chairman.
[The prepared statement of Mr. English follows:]

PREPARED STATEMENT OF HON. GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVES ASSOCIATION, WASHINGTON, D.C.

Mr. Chairman, Ranking Member Lucas and Members of the Committee, thank you for inviting me to discuss the perspective of electric cooperatives regarding the U.S. Department of the Treasury's proposal to regulate the over-the-counter (OTC) derivatives market. The National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing nearly 930 not-for-profit, member-owned, rural electric cooperative systems, which serve 42 million customers in 47 states. NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering ¾ of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties.

Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including constituents of many Members of the Committee. That challenge is critical when you consider that the average household income in the service territories of most of our member co-ops lags the national average income by over 14%.

Mr. Chairman, the issue of derivatives and how they should be regulated is something with which I have a bit of personal history going back twenty years in this very Committee. Accordingly, I am grateful for your leadership, in pursuing the reforms necessary to increase transparency and prevent manipulation in this marketplace.

From the viewpoint of the rural electric cooperatives, the U.S. Department of the Treasury's proposal to regulate the $600 trillion over-the-counter (OTC) derivatives market can be boiled down to a single, simple concern that I know you have heard me articulate before: affordability.

NRECA's electric cooperative members, primarily generation and transmission members need predictability in the purchase price for their inputs if they are to provide stable, affordable prices to their customers. Rural electric cooperatives use derivatives to keep costs down by reducing the risks associated with both volatile energy prices and financial transaction costs. It is important to understand that electric co-ops are engaged in activities that are pure hedging, or risk management. We DO NOT use derivatives for other purposes. We are in a difficult situation, but OTC derivatives are currently the best tool we have to manage risk.

Most of our hedges are bilateral trades on the OTC market. Many of these trades are made through a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing, which was founded a decade ago by many of the electric co-ops that still own this business today. Through ACES, our folks make sure that the counterparty taking the other side of a hedge is financially strong and secure.

Half of the electric cooperatives' finance needs are met by private cooperative lenders, including the National Rural Utilities Cooperative Finance Corporation (CFC). Derivatives, specifically interest rate and currency swaps, are an important asset/liability management tool for cooperative lenders. As a cooperative lender, CFC is not a broker or dealer, nor does it invest in derivatives for trading or speculative purposes. It uses derivatives to manage currency and interest rate risk, and thereby affords our electric cooperative borrowers more loan options.

While hedges are necessary for electric co-ops, they pose risks. If a counterparty does not pay up, there will be severe consequences for our members, so we are extremely careful about who we trade with and for how much. Our consumers expect stable, affordable electricity prices, and electric suppliers need the OTC markets to manage the price volatility risk for our consumer-owners.

Even though the financial stakes are serious for us, rural electric co-ops are not big participants in the derivatives markets. I mentioned earlier that this market is estimated at $600 trillion. Our members have a fraction of that sum at stake and are simply looking for an affordable way to hedge. Because many of our co-op members are so small, legislative changes that would dramatically increase the cost of hedging or prevent us from hedging all-together will impose a real burden.

Electric cooperatives are owned by their consumers. Those very consumers expect us, on their behalf, to protect them against volatility in the energy markets that can jeopardize small businesses and adversely impact the family budget. The families and small businesses we serve do not have a professional energy manager. Electric co-ops perform that role for them and should be able to do so in an affordable way.

Our primary concern with the Treasury Department's proposal is that it would require most of our transactions to be cleared since our natural gas trades likely would be considered "standardized". And, before going further, I want to remind you that we are NOT looking to hedge in an unregulated market. NRECA DOES want derivatives markets to be transparent and free of manipulation. The problem is that requiring all derivatives contracts to clear is just not affordable for most co-ops. That is because the initial and the "working" or "variance" margin we would have to provide would make hedging untenable for many of our members—we would have to come up with hundreds-of-millions of dollars in cash that we just do not have on hand.

In general, co-ops are capital constrained due to other capital demands, such as building new generation and transmission infrastructure to meet load growth, installing equipment to comply with clean air standards, and maintaining fuel supply inventories, not to mention the fact that as member-owned cooperatives, we cannot go to the equity markets for additional resources. Maintaining 42% of the nation's electrical distribution lines requires considerable and continuous investment.

We have the same concern with Treasury's proposal to require higher capital and margin requirements for non-standard products that are not cleared; it comes back to the need for predictable affordability.

Clearing also presents a significant potential predictability issue. In case of a catastrophic event, the marketplace could change dramatically in a very short timeframe. If a catastrophic event triggered market concern over fuel supplies, ratings could shift and the prices for contracts could swing dramatically, triggering a sizable margin call for a reason unrelated to the original trade. A co-op in that position would not have the cash reserve to cover the margin call, leaving only one, unattractive option—to borrow a large sum at unaffordable rates.

Rural electric cooperatives do trade on exchange (and thus have some trades cleared) when we can. Electric cooperatives customarily have a couple thousand trades at any given time on NYMEX, but due to the working margin requirements associated with clearing, most of our trades are made on the OTC market. We don't like this situation, but we feel pushed into hedging on the OTC market by the cost. We would like to be able to trade everything on an exchange or go through a clearinghouse, but many of our members just cannot afford it.

Another concern with the Treasury Department's proposal is that for the electric power supply and natural gas business engaged in trading actual electricity or natural gas, the exemption for any transaction that is "physically settled" requires further clarification to exempt transactions already regulated by the Federal Energy Regulatory Commission (FERC), such as virtual bidding in day-ahead markets or the purchase or sale of Financial Transmission Rights, market capacity, and similar products in the organized markets. Importantly, many bilateral physical electric and natural gas transactions are "booked-out" before delivery, for physical scheduling efficiencies. These "booked out" transactions which are already regulated by FERC should not be subject to additional regulation. Absent this clarification, the proposal could accidently put such transactions within the domain of derivatives regulation.

Mr. Chairman, at the end of the day, we are looking for a legitimate, transparent, predictable, and affordable device with which to hedge. I know there are many ideas under consideration, but regardless of what specific solution is arrived at, I know that you and your Committee are working hard to ensure these markets function effectively. The rural electric co-ops just hope that at the end of the day, there is a way for the little guy to effectively manage risk.

Thank you.

The CHAIRMAN. Thank you very much, Mr. English. Appreciate it.

Mr. Schryver, welcome to the Committee.

STATEMENT OF DAVID SCHRYVER, EXECUTIVE VICE PRESIDENT, AMERICAN PUBLIC GAS ASSOCIATION, WASHINGTON, D.C.

Mr. SCHRYVER. Chairman Peterson, Ranking Member Lucas, and Members of the Committee, I appreciate this opportunity to testify before you today, and I thank the Committee for calling this important hearing.

My name is Dave Schryver, and I am the Executive Vice President for the American Public Gas Association. APGA is the national association for publicly owned, not-for-profit natural gas retail distribution systems. There are approximately 1,000 public gas systems in 36 states, and over 720 of these are APGA members.

APGA's number-one priority is the safe and reliable delivery of affordable natural gas. If we are to fully utilize natural gas at long-term affordable levels, we ultimately need to increase the supply of natural gas.

However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces, and not the result of manipulation or other market abuses.

Public gas systems depend upon both the physical commodity markets, as well as the markets in OTC derivatives, to meet the natural gas needs of their consumers. Together, these markets play a critical role in these utilities' securing natural gas supplies at stable prices for their communities.

APGA believes that the provisions relating to the unregulated energy trading platforms contained in the CFTC Reauthorization Act passed last Congress was, and is, a critically important step in addressing our concerns. And we commend this Committee for its work on the Reauthorization Act.

In addition, the CFTC, under the leadership of Chairman Gensler, has taken many significant steps to address the concerns raised by APGA through exercising their new authority provided under the Reauthorization Act and using its existing administrative authority.

However, APGA believes that significant regulatory gap still exists with respect to the over-the-counter markets and that Congress should provide the CFTC with additional statutory authorities to enhance transparency, limit excessively large speculative positions, and help prevent abuses in the markets for natural gas.

The proposed legislation by the Department of the Treasury offers Congress a constructive basis for addressing many of the issues that remain open following enactment of the CFTC Reauthorization Act. APGA strongly supports many of the provisions suggested by the Treasury proposal, particularly those relating to the reporting of large positions and OTC transactions that serve a significant price discovery function. APGA believes that these regulatory tools to enhance transparency, and to limit excessively large speculative positions, are a critically important step in effectively addressing consumers' concerns.

APGA also supports the Treasury proposal's nuanced approach to the mandated clearing of OTC contracts with certain clarifications to the exemption. We are concerned that certain recommendations to this Committee to require mandatory clearing of all standardized transactions would have serious negative consequences to public gas systems.

Public gas systems purchase firm supplies in the physical delivery market at prevailing market prices and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations, and stabilize rates.

By using both markets, public gas systems are able to purchase firm deliveries of natural gas from a diverse set of suppliers, while hedging the risk of future market price fluctuations. Proposals that would require all standardized OTC transactions to be cleared would significantly impair the ability of public gas systems to engage in these gas supply strategies.

Under current practices in the OTC markets, many public gas systems are not required to pledge collateral for transactions below agreed-upon levels based upon their very high credit-worthiness. In contrast, the mandated clearing of all OTC transactions would require public gas systems to post initial margin for all transactions and to meet potential margin calls whenever required and on little notice. This would constitute a significant financial and operational burden on these systems, their communities, and their consumers.

It has been suggested that the clearing requirements would be less burdensome if some end-users are given the option of posting noncash collateral. Unfortunately, the alternative of using noncash collateral would not provide any relief to public gas systems. Noncash collateral would entail the deposit of liquid assets, and public gas systems simply do not maintain liquid assets in a quantity necessary to meet the requirements associated with clearing.

APGA understands that provisions that require the clearing of all OTC transactions are intended to address issues related to systemic risk. However, the hedging of natural gas supply purchases by public gas systems using noncleared bilateral OTC derivatives do not present systemic risk to the market. In addition, a proposed mandate to clear all standardized OTC derivatives transactions would increase costs for public gas systems and their municipalities, an increase which would be borne 100 percent by their consumers.

It is critical that the nation's regulators have the tools that they need to detect and deter market abuses. APGA believes that the Treasury proposal provides this Committee with a very good foundation for achieving those goals. And we look forward to working with the Committee towards the passage of legislation that strengthens consumer confidence in the integrity of the markets' price discovery mechanism.

Thank you.

[The prepared statement of Mr. Schryver follows:]

PREPARED STATEMENT OF DAVID SCHRYVER, EXECUTIVE VICE PRESIDENT, AMERICAN PUBLIC GAS ASSOCIATION, WASHINGTON, D.C.

Chairman Peterson, Ranking Member Lucas and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing to review proposed legislation by the U.S. Department of the Treasury regarding the regulation of over-the-counter derivatives markets. My name is Dave Schryver and I am the Executive Vice President for the American Public Gas Association (APGA).

I testify today on behalf of the APGA. APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 720 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. If we are to fully utilize clean domestically produced natural gas at long-term affordable prices, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, other abusive market conduct or excessive speculation.

Over the past several years, and leading up to the passage of the Reauthorization Act, APGA has sounded the alarm with respect to the need for greater oversight and transparency of the over-the-counter markets ("OTC") in financial contracts in natural gas. APGA previously testified before this Committee that APGA's members have lost confidence that the prices for natural gas in the futures and the economically linked OTC markets are an accurate reflection of supply and demand conditions for natural gas. APGA further testified that restoring trust in the validity of the pricing in these markets requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, excessive speculation or other abusive market conduct. APGA therefore strongly supported an increase in the level of transparency with respect to trading activity in these markets. For this reason, APGA strongly supported the recent enactment of the CFTC Reauthorization Act of 2008.[1]

The Reauthorization Act

APGA believes that the increased regulatory, reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in the CFTC Reauthorization Act of 2008 was, and is, a critically important step in addressing our concerns. We commend this Committee for its work on the Reauthorization Act. The market transparency language that was included in the Reauthorization Act will help shed light on whether market prices in significant price discovery energy contracts are responding to legitimate forces of supply and demand or to other, non-*bona fide* market forces.

APGA notes that the CFTC, under the leadership of Chairman Gensler, has taken many significant steps to address the concerns raised by APGA, exercising the new authority provided under the Reauthorization Act and its existing administrative authority under the Act. For example, the CFTC has exercised the authority given it in the Reauthorization Act, finding that the LD1 natural gas contract traded on the Intercontinental Exchange, Inc. is a significant price discovery contract[2] and is thereby subject to the enhanced regulatory requirements of the Reauthorization Act. It also is providing enhanced transparency through its Commitment of Traders Report and is using its special call reporting authority aggressively in connection with OTC contracts. In addition, the CFTC has formed and continues to seek advice of an energy markets advisory committee. Many of these steps were first recommended by APGA. APGA believes that all of these enhancements have been important steps in addressing the problems faced by the markets in natural gas.

The Treasury Proposal on Regulating OTC Derivatives

However, we have also noted to the Committee in prior testimony that we believed that it was likely that it would be necessary for Congress to provide the CFTC with additional statutory authorities to respond fully and effectively to the issues raised by trading in the energy markets. We have expressed the view to Congress that additional transparency measures with respect to transactions in the OTC markets are needed to enable the cop on the beat to assemble a full picture of a trader's position and thereby understand a large trader's potential impact on the market.

APGA believes that the proposed legislation by the U.S. Department of the Treasury, the "Over-the-Counter Derivatives Markets Act of 2009," ("Treasury Proposal"), offers Congress a constructive basis for addressing many of the issues that remain open following enactment of the Reauthorization Act. Accordingly, APGA supports fully many of the provisions suggested by the Treasury Proposal, particularly those relating to reporting of large positions in OTC transactions and the application of speculative position limits to such contracts. APGA believes that these regulatory

[1] Food, Conservation, and Energy Act of 2008, P.L. 110–246, 122 Stat. 2189, Title XIII.

[2] See "Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function," 74 *Fed. Reg.* 37988 (July 30, 2009).

tools to enhance transparency, and to limit excessively large speculative positions, are a critically important step in effectively and fully addressing the issue we have raised with respect to pricing anomalies in the natural gas market. APGA also supports the Treasury Proposal's nuanced approach to mandated clearing of OTC contracts. At the same time, we note that certain recommendations to this Committee with respect to mandatory clearing of all transactions would have serious, negative consequences to our members. We will address each of these issues in turn.

The Treasury Proposal seeks to apply a regulatory framework to trading in OTC swaps. Many public gas systems use both or either the OTC derivatives markets and regulated futures markets to hedge their exposures related to their purchases and sales of natural gas. As publicly-owned distribution systems, the savings that public gas systems realize from hedging their purchases and sales of natural gas using exchange-traded or OTC derivatives directly lowers the rates paid by their customers. Thus, the proper functioning of the markets is important to public gas systems because well-functioning markets affect the rates that their consumers will ultimately pay.

APGA believes that the goal of Treasury's Proposal to close regulatory loopholes and bring needed regulatory oversight to the OTC markets is sound. In light of the importance of these markets to public gas systems, and ultimately to their customers, we endorse the goal of Treasury's Proposal, generally, including the expectation that regulatory agencies will cooperate in overseeing the OTC derivatives markets.

Mandatory Clearing.

Section 713 of the Treasury Proposal requires the clearing of standardized swap contracts by a derivatives clearing organization except if no derivatives clearing organization will clear the transaction, or one of the counterparties is not a dealer or a "major swaps participant and does not meet the eligibility qualifications of a derivatives clearing organization. A major swap participant is defined as an entity that maintains a substantial net swap position other than to create and maintain a hedge under generally accepted accounting principles, or as the CFTC and SEC further define by rule."

APGA supports this exemption from the mandated clearing requirement. As hedgers, with very high credit ratings, assured collections from rate payers, and substantial assets in physical infrastructure, public gas systems under current practice in the bilateral swaps market often are not required to pledge liquid collateral for transactions below agreed upon levels. Moreover, adjustments to collateral levels are made on a pre-defined, periodic basis. This is particularly suitable to the routine funding and fee collection practices of public natural gas distribution systems. The customers of public gas systems reap the benefits of these arrangements through lower rates for the natural gas which they purchase. The hedging of natural gas supply purchases by public gas systems using non-cleared bilateral OTC derivatives do not present the types of systemic risks posed by some dealers of credit-default swaps, which is the impetus behind the proposed clearing mandate.

Accordingly, APGA strongly supports the inclusion of the exemption for hedgers which are not major swap participants. The availability of this exemption is critical to our member's ability to continue to bring natural gas to their customers at the lowest possible cost in a fiscally sound and operationally efficient manner.

However, we suggest that the definition of "major swap participant" be revised. Currently, the definition is tied to a finding that the net position of outstanding swaps is an effective hedge under generally accepted accounting principles (GAAP). APGA members use the OTC derivatives markets to hedge their physical operations. We are concerned that an overly rigorous interpretation of this definition may require tying particular swaps transactions to particular physical requirements. We suggest that the definition of "non-major swap participant" address this concern by being revised to include a category for "an entity which is a commercial user, processor or distributor of the physical commodity that enters into swap contracts in connection with their purchase or sales of the physical commodity."

There have been some who have suggested that Congress should not include this exemption in a final bill, and mandate that all standardized OTC derivatives be required to be cleared regardless of the nature of the end-user counterparty.

Public gas systems depend upon both the physical commodity markets as well as the markets in OTC derivatives to meet the natural gas needs of their consumers. Together, these markets play a critical role in these utilities securing natural gas supplies at stable prices for their communities. Specifically, natural gas distributors purchase firm supplies in the physical delivery market at prevailing market prices, and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations and stabilize rates. By using both markets, these public gas systems are able to purchase firm deliveries of natural gas from a diverse set of suppliers while hedging the risk of future market price fluctuations.

However, proposals that would require all standardized OTC derivatives transactions to be cleared would significantly impair the financial ability of public gas systems to engage in these gas supply strategies. As noted above, under current practices in the OTC markets, many APGA based upon their very-high credit worthiness are not required to post collateral for an agreed upon number of transactions. In contrast, the mandated clearing of all OTC transactions would require public gas systems to post initial margin for all transactions and to meet potential margin calls whenever required on little notice. This would constitute a significant financial and operational burden on these systems, their communities and their consumers.

It has been suggested that the clearing requirements would be less burdensome if some end-users are given the option of posting non-cash collateral. Unfortunately, the alternative of using non-cash collateral would not provide any relief to public gas systems. Public gas systems generally are prohibited by their constitutional documents from pledging as collateral the components of their physical infrastructure, such as pipelines. Accordingly, public gas systems would only be permitted to pledge non-cash collateral in the form of liquid assets. However, public gas systems simply do not maintain such liquid assets in the quantity necessary to meet the requirements associated with clearing. And maintaining this level of liquid assets would be at odds with their routine funding operations.

Another result of mandatory clearing would be the de facto elimination of the use of tax-exempt financing for the prepayment of long-term natural gas contracts, also known as “prepays.” Prepays were endorsed by Congress as part of the Energy Policy Act of 2005 and have been a key tool that public gas systems, including ours, have used to secure long-term, firm supplies for terms up to 30 years. One critical component of the prepay is an OTC swap transaction that enables the public gas system to ultimately pay a price discounted below the prevailing spot market price. Importantly, the OTC derivatives utilized in prepays are “tear up” agreements, that is, they terminate at no cost in the event the prepay terminates. Because of their size and long-range nature, requiring clearing of the prepay swap would be cost prohibitive, thereby eliminating a tool public gas systems have utilized to lock into long-term supplies of natural gas and protect our consumers from price volatility.

Accordingly, APGA strongly rejects the suggestion that all OTC derivatives be required to be cleared regardless of the nature of the end-user counterparty. That suggestion, if enacted into law, would constitute a significant financial and operational burden on publicly owned natural gas distribution systems, their communities and their consumers, and would not address any problem which has brought about the current financial crises. From our perspective, the continued availability of individually negotiated, non-cleared OTC transactions will provide our Members the widest range of tools to continue to offer natural gas at the best possible prices to their customers.

Speculative Position Limits

Section 723 of the Treasury Proposal would make the Commodity Exchange Act’s speculative position limit provisions applicable to any swaps that perform or affect a significant price discovery functions with respect to regulated markets. Such limits may be aggregated across positions held in designated contract markets, contracts on a foreign board of trade, or swaps serving a significant price discovery function with respect to a regulated market.

As hedgers that use both the regulated futures markets and the OTC energy markets, our members value the role of speculators in the markets. We also value the different needs served by the regulated futures markets and the more tailored OTC markets. As hedgers, we depend upon liquid and deep markets in which to lay off our risk. Speculators are the grease that provides liquidity and depth to the markets.

However, speculative trading strategies may not always have a benign effect on the markets. For example, the dramatic blow-up of Amaranth Advisors LLC and the impact it had upon prices exemplifies the impact that speculative trading interests can have on natural gas supply contracts for local distribution companies (“LDCs”). Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. The Report by the Senate Permanent Committee on Investigations affirmed that “Amaranth’s massive trading distorted natural gas prices and increased price volatility."[3] APGA believes that these price distortions directly increased the cost of natural gas for many of our member's customer rate payers.[4–5]

Applying Aggregate Position Limits Across all Positions.

The Treasury Proposal would apply speculative position limits across all economically linked instruments, regardless of whether they are exchange-traded or traded OTC. The determination of whether to apply position limits consistently across all markets and participants is perhaps the single most important issue for the energy market. As we noted above, the various market segments for energy contracts are economically linked, and actions in one market segment can affect prices in the other segments. Recent events in the economically linked markets for natural gas have shown the danger of traders being able to move positions from one market to another in order to evade application of a market's position accountability rule or position limit.[6] A unified limit administered by the Commission across all markets, including the OTC markets (in addition to the limits adopted and administered by each separate market) would effectively address this issue and provide an effective and meaningful limitation on the total size of positions that a trader could amass in the delivery month.

APGA strongly supports the use of spot month speculative position limits as a proven and effective tool for addressing markets with constrained deliverable supplies, which is typical of the markets for natural gas. The CFTC recently promulgated rules implementing the Reauthorization Act's provisions with respect to the oversight of SPDCs.[7] APGA believes that the final rules are a very good foundation for addressing the issue, but recommends that the CFTC consider taking additional steps within its existing statutory authority to strengthen the effectiveness of this important regulatory tool.

In this regard, APGA notes that the CFTC deferred action to make spot month speculative position limits or back month position accountability apply to both cleared and non-cleared transactions on a market that operates as a SPDC. Despite recognition of the important role that non-cleared transactions play in price formation, the speculative position limits that the Commission's rules require apply only to cleared transactions and do not require that non-cleared transactions be included in calculating whether a trader has violated a spot month speculative position limit. This clearly and inexplicably weakens the prophylactic protection that spot month speculative position limits are intended to provide. Accordingly, APGA suggests that the Commission use its current statutory authority and include linked, non-cleared SPDCs within the speculative position limit requirement.

The Treasury Proposal would address this regulatory gap by expressly providing that speculative positions limits shall apply to swaps that serve a significant price discovery function with respect to a regulated contract. APGA considers it vitally important that any legislative proposal include unified speculative positions limits for contracts that are traded and maintained OTC. Where such contracts are economically linked to contracts traded on exchange traded or exempt commercial markets, such OTC contracts may have an important influence on pricing and on the performance of other market segments.

---

[3] *See "Excessive Speculation in the Natural Gas Market,"* Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report") at p. 119.

[4] Many natural gas distributors locked in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth's positions. They did so because of their hedging procedures which require that they hedge part of their winter natural gas in the spring and summer. Accordingly, even though natural gas prices were high at that time, it would have been irresponsible (and contrary to their hedging policies) to not hedge a portion of their winter gas in the hope that prices would eventually drop. Thus, the elevated prices which were a result of the excess speculation in the market by Amaranth and others had a significant impact on the price these APGA members, and ultimately their customers, paid for natural gas. The lack of transparency with respect to this trading activity, much of which took place in the OTC markets, and the extreme price swings surrounding the collapse of Amaranth have caused *bona fide* hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

[5] The additional concern has been raised that recent increased amounts of speculative investment in the futures markets generally have resulted in excessively large speculative positions being taken that due merely to their size, and not based on any intent of the traders, are putting upward pressure on prices. The argument made is that these additional inflows of speculative capital are creating greater demand then the market can absorb, thereby increasing buy-side pressure which results in advancing prices.

[6] *See generally, PSI Report.*

[7] "Significant Price Discovery Contracts on Exempt Commercial Markets; Final Rule," 74 *Fed. Reg.* 12178 (March 23, 3009).

Recent events in the economically linked markets for natural gas have shown the danger of traders being able to move positions from one market to another in order to evade application of a market's position accountability rule or position limit.[8] A unified limit administered by the Commission across all markets (including OTC transactions), in addition to the limits adopted and administered by each separate market would effectively address this issue and provide an effective and meaningful limitation on the total size of positions that a trader could amass in the delivery month.

Large Trader Reporting

Section 731 of the Treasury Proposal would add a new provision requiring persons holding swaps positions in swaps that perform a significant price discovery function in respect of a regulated market which exceed a stated size to report to the CFTC such information as the CFTC shall require. This mirrors the requirement which underpins the current CFTC Large Trader Reporting System. The provision includes a books and records requirement.

The current lack of transparency with respect to large OTC transactions leaves regulators unable to answer questions regarding speculators' possible impacts on the over-all market. Without being able to see a large trader's entire position, the effect of a large OTC trader on the regulated markets is masked, particularly when that trader is counterparty to a number of swaps dealers that in turn take positions in the futures market to hedge these OTC exposures as their own.

The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on the regulated market. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/non-commercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the regulated market. In conducting surveillance of the regulated natural gas futures market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.

The CFTC Reauthorization Act, recently empowered the CFTC to collect large trader information with respect to "significant price discovery contracts." However, there remain significant gaps in transparency with respect to trading of OTC energy contracts, including many forms of contracts traded on the Intercontinental Exchange, Inc. Despite the links between prices for the regulated futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas. More profoundly, it leaves the regulator unable to assemble a true picture of the over-all size of a speculator's position in a particular commodity.

Our members, and the customers served by them, believe that although the Reauthorization Act goes a long way to addressing the issue, there is not yet an adequate level of market transparency under the current system. This lack of transparency has led to a continued lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one, or two, segments of the total market. Without comprehensive large trader position reporting, the government will remain handicapped in its ability to detect and deter market misconduct or to understand the ramifications for the market arising from unintended consequences associated with excessive large positions or with certain speculative strategies. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a

[8] *See PSI Report.*

high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists. Similarly, we simply do not have the information to analyze the over-all effect on the markets from the current practices of speculative traders.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on a regulated futures exchange, on an exempt electronic market or through bilateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms.

The Treasury Proposal addresses this regulatory gap by including all economically linked contracts that affect price discovery in the regulated market within a large trader reporting system. APGA strongly backs this proposal. We note that this is necessary in order to achieve meaningful transparency in the market. We believe that this would give the cop on the beat the tools necessary to patrol for manipulation, abuse, congestion, and price distortions. We urge that this provision be included in any financial reform legislation.

* * * * *

In order to protect consumers the regulators must be able to (1) detect a problem before harm has been done to the public through market manipulation or price distortions; (2) protect the public interest; and (3) ensure the price integrity of the markets. Accordingly, APGA and its over 720 public gas system members applaud your continued oversight of the futures and related markets for natural gas markets. We look forward to working with the Committee to determine the further enhancements that may be necessary to address the remaining regulatory gaps, enhance enforcement and restore consumer confidence in the integrity of the price discovery mechanism.

Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. Without giving the government the tools to detect and deter manipulation, market users and consumers of natural gas who depend on the integrity of the natural gas market cannot have the confidence in those markets that the public deserves. We believe that the Treasury Proposal provides this Committee with a very good foundation for achieving those goals.

The CHAIRMAN. Thank you very much.

Your testimony, Mr. Hirst?

STATEMENT OF RICHARD B. HIRST, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, DELTA AIR LINES, MINNEAPOLIS, MN; ON BEHALF OF AIR TRANSPORT ASSOCIATION

Mr. HIRST. Thank you, Mr. Chairman. My name is Ben Hirst. I am General Counsel at Delta Air Lines, but I appear today on behalf of the Air Transport Association, which represents the major passenger and cargo airlines in the United States, an industry which has been devastated in the past 2 years by the high price of fuel and volatility in the oil markets.

We appreciate your determination to address the causes of these conditions, which have destroyed some airlines and deeply damaged the rest. We strongly support strengthened regulation of the oil futures market.

U.S. airlines are suffering through a very difficult economic climate and have been forced to cut employees and air service. Unfortunately, the impact of the recession on the airlines has been exacerbated by a recent volatility in the fuel markets. In 2008 alone, U.S. airlines spent $16 billion more on fuel than they did the year prior, almost $60 billion in total, despite the fact that they actually decreased their fuel consumption by more than five percent.

Because fuel is our largest single expense, we are particularly susceptible to the recent wild swings in fuel prices. At Delta Air Lines, we consume approximately 4 billion gallons of jet fuel annually, which makes us the second-largest consumer of jet fuel in the world, after only the U.S. Government. Jet fuel consumes 30 to 40 percent of our total revenues. A $1 increase in the price per barrel of oil, annualized, increases Delta's fuel cost by $100 million.

The speculative oil price bubble that began in mid-2007 cost Delta approximately $8 billion in fuel expense and hedge losses compared with what we would have spent on jet fuel if the price of oil had remained where it was in mid-2007 at $60 a barrel. In addition, it forced Delta to reduce capacity by ten percent and eliminate 10,000 jobs.

In the past 3 years, we have seen a significant increase in the volatility of oil prices. This increase in volatility has been associated with a massive increase in speculative investment in the oil market. The total value of investment in commodity index funds has increased tenfold since 2003, from an estimated $15 billion in 2003 to around $200 billion in mid-2008. Over the same period, global demand for physical barrels of oil has remained static, virtually unchanged.

For airlines, the volatility in oil prices associated with this increase in speculation creates three serious problems: First, it increases the costs and risks of hedging. As a result of last year's oil bubble, for example, Delta incurred about $1.7 billion in hedge losses when the bubble burst and the price of oil fell precipitously. Second, speculative activity last year pushed fuel prices so high that capital within the industry has been depleted. And, finally, with each spike in oil prices, airlines ground aircraft, reduce air service, eliminate jobs, and defer capital expenditures.

It is worth remembering that the ultimate purpose of commodities futures markets is to provide hedging opportunities for producers and end-users of commodities, not to provide a financial playing field for speculators. Speculators play a valuable role in providing the liquidity needed for hedging to occur; however, to the extent excess speculation destabilizes actual commodity prices and markets, Congress should provide the CFTC with adequate authority and resources to ensure that markets enjoy enough speculation to provide liquidity, but not so much as to create wild volatility and harm to consumers.

Congress and the CFTC can look to the period before the explosion of index fund investment in the earlier years of this decade as a guide to appropriate speculative levels in relation to levels of volatility.

About 10 years ago, when volatility was low, it has been estimated that only about 25 percent of the open interest in oil futures was held by speculators. Today, the percentage is estimated at 70 to 80 percent. Unfortunately, the CFTC's authority over the swaps in OTC markets, which have greatly expanded in the last decade as speculation has increased, is ambiguous, and it was weakened by loopholes in the Commodities Futures Modernization Act.

The Treasury Department recently sent Congress proposed legislation that would give the CFTC clear authority to exercise oversight over the swaps and OTC derivatives markets. It would expressly repeal the swaps in Enron loopholes and strengthen oversight of foreign boards and trades. It would increase transparency by requiring reporting of all derivatives and futures trades to a central repository, and by making available to the public aggregated data on all open positions in trading volumes. It would clarify the CFTC's authority to deter market manipulation and to police conflicts of interest. And, most importantly from our perspective, it would give the CFTC clear authority to set position limits for OTC and swaps markets that perform a significant price discovery function.

The airline industry would support legislation which requires the CFTC to set aggregate and individual position limits in the oil futures markets. Now, the Administration proposal does not go that far, but it does require the CFTC to set position limits—I am sorry, it gives the CFTC authority to set position limits across all markets, which is a very important step, where it determines that those markets would significantly affect price discovery. And, as a result, we strongly support these provisions.

The current state of the oil futures market is completely unworkable for the airline industry, and that is not debatable. It is also harmful to our nation's economy as a whole. We urge you to enact legislation to restore the proper balance between commercial hedging and speculative investment, to increase the transparency of trades and traders in these markets, and to close the loopholes that have hindered adequate oversight of these vital markets for years.

Thank you very much, and I look forward to answering your questions.

[The prepared statement of Mr. Hirst follows:]

PREPARED STATEMENT OF RICHARD B. HIRST, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, DELTA AIR LINES, MINNEAPOLIS, MN; ON BEHALF OF AIR TRANSPORT ASSOCIATION

Introduction

Good morning Chairman Peterson, Ranking Member Lucas, and Members of the Committee. I am Ben Hirst, General Counsel of Delta Air Lines, and I am appearing today on behalf of the Air Transport Association, which represents the U.S. commercial airline industry, an industry that has been devastated in the past 2 years by the high price of fuel and volatility in oil markets. We, and our employees, are grateful for your commitment to addressing the causes of these conditions, which have destroyed some airlines and deeply damaged the rest.

Industry Conditions

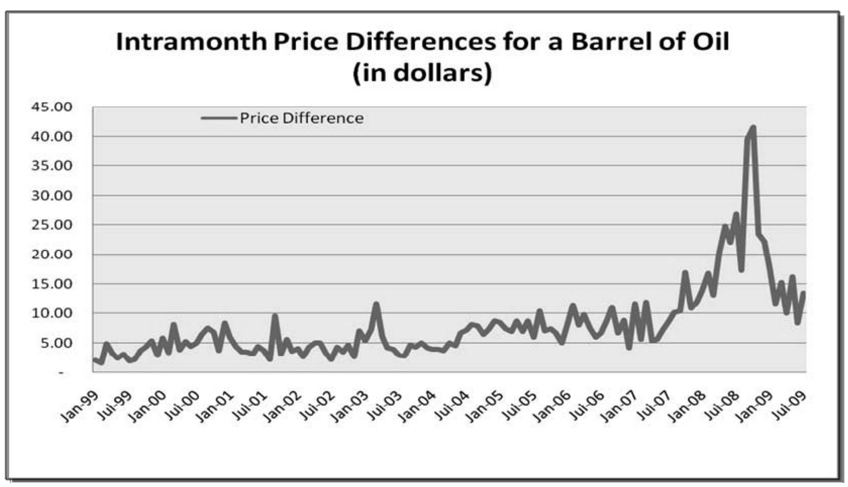
As an industry, commercial aviation helps drive $1.14 trillion in annual economic activity in the U.S., $346 billion per year in personal earnings, and 10.2 million jobs. It also contributes $692 billion per year to our nation's gross domestic product—roughly 5.2% of GDP.Unfortunately, U.S. commercial aviation is suffering through a very difficult economic climate. Recently, Merrill Lynch analyst Michael Linenberg was quoted as saying, "We are lowering our 2009.net income forecast [for the airline industry] . . . from a profit of $1.0 billion to a loss of $2.3 billion. While at the start of the year we were projecting a modest net profit for the industry despite the worst global economic downturn since World War II, our forecast has been stymied by the impact of the H1N1 influenza, creeping energy prices, and a revenue environment that is showing no signs of improvement." Demand for air travel and air cargo is down sharply in 2009—by approximately 21 percent below the same period last year—and U.S. airlines expect 14 million fewer passengers in the summer 2009 than we had in 2008. This has forced our industry to do the only thing it can to survive—cut capacity, ground planes, eliminate routes, and reduce the number of cities served.

The number of full-time employees at passenger airlines is down 29 percent from our peak employment in May 2001—a total of 154,000 jobs lost in our industry. And airlines continue to cut. In the fourth quarter of this year, domestic seating capacity is expected to decline to levels we last saw in the fourth quarter of 2001, in the immediate aftermath of 9/11. In fact, by the fourth quarter of this year, U.S. carriers will offer almost 1.8 billion fewer available seat miles[1] *every week* than they did in the fourth quarter of 2007. And that figure represents the cuts on domestic routes only. When you add the cuts that have been made to international routes, the numbers are even larger.Unfortunately, all of these problems are being exacerbated by volatility in fuel markets. In 2008, U.S. airlines spent $16 billion more on fuel than they did the year prior—almost $60 billion in total—despite consuming more than five percent fewer gallons of fuel.

We at Delta Air Lines employ over 70,000 people worldwide and offer service to more than 170 million passengers each year to 382 destinations in 69 different countries. We consume approximately 4 billion gallons of jet fuel annually, making us the second largest consumer of jet fuel in the world, next to the U.S. Government. Our business is dramatically impacted by volatility in the oil markets. Each $1 change in the cost of a barrel of oil has an annual impact of $100 million to Delta's bottom line. In 2008, as oil prices and volatility peaked, fuel expense (including the cost of hedging) consumed 40 percent of our total revenues directly resulting in the need to reduce our capacity by more than ten percent and eliminate nearly 10,000 jobs.The financial health and security of the airline industry depends, in significant part, on a commodities market structure that is stable, rational and predictable. Today's energy commodities markets, however, do not display these characteristics.

Excessive Speculation Drives Volatility

Since 2005 we have seen a significant increase in the volatility of oil prices. The increase has been particularly dramatic in the last 2 years. From 1999 through 2004, the average annual variance between the high price of a barrel of oil for the year and the low price was about $16. From 2005 through 2008 the average annual per-barrel variance was about $52. In 2007 the variance between the high and low prices was $48 and in 2008 it was $111. Daily volatility in 2004 was generally under one dollar. In 2008, the price of a barrel of oil rose $10.75 in a single day (June 6), and daily volatility of $3 or more became the norm. The average monthly difference in prices in 2008 was over $19 per barrel.



This increase in volatility has been associated with a massive increase in speculative investment in oil futures. A recent study by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs noted that over the last 6 years, financial institutions have aggressively marketed commodity index funds, which are heavily weighted to oil futures, as a way for hedge funds, pension funds, and other investors to diversify portfolios and speculate on rising commodity prices. The study noted that the total value of investment in commodity indexes has increased tenfold since 2003, from an estimated $15 bil-

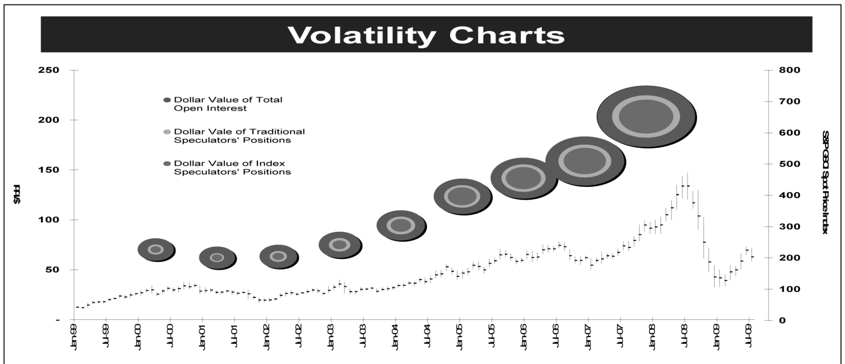
[1] An available seat mile (ASM) is one passenger seat flown one mile and is the standard unit of capacity in the passenger airline sector.

lion in 2003 to around $200 billion in mid-2008. During that period, the volumes of oil futures traded on the exchanges quadrupled despite the fact that, over the same period, global demand for physical barrels of oil remained virtually unchanged.[2] Moreover, these indices tend to have a very heavy bias toward long investing, further increasing the upward pressure on energy markets. This increase in speculative activity is closely correlated with the increased volatility of oil prices, which has caused so much harm.

For an airline, an oil market characterized by high volatility driven by speculation presents a number of serious problems. First, it increases the costs and risks of hedging. Second, in recent years this volatility has pushed prices to levels so high that they have depleted the capital of the firms in our industry. Third, with each spike in oil prices, airlines ground aircraft, reduce air service, and eliminate jobs.

To be clear, we acknowledge that a certain level of speculative investment in commodity markets injects much-needed liquidity in those markets and positively impacts market functions. However, because excessive speculation clearly destabilizes commodity markets and harms consumers, Congress should provide the CFTC with the authority and guidance it needs to ascertain the proper level of speculative investment in the market while preventing volatility. The period before the explosion of index fund investment in the early years of this decade can serve as a valuable guide to appropriate levels of speculative positions in relation to acceptable levels of volatility.

Oil Prices and Volatility Have Risen as Speculation Has Increased



Source: Bloomberg, CFTC Commitments of Traders CIT Supplement, calculations, Testimony of Michael W. Masters before the Senate Committee on Homeland Security and Governmental Affairs on May 20 2008

– In the chart above, the bubbles represent the size, measured in dollars (on the right axis), of the commodities futures market. Over time, not only has the total volume increased, but the amount of Index Speculators relative to the Total Open Interest has risen drastically.

– On the left axis, the high, low, and settled prices for crude oil are displayed by month since 1999 through mid-July 2009. The distance between highs and lows has increased in recent years.

– The two charts together show how the increase in volume has affected the volatility of market prices.

Date	High	Low	Settle	H-L Spread
Jul-99	21.12	19.15	20.04	1.97
Jul-00	32.35	27.35	29.74	5.00
Jul-01	28.29	24.60	26.45	3.69
Jul-02	27.95	25.73	26.90	2.22
Jul-03	32.05	29.17	30.62	2.88
Jul-04	43.85	36.69	40.68	7.16
Jul-05	62.10	56.10	58.93	6.00
Jul-06	78.40	71.65	74.53	6.75
Jul-07	78.28	69.57	73.91	8.71
Jul-08	147.27	120.42	133.87	26.85
Jul-09	71.85	58.32	62.86	13.53

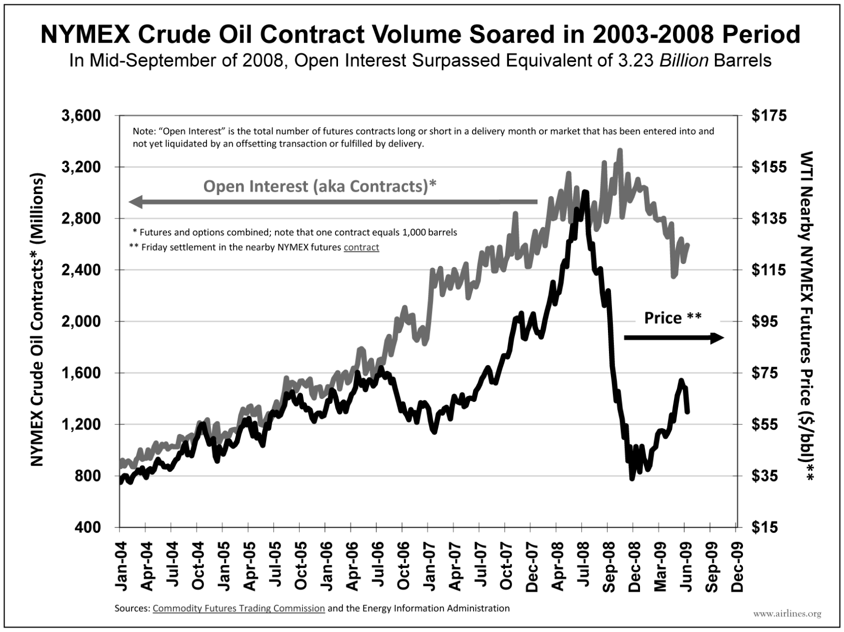
We estimate that the speculative oil price bubble that began in mid-2007, peaked in mid-2008, and then plummeted abruptly, cost Delta $8.4 billion, compared with what we would have spent on jet fuel if the price of oil had remained at $60 a barrel. This includes $1.7 billion in hedge losses and premiums. At least we're still in

[2] Total world demand for oil from 2005 to 2008 (in million barrels per day):

2005—84.00
2006—84.98
2007—85.90
2008—85.33

Source: Energy Information Administration.

business. Other airlines without our financial reserves have not been so fortunate. Since December 2007, eight airlines have ceased operations.



In 2008 alone, some 28,000 pilots, flight attendants, mechanics, ramp workers, gate agents, reservation sales and service representatives, and office workers lost their jobs due to cutbacks in our industry, and air service was reduced at countless communities across the country. Further capacity reductions, layoffs, bankruptcies and liquidations will occur if oil price volatility is not reduced to more manageable levels.

Solutions

Delta Air Lines and the Air Transport Association strongly support reforms to energy market regulation that promote price stability, market integrity, and accurate price discovery. This is because the fundamentals of supply and demand alone, while certainly influencing the price of commodities, cannot explain the destructive volatility we have seen in oil markets over the past 16 months. The dramatic and devastating run-up in oil prices that we experienced last summer—and the almost-as-devastating price crash last fall—was largely caused by a massive influx of speculative investment into commodity markets generally and energy markets in particular. Congress must provide the CFTC with the authority needed to prevent a recurrence of these devastating conditions by enacting bold commodity market reform legislation. The draft legislation recently released by the Obama Administration provides a strong blueprint for this reform and we urge congress to consider it in the coming weeks.

Delta Air Lines and the Air Transport Association are pleased that the Obama Administration has taken an active role in advocating significant reforms to the laws governing the regulations and oversight of derivatives markets. We applaud the President for coming forth with a strong and detailed legislative proposal to deal with the many shortcomings we see in the current oversight framework and generally support the reforms that he is advocating.

Furthermore, Delta Air Lines uses derivatives markets to hedge in both financial risk and commodity price risk, and we view both tools as valuable. That said, my company continues to be more concerned with the explosion of price volatility that we have seen in energy commodities in recent years than it is about increased costs for managing financial risks using financial derivatives. Excessive speculation in oil markets, and the volatility it foments, has been our focus throughout this debate and we continue to primarily advocate policies that reform commodities markets—the portion of this provision that is the purview of this Committee.

Now to discuss some of the specifics of the bill. The President's proposal addresses most of the policy priorities the ATA has enumerated throughout this debate. It effectively closes the loopholes in the law that hamper the ability of the CFTC to effectively regulate the market—the Swaps Loophole, the "Enron" Loophole, and the foreign exchange loophole. It also has the potential to limit the massive influx of speculative dollars that we have seen flow into the markets in recent years by providing the CFTC the authority to impose speculative position limits, requires more transparency and reporting, implements conflict-of-interest rules in this area for the first time, and increases CFTC funding or staff.

Regarding the imposition of aggregate position limits across all markets, one of the ATA's highest policy priorities, the proposal gives the CFTC clear authority to set position limits for any futures transactions that "perform or affect a significant price discovery function." This change will allow the CFTC to address the excessive speculative pressure—and the concomitant volatility—imposed on oil markets by massive pension funds, sovereign wealth funds, and other major market players that use index funds to trade immense amounts of commodity contracts. While the ATA would prefer language to *require* the CFTC to take such steps rather than the mere grant of authority contained in the Obama Administration proposal, we are confident that the current leadership of the CFTC would effectively use this authority to increase oversight and inject stability into these markets.

By imposing consistent position limits on all non-commercial traders across all markets, traders will continue to have the opportunity to invest in energy commodities, but only up to the level necessary to ensure adequate liquidity in the market. This would prevent a recurrence of excessive speculative activity that created the 2008 commodity bubble while ensuring that the markets continue to enjoy the liquidity they need to function efficiently.

The Obama proposal also contains major improvements in transparency. It requires traders to report to the CFTC many types of transactions not currently reported and requires CFTC to aggregate that data and make it available to the public. The bill also would require most transactions not cleared or exchange traded to be reported to the CFTC. The collection and dissemination of this information would greatly enhance the ability of both the CFTC and public watchdogs to monitor market activity and maintain market integrity.

The Obama proposal supports the harmonization of regulations regulating commodity and financial derivatives, and imposes conflict-of-interest rules on swap dealers and major swap participants. Swaps dealers would have to create "firewalls" between their market research arms the branch of the company that engages in trading. They also will have to disclose related conflicts, material risks, financial incentives, and other interests to counterparties.

Finally, the proposal requires many transactions in standardized swaps be traded on a board of trade or cleared through an "alternative swap execution facility." To ensure the integrity of these trades, margin requirements sufficient to cover potential exposure will likely be required. While Delta Air Lines and other ATA members are generally more concerned with market volatility than the potential burdens market reform impose, it is imperative that actual physical hedgers in commodity markets be allowed continued access to these risk management tools without significantly increased cost burdens. Commodity markets were created for the benefit of physical hedgers and they must continue to remain accessible to them. In a trade where at least one party is a legitimate physical hedger in a commodity, the Agriculture Committee should consider provisions that would enable these transactions to occur to with little additional financial burden on the parties involved.

Conclusion

Again, thank you for the opportunity to testify before the Committee on these vital issues. Fuel has become airlines' single largest expense. The extreme volatility we have seen in these markets in recent months has made it impossible to undertake necessary corporate planning and has been devastating to our industry and the employees and communities that depend on us. The Obama Administration has laid out a workable blueprint and we urge Congress to take the significant steps needed to reform these markets. We in the airline industry, on behalf of our employees and the communities we serve, commend you for the leadership you are exercising on this critical issue. I look forward to answering any questions you may have.

The CHAIRMAN. Thank you, Mr. Hirst.

And I thank all of the members of the panel.

Part of what I was trying to do here today, and Tuesday, is to get to the bottom of this issue of how the proposal affects folks that use this in the real world that need to use this for their business. And they get tangled up in all these folks that are involved in this for other reasons, either making a lot of money putting these things together, or selling investments, or whatever they are doing.

So part of what I was trying to do here with these panels is to kind of flesh out the concerns. And then hopefully on Tuesday we can get some more direct answers from Mr. Gensler and Ms. Schapiro about what they actually intend to do.

I think some of the current concerns that people have are—I don't get the sense that they are going to go as far as what some people think, and I think there is some lack of clarity in the proposals that have been put forward. But that is part of what I am trying to do here, is see if we can get that nailed down and figure out how to proceed.

I am somewhat concerned that the big players in this are sending people over here to talk to Members to try to get exemptions for themselves again. And there is some of that going on, I am sure. And I want to sort all that out. But, I guess where I am coming from is we are not really here to put you guys in a tougher position, drive up your costs, screw up what you are doing. You are not the problem. But, in the process, I don't want to leave a loophole that is going to get us back in this position again. And that is what I am trying to sort through here.

You know, as far as I am concerned, we are not going back to the system we had before. And, in the big picture what I am trying to do is make sure that the risk that is out there is going to be borne by the people that are doing the business and not by the government. And, if you have a different way of covering the risk, then we should be able to accommodate that. But all we are trying to do is make sure that we are not setting up some big risk here that they are going to come back and try to get the taxpayers to take care of.

So, Mr. Hixson, there was a concern about this exemption, I guess. For standardized swaps to become exempt, one of the swap counterparties must not be a swap dealer or a swap participant as defined, and then the additional condition is that the counterparty does not meet the eligibility requirements of any clearinghouse that clears a swap, even if the counterparty is not a clearing member. And if they meet the clearing member eligibility, then they would still be required to clear the swap.

So this additional condition could reduce the number of end-users who could qualify for the exemption. Mr. Hixson mentioned this concern.

Did anyone else have this concern? Do any of you know, generally, what is required to be a clearinghouse member and whether your company or members of your association would meet those requirements and, hence, would be required to clear all the standardized swaps?

We know where Mr. Hixson is at. So, Mr. English?

Mr. ENGLISH. Mr. Chairman, we do and are involved through NYMEX, as far as natural gas is concerned. And we anticipate, as we move forward, again, looking to the likelihood of dealing with the issue of climate change, that we will be even more heavily involved, as far as natural gas is concerned and the need for hedging. So, yes, that is an area that does concern us.

The CHAIRMAN. Mr. Schryver?

Mr. SCHRYVER. We are concerned, as well. We are concerned that we might be eligible as customers. If the intent is to exempt end-users from hedging, then we think there might be a better way to do it.

The CHAIRMAN. Have you got language or a proposal of how—I met with some people yesterday that are getting us some language or ideas about how to deal with it. Maybe you are involved with those folks.

Mr. SCHRYVER. We are not, but we would be happy to submit some language.

The CHAIRMAN. Well, if you could get us that, that is what we need. We need ideas about how we can split this baby so that we get the right outcome here.

Mr. SCHRYVER. We will do that.

The CHAIRMAN. Mr. Hirst?

Mr. HIRST. Mr. Chairman, most fuel hedging that airlines do is done on the swaps market in nonstandardized ways under conditions in which it is not necessary to post initial margin. And we would be concerned about provisions that would make that difficult and require us to operate on the exchanges where we would have to post initial margin. The expense of that might cause us to reduce hedging or not hedge at all.

But, having said that, the issue of overriding importance to us is the actual price of oil and the effect that the futures markets have on that price. And if we had to choose between reducing volatility in the oil market and not hedging at all, we would prefer to reduce volatility in prices.

The CHAIRMAN. Yes. Well, I am not sure I am totally up to speed on understanding the nuances of all of this. But where we are coming from, or where I am coming from anyway, is I am not that hung up on putting these on the exchanges. I am more focused on going to clearinghouses, which is a different level.

And I believe that we can devise a system whereby, if the clearinghouse decides that it is not something that they can clear—and that is where I would be coming from for the standard—if they decide they can't clear it, then it is going to go over into some other category. And then we would have to try to figure out what kind of collateral or what kind of backing is sufficient. And, it doesn't have to be, necessarily, margins or Treasury bills or whatever. For myself, I think there are other ways we can make sure we have adequate backing.

And that is where I am coming from, trying to find how we do that. But you get these folks involved in this thing that have a different agenda here. And, frankly, a lot of this fight over all of this has to do with how much money you make in the end. The more you standardize this stuff and the more you clear it, the more the margin narrows and the less money some of these big sell-side banks are going to make. So that is part of what is going on here, and I understand that.

But, anyway, whatever you can do or whatever you can bring to us, ideas of how to deal with this so that we make sure that we are not creating some kind of risk out there that is not covered but works within your business model, that is what we are trying to find, the way to proceed on that, I would appreciate it.

Mr. Lucas?

Mr. LUCAS. Thank you, Mr. Chairman.

And I would note, before I ask my questions to the panel, that your input today and the input to the Committee and the Members over the coming days and weeks, perhaps months, is critically important. There will be a bill. It is just how will it be structured, how will it be crafted, what will the net effect be? There will be a bill. So these issues, these nuances are so critically important.

And, with that, I guess I would like to turn first to Mr. English and perhaps Mr. Schryver. Let's discuss for just a moment this issue about collateral in the way the Treasury's proposal seems to work.

I mean, what do you gentlemen have, in particular in your areas, for use as collateral? I don't think you sit on piles of cash. I am not sure how you mortgage the lines or the pipes. But let's touch on that for a moment. What would be your base under the Treasury proposal for collateral to cover your margins?

Mr. ENGLISH. Well, from our standpoint, you are right, we don't have a lot of money. As I mentioned, we have a lot of equity; we don't have a lot of cash on hand. So, basically, the more volatile this becomes, the greater the call, it means that our members are going to have to go out and borrow large sums of money. That is about the only way in which we can address it.

And that is where our concern is, with regard to the cost. That is going to be a very expensive proposition. And we have no choice; since we are a not-for-profit, that will be passed on to our members. That goes directly to the electric bills.

The CHAIRMAN. Mr. Schryver?

Mr. SCHRYVER. We have pretty much a similar concern. Our belief is, by requiring public gas systems to post collateral, you are, in effect, punishing the victim. You know, our members have been victims of market volatility.

And by requiring them to post collateral, they are either going to have to get a line of credit, with is going to affect their municipality's credit rating; raise rates on ratepayers; or not hedge or reduce their hedging, which, in effect, would hurt their consumers as well. So any efforts to require public gas systems to post collateral would harm their consumers.

Mr. LUCAS. And while we are on this point, gentlemen, explain for just a moment in greater detail how the regulatory regime that you are subject to from the Federal Energy Regulatory Commission, how this would be impacted by the proposal, as it now appears the White House has offered up. And would it, in effect, lead to double regulation or uncertainty in regulation, potentially? Could you expand on that for a moment?

Mr. ENGLISH. I don't think there is any question unless that is a very bright line that is drawn with regard to the exemption, any transaction that is physically settled, we would be uneasy, even given the language that is contained, that has been put forward to this point, we would feel uncomfortable that we are going to be regulated by both entities. Even though there is some language there that addresses that, we think that needs to be clarified.

But, obviously, FERC already deals in this area, and we really find ourselves in a very difficult position if we get regulated by two Federal agencies. We have had that experience in the past, and that was not good.

Mr. LUCAS. Mr. Hirst, you stated quite clearly you believe that the volatility, the price volatility that has been so devastating, so crippling to the airline industry—and this Committee has had various hearings on that in the past, your fuel cost—would cause problems with the swap activity.

Would you say it was a greater issue in the swap activity or over the regulated exchange activity? Could you expand on that for just a moment?

Mr. HIRST. Well, it is really hard, sir, to sort this out with precision because there isn't transparency today into the level of activity in the swaps market. But we have seen a huge increase in index fund investment in the market. And that, in growing from $15 billion to $200 billion over the last 5 years, has clearly had an impact on futures prices, which is translated into pressure on the upside on oil prices.

And we support the aspects of this bill that would extend CFTC jurisdiction into the swaps markets so that it can determine exactly how much activity is going on there and what ought to be done to it.

Mr. LUCAS. My understanding is that one of the highest policy priorities you all have advocated, of course, are the aggregate position limits. Do you support the imposition of those position limits on all contract months, not just the nearbys, but all contract months? Could you expand on that for a moment?

Mr. HIRST. Well, again, we strongly support extending the authority of the CFTC to the over-the-counter and swaps markets, clarifying that it has the authority to do what needs to be done there.

We think that the CFTC should act with respect to all months that do have a significant price discovery function. You know, whether the outer months exert the same level of influence on spot prices as the close-in months is a fact question that probably ought to be left to them to determine.

Mr. LUCAS. Thank you.

And thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Iowa, Subcommittee Chairman, Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman, and I appreciate you doing this today.

I wonder, Mr. Hixson, Cargill has such a big play in so many things because of your size, and we understand that, but could you explain a little more, if Cargill produces—the cost of the food products Cargill produces if costs imposed by the Treasury proposal actually would discourage prudent hedging, as you have suggested, leading to volatile market conditions, could you kind of expand on that a little bit?

Mr. HIXSON. Sure. I think we have analyzed this as a company, and I think if—and I should state from the outset, we are huge fans of exchange traded markets. We use them extensively for our price discovery purchases. So whenever we are buying from farmers, that is typically hedged directly at an exchange. Sometimes there is an appearance of, kind of, a one or the other, which we, I don't think, view it as that way. We kind of view it more symbiotic, that they really can work together and well between the OTC and the exchange traded markets. So we do rely heavily on the exchange traded markets.

But, for example, if you go with the Treasury Department's proposal, through our over-the-counter work, even though about 90 percent or more of our trades are exchange traded, it would require us to take a billion dollars of capital and remove it from either building new facilities, new crush plants in Iowa and that sort of thing and putting it into margin accounts. And that would, obviously, change, kind of, our cost structure and our investment decisions on where we deploy capital.

But probably more important is to understand the benefits as it moves down the supply chain, if you will. I think in my examples we talk about, kind of, both a bakery customer or more kind of an odd one for us, it might seem from an Iowa standpoint, but the hedge we do for a heating oil customer. Well, the initial margin on that heating oil would be about at ten percent. So if that contract now has to be margined, and you are a small jobber selling a million dollars of heating oil, you now have to come up with $100,000. That is a major change for a small player.

So it affects us, and I hope that casts a little bit of light on how it treats us. But it is also important to look at it through the supply chain on where the ultimate beneficiary sometimes resides.

Mr. BOSWELL. Anybody else want to make a comment on the panel?

Mr. English, I appreciate that you helped us out when we worked on the, if you will, the energy bill. We thought we had worked out a pretty good—keep us whole. I say "us"; I am a user. But then we go back out in our districts, and you need to communicate some more that we actually worked this out together. I just throw that in, a little extra here. And you don't have to say a lot about it, but you are welcome to say what you want. But, nevertheless, it seemed to be a lack of appreciation that we did communicate and got a response from you in writing that we did okay; of course, you would like more. But at least we got to the table and got some resolve in that question.

So I just want to throw that in. Maybe we could talk later. But I would just like for you to make sure they understand the effort that you made and that we made up here to make sure that no harm was done.

Mr. ENGLISH. I appreciate that very much and certainly appreciate this Committee, appreciate the Chairman. And I think we made great progress.

The point that I think a lot of our folks, your constituents, my members, probably view the process as the end. They consider the House legislation the end. And we have been trying to explain to them, this is only the beginning; we still have to go through the

Senate and see what we can do with regard to a conference, and we expect this legislation will do far better.

So I appreciate that.

Mr. BOSWELL. We don't have to belabor it. But, anyway, I just want to get the point across to give them a little reminder, please.

Mr. ENGLISH. I will be going to a regional meeting this afternoon. So we will again underscore that.

Mr. BOSWELL. I yield back. Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from Kansas, Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you.

I am sorry I heard only the testimony of two of the panelists before I had to step out, but I am looking for the kernel. What is it that we should—in your opinion, what problem are we trying to fix, and what is the solution?

My guess is that the two panelists I didn't hear—kind of, the typical testimony we will hear is that we have broad agreement that we need to make some changes, we are concerned about some specifics that are included in this legislation, please don't do this.

What is it that you would like to see or what do you believe is necessary for us to accomplish the goal of a fairer, freer market?

Yes, sir, Congressman?

Mr. ENGLISH. That is an issue that we were examining 15 years ago, so this is nothing that is new. I think the point that I would make, and I think that we all can agree on, is that there needs to be transparency in these markets. There is absolutely no question about that. I think we need to also be focused on manipulation, no question about that. And we do have those people doing it.

It is a difficult challenge, as you look at both the exchanges under regulation with the CFTC and the derivatives, which don't bear the same kind of scrutiny. And as I understand where the Chairman is trying to go, and what this is really focused on, is how we maintain that level of protection and enhance the protection to the government and to the American people, while, at the same time, understanding the fact that we want to continue the legitimate efforts of, in fact, allowing people to hedge and meet their needs. And we have to have speculation involved in that.

And so it is a careful balancing act. I hate to say, before I left, I never did find that right balance, and I know the Committee is still searching for it. But that is about the best I can do for you.

Mr. MORAN. Mr. Schryver?

Mr. SCHRYVER. We also support transparency. We think it is important to help ensure that——

Mr. MORAN. Let me try to narrow that. When you say "we support transparency," what does that mean we should do legislatively?

Mr. SCHRYVER. I think enhanced large trader reporting. I don't think you need clearing, at least as it pertains to public gas systems, to enhance transparency. We think position limits make sense for natural gas. You have a finite supply, few deliverable points, so position limits for natural gas make sense.

But, again, our concern is that clearing is really intended to address systemic risk. And our APGA members, public gas systems, just don't present a systemic risk to the market. And, in effect, you will be punishing the victims.

Mr. MORAN. The typical painting-with-too-broad-of-a-brush approach.

Mr. SCHRYVER. Yes.

Mr. MORAN. Mr. Hixson?

Mr. HIXSON. I think we share a similar concern on the transparency front. And maybe to give a tangible example of that, it has been mentioned the bid has spread the market efficiency on the exchange traded side. And we certainly see that, as heavy users over on that side. But, a lot of that can occur with more transparency. And, actually, we, as end-users, will benefit because we will see these situations where you have pockets of similarly traded contracts and see what the spreads are. It is better than likely that a exchange can develop a contract that will provide that efficiency.

So, there are a lot of gains to be achieved from the transparency alone that probably aren't truly recognized.

Mr. MORAN. Mr. Hixson, you talk about mandatory margining and capital charges. If that is included in the legislation and becomes law, how do you see that playing out in the marketplace?

Mr. HIXSON. I think you will see a couple of different changes. You know, already it kind of depends upon where you are in the marketplace, if you will. In the heating and oil example I used, you might see more fuel surcharges. I think there are multiple ways of handling risk. It can either be done through an efficient means of some sort of a hedge. The other way to handle it is to try to force that onto your ultimate consumers. And some industries do that and do that pretty well. So I think you will see, kind of, a drive for more surcharges and of that sort of nature.

The real challenge is if you are perhaps an international manufacturer, where you are building a bulldozer in Illinois and you are competing with a firm that is building them and has a home in Japan. Well, if they can hedge all the risks in their supply chain and you can't, you have to go to that end customer and say, "Well, I would like to sell you bulldozers, but I am going to need a rider on there for any steel volatility I may have and a surcharge for steel. And, oh, by the way, if your local currency goes down, I am going to need a rider for that, as well."

So, when you are looking at those two bids, it is going to be very challenging for the U.S. manufacturer to compete with that inherent level of uncertainty in the bid that they can provide compared to the international competitor.

Mr. MORAN. Thank you very much.

Thanks, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

I really appreciate the Chairman's very practical approach to this. None of us is as facile as any of you are with regard to these issues. You know, we dabble in them; you live with them. And so we have to take a lot of guidance from you.

And the Chairman has asked that you give us language. In addition to giving us the language, if you could explain why that language works and it is not going to create a loophole, that would be helpful.

And those who think that exceptions along the lines that you all are suggesting should not be granted—no doubt they are listening in to this hearing—they probably ought to look at the language that is submitted and start suggesting to us what sort of loopholes would be created if we adopted that kind of language. None of us wants to excessively burden you.

I find myself wondering—it seems to me quite likely that there are a very small number of swaps dealers that provide the hedging that you all need, and that in some instances the hedge is pretty substantial. I mean, it is a big deal for your businesses. And say you are looking to cover the cost of jet fuel in February anticipating X, and you want to be pretty sure that you can pay X and get the jet fuel you are going to need, and something happens in the market and all of a sudden X is 4X. You are relying upon the solvency of the entity that you are dealing with, and if that entity goes under, if the entity turns out to not have the wherewithal in order to meet the obligation, then you are kind of in trouble.

And it would be natural, under those circumstances, for you to want the entity to be putting up capital as the market starts moving, you would want the entity to be margining in some way, just to protect yourself.

Now, from our perspective, while we care about each of our individual businesses, I don't think—your failure doesn't pose a systemic risk, really. So we could say, "Well, that is your business. You are big boys. Why should we insist that you insist on some sort of margining, some sort of capital exchange to assure that the deal is going to be doable as the price catastrophically moves higher and higher and higher?"

What we are really worried about is, what happens with these big banks? Historically here, in part, I guess, because they figure we will bail them out—and that is the unfortunate part of having to step in and do things like TARP—and we will bail them out without insisting that the shareholders take the hit or the bondholders take the hit, as they should—they should be the first entities to step up—they take excessive risks. And so, they are guaranteeing your swaps and other swaps, *et cetera*, and they are not putting up enough to assure that they are actually going to be able to meet these obligations. Things aren't sufficiently transparent. And the upshot is that all these entities that are dealing with them, they are afraid to deal with them and we have another credit freeze and it happens 2 or 3 years from now.

So, I also think you need to be telling us how we get around that. Do we say, "Well, it is only one side that is going to have to put up some collateral, it is the big banks that are going to have to put up some collateral," as price moves in a certain direction, to discourage their risk-taking? I don't know, and it would be great to have some guidance along those lines.

Mr. HIRST. If I could, Mr. Marshall, in the current world, when airlines hedge in the swaps market and if price moves against us, we have to post collateral. So there is some balance in that world from our perspective.

The biggest issue for us——

Mr. MARSHALL. Could I interrupt?

Mr. HIRST. Yes, sir.

Mr. MARSHALL. So you are already posting collateral, both sides to the transaction?

Mr. HIRST. Yes.

Mr. MARSHALL. You know, I have a sense that there are people out there right now talking about how they are going to develop the entity that is going to be providing the $100,000 that your dealer needs in doing a hedge and collateral—in doing those loans. The cost will be cost to carry it, it would seem to me if the market is working appropriately.

So it doesn't sound to me like there is that much change if you are actually putting up collateral anyway.

Mr. HIRST. The big issue for us is the impact of the futures markets on spot prices. And the most important aspect of the Treasury proposal, from our perspective, is the authority it gives to the CFTC to bring that back into balance.

Mr. MARSHALL. As the Chairman has noted, we have had hearings on this. We are with you; we have to figure that one out. We would like to see something reasonable done in that regard, and we have proposed legislation here.

But back to this concern that these margining requirements are going to somehow really kill the market and unreasonably so.

Mr. SCHRYVER. Right now, public gas systems, they will engage in an OTC transaction, bilateral transaction, and they will have a built-in agreement within that transaction where neither party will have to post collateral.

Having standardized clearing would eliminate that ability for them to do that and they, in turn, would have to post collateral; and as I said, that would eventually raise their rates or it would reduce their ability to hedge.

Mr. MARSHALL. My time is up, Mr. Chairman. If we have a second round——

The CHAIRMAN. Yes. We will get through the Members and then we will see.

The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thank you for calling this hearing.

Mr. Hixson, you talked about in your testimony that there could be some unintended consequences of this legislation. One of the things I am always concerned about legislation is, sometimes we are trying to address one thing and we maybe make a dab at that, but then we end up with some unintended consequences. And particularly right now in our financial markets we don't need any unintended consequences, because we have them under about as much stress as they probably need to be at this point in time.

This exemption piece we have heard testimony about, you mentioned the baker on flour. We have heard from a lot of small, intermediate-size businesses that they are using OTC derivatives to manage risks, and that it is more important for their working capital to be working rather than sitting in a margin account somewhere.

Would Cargill be considered to meet the eligibility requirements of a clearinghouse? And then would you be required to clear your standardized OTC contracts?

Mr. HIXSON. Some of the definitions we are not quite sure on, but—I mean, let me explain a little bit more in a generic sense that might add a little clarity to what we view as the conflict of interest.

And the example I have been using is, say you are the doorman at a night club, and you are paid a dollar a person if they come in the door. Well, no matter how full the room gets paid, you kind of have a dollar incentive to let a few more people in the door.

So to the extent that you have an entity that is built upon collecting that dollar by determining that more people are eligible, we would suspect that the threshold for eligibility would be pretty modest. So, yes, we would think under that scenario we would likely be forced into that category.

Mr. NEUGEBAUER. You know, one of the things that goes on in the OTC market, and the analogy I would use is, there is a lot of credit lending, as opposed to using margin for, and that basically in many cases that you may loan that banker—baker a position. He is buying a position from you, and you are loaning him the ability based on his financial statement to do that.

Is that a correct assumption?

Mr. HIXSON. That is a correct assumption, and maybe I should just set shed a little light on kind of how that transaction works, and that might address a few of Congressman Marshall's concerns as well.

So in the baker example, what Cargill would likely do is work with the customer and figure out what specific volume they want to cover, what specific time frame they want to cover; and then what is their risk tolerance, as well as kind of how financial well capitalized they are.

You know, you can pay more or less, depending on how much volatility you want to take out of the system. If you want to narrow it down very tight, it costs a little more; if you have a little wiggle room, it costs a little less. So you design the specific product for their risk thresholds.

Then we, as the dealer in this case, turn around and do go and park off as much of that risk into the exchange, which we think is an absolutely critical piece of this. You know, there is value in mutualization of that risk, and we want to make sure that is clearly understood that the baker has the inherent risk on their books already because they have to buy the flour. So they are inherently going to be long in flour, if you will. The hedge just allows them to help offset that risk. But then throughout the supply chain as it moves back, we then seek to hedge as much of that risk as we can.

Certainly we keep working capital for any portion of it that we can't hedge, but by and large we seek to lay off as much of that risk in the regulated exchange, which we think is absolutely the proper thing to do. So what the baker in this case is doing is focusing on baking and kind of outsourcing the service of designing the hedge to a trading company. And Cargill certainly has a background in hedging and trading.

Mr. NEUGEBAUER. Mr. Hirst, I want to go back. In your testimony you indicated that Delta does use the swap market, I believe, to do your hedging; is that correct?

Mr. HIRST. That is correct, sir.

Mr. NEUGEBAUER. But you are concerned about the volatility of the exchanges and with the speculation. Your indication is that there is too much speculation in that market, and you believe that is impacting the price of the commodity; is that correct?

Mr. HIRST. Well, we think that all the futures markets, both over-the-counter swaps and exchange-based markets, have a price discovery function in the oil market; that is, they influence the spot price of oil. And so if we have a single issue that is of overriding importance to us, it is the necessity of imposing position limits on speculative activity in these markets.

Mr. NEUGEBAUER. Just a final question then. You said there is too much speculation. We have heard people say that testimony before.

What is the appropriate amount of speculation in the market?

Mr. HIRST. Sir, in our view, the appropriate amount of speculation is that amount which provides sufficient liquidity for hedging to occur, but not so much that it creates volatility in the market. And where that level is probably can't be determined with scientific precision.

But when we look at the history of oil prices in relation to the level of speculation, if you look back about 10 years, what you would see is that the level of speculation in relation to hedging by producers and end-users was about 25 percent or thereabouts. And it is currently about three times that. It is something on the order of 70 to 75 percent of the activity in the futures market, so people have estimated.

And so we believe that is out of balance.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, the Subcommittee Chairman, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

I would like to get each of your responses to this scenario. Presumably we are working on increased regulation and improving transparency in the over-the-counter markets in order to protect end-users of commodities and, ultimately, consumers from excessive speculation, however you may define that, which may lead to unwarranted spikes in the prices of commodities.

There is a real risk, however, that too much regulation—that is to say, too strict clearing requirements or capital requirements that are too high—could actually prevent end-users and legitimate hedgers from mitigating their risks. In fact, it seems the loosely defined end-user commodity, as diverse as it is, is not really of one mind on this issue, with some fearing the loss of their ability to hedge more than they fear the effects of speculators.

So it would appear that the Treasury has recognized the risk to legitimate hedgers in its proposal, that its proposal may pose and, as such, they have tried to build in some exemptions to its clearing requirements. However, these exemptions are tied to what seems to be a long and complicated set of conditions placed on the contract participants.

Now, many of you all have touched on this before, but I would like each of you to elaborate on, one, whether or not you think these conditions are overly stringent; two, whether or not you think you would qualify for these exemptions as they stand now; and three, if not, would exposure to these new clearing and capital requirements prevent you from doing the hedge your business needs to do either for financial or technical reasons?

Mr. HIRST. I would be happy to start, sir.

As I mentioned earlier, airlines generally, when they hedge, hedge in the swaps markets with nonstandardized instruments that don't require posting initial margin, although if the price moves against you, then you do have to post margin. But you enter into an agreement with the swaps dealer that, in effect, extends you credit for that initial margin requirement.

To the extent that the rules change and airlines are required to post initial margin in order to hedge, it would deter hedging. To the extent that we are able to continue hedging in other *fora* without having to post initial margin, we would welcome that.

Mr. SCHRYVER. From APGA's perspective, I don't know if I would use the word—an overly stringent definition, but we think the definition—if the intent is to exempt end-users that don't pose a systemic risk, we think the definition can be clarified.

In terms of if we do qualify for the definition under the current language that is unclear to us, we are not sure if we would be exempted or not, which is one of our concerns. And that is why we support clarifying the definition.

And third, if we did fail to qualify for the exemption and would be required to post collateral, it would certainly impact our members' ability to hedge.

Mr. ENGLISH. We believe that most of our contracts, as it applies to natural gas in particular, would be considered standardized. And as a result of that, that would put us in a position that the margin requirements would be such that it would be unaffordable for our members. And that is where our difficulty comes in. We have to keep it affordable and we have, in order to take care of risk, we have to hedge. So if this crowds us into a position that it becomes unaffordable for us to hedge, then obviously, the risks become enormous.

Mr. HIXSON. I think we tend to agree. We would say the contingencies are a little too stringent. I think they can clarify.

What we view as their intent was to try to remove hedgers from this obligation, and we think yes, we probably would be captured under this. There is an incentive to capture as many people as you can, and we think the ultimate end result of this would indeed be to have less hedging.

Mr. SCOTT. Thank you. Your comments have been very helpful.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Virginia, Mr. Goodlatte.

Mr. GOODLATTE. Thank you, Mr. Chairman. I want to thank you, as others have, for holding this hearing, in fact, a series of hearings which are very important as we work on this issue. I would like to ask anyone on the panel about the authorities that are proposed to be granted in this proposal. Everyone, well, I should say, almost everyone supports greater transparency, but transparency alone is not enough. Additional authorities need to be granted to the regulators so that the information that comes along with greater transparency is meaningful. What regulatory authorities that are in this proposal do you agree with? What ones do you disagree with? And are there others that are not in this proposal that you would consider? Anyone want to jump in there?

Mr. HIRST. I would be glad to start. Really I am just repeating what I said earlier sir. But the most important issue from the airlines standpoint is position limits in the oil futures market. And this proposal clarifies the CFTC's authority to impose position limits in all markets that have a price discovery function of significance, not just the exchanges.

There is ambiguity largely because of the loopholes in the Commodity Futures Modernization Act; and we think the thrust of this bill, if it becomes a bill, would be very helpful in that regard.

Mr. GOODLATTE. Anyone else? Mr. Schryver?

Mr. SCHRYVER. We also support position limits. We think they need to be enforceable, as Mr. Hixson said. We also think they need to be aggregate, so you don't have a case where an entity moves from one area to another to escape position limits.

Mr. ENGLISH. Reporting and position limits.

Mr. HIXSON. I think we are directionally okay on the transparency. But you have hit on probably—what we would probably view as the most complex part of the bill is truly understanding what the authorities are relative to the CFTC, SEC, and how they are split. I will have to just get back to you with a more detailed answer.

Mr. GOODLATTE. Okay. Thank you.

You know, this Committee has witnessed firsthand how poorly the CFTC and the SEC work together. The Commodity Futures Modernization Act passed by this Committee nearly 10 years ago charged them with a few joint rule-makings. We are still waiting for the two agencies to produce what the law mandated a nearly a decade ago.

This proposal is replete with joint rule-making between the CFTC and the SEC, and I want to know if this causes any concern to anyone. Is anyone concerned that the Secretary of the Treasury will make the decision if the two independent regulators can't?

The gentleman from New York is concerned. Anybody on the panel?

Mr. ENGLISH. I have a little history with that, and I think your concerns are very valid. I think you have to take that particular provision with an understanding of the history and the likelihood of not much improvement for the future. So it sounds good, it is a nice phrase, but the history kind of indicates it is not likely to take place.

Mr. GOODLATTE. Is there anyone else?

Let me also ask you—and again I will address this to the whole panel—what percentage of your current swap contracts would be considered standardized, and how much more do you think it will cost to trade those same contracts on-exchange and have the contracts cleared by a designated clearinghouse? Where will you get the money to cover the increased costs, and how will the trading and clearing mandate affect your risk mitigation strategy?

Mr. HIRST. On behalf of Delta Air Lines, and I can't really speak with precision for other airlines, virtually all our hedging activity takes place in swaps market. We do not have to post initial margin. If we had to transfer that activity into the regulated exchanges, post initial margin, a sort of back-of-the-envelope estimate that we made a couple of weeks ago was that it would cost us about $300 million annually in liquidity.

Mr. SCHRYVER. From APGA's perspective, most of the contracts we engage in we believe would be considered standardized. It would have a significant cost upon our members at roughly $5,000 a contract; it would certainly reduce their ability to hedge.

Mr. ENGLISH. Most would be considered standardized. There is no question that it would cost us hundreds of millions of dollars, and we would just have to borrow the money.

Mr. GOODLATTE. And Mr. Hixson.

Mr. HIXSON. Well, that is an interesting question. Like I said, even though we trade the vast majority, some 85 to 90 percent, kind of, on the exchange already, the move to roll in these other products would cost us an additional billion dollars a year.

Mr. GOODLATTE. That is pretty—collectively, you are talking about a couple of billion dollars or more. That is pretty stunning.

Mr. Hixson, currently, when you enter into a swap, do you know who your counterparty is?

Mr. HIXSON. Yes, we do. That is kind of the nature of the swap. It is a very bilateral transaction between two known counterparties.

Mr. GOODLATTE. How much due diligence do you conduct before you enter a swap with most of your other parties?

Mr. HIXSON. An enormous amount. It is a critically important component of what we do.

First of all, we typically try to have a relationship with them and understand what their business model is. We generally offer most of our hedging activities in markets where we have some physical presence, so it is in the food and agricultural and maybe energy industry. So we do that.

We also do margining with about 80 percent of our customers, so it is not like there is no margin that goes on, it is just set on a different parameter. And then we also have an independent credit department within the company as well. So we do margining, a lot of research on understanding their physical needs and their risk tolerances, and then also have credit analysis on top of that

Mr. GOODLATTE. Mr. Chairman, I know my time has expired. I wonder if I could ask one follow up to Mr. Hixson about that.

If you are forced to clear, does the increased cost of clearing pay for the benefit of not needing to know who your counterparty is, or is that just a cost that outweighs the benefit?

Mr. HIXSON. Well, it probably outweighs the benefit because we use the markets for different purposes to some degree. Like I said, we trade extensively, and we are huge fans and just supporters of the regulated exchanges. For price discovery and for the bulk of our trading and hedging activities, they serve that purpose really well.

But the expense you would be adding on the over-the-counter side for many counterparties and customers that don't have that in-house trading and hedging expertise that would by far outweigh the benefit over there.

Mr. GOODLATTE. Thank you.

Thank you, Mr. Chairman.

Mr. BOSWELL [presiding.] Let's see. I am trying to fill in up here and see who we have up next. I believe it is Mr. Schrader from Oregon.

Mr. SCHRADER. Thank you, Mr. Chairman.

I guess a question for the panel as a whole is, a few years ago, the CFMA was passed; and I am curious how that changed your investment, your accounting and your hedging practices, and whether or not it affected the margins you are required to have.

Mr. Hixson, I'll start with you.

Mr. HIXSON. Cargill has been in the risk management business offering customized risk contracts and the OTC product since 1994. So for the types of bilateral transactions we do, where we oftentimes have a relationship of selling the product—corn or beans or flour, for example—it didn't really change much in the dynamics of the products that we tend to offer.

Mr. ENGLISH. We created a group that I mentioned earlier known as ACES Power Marketing. It is owned by our members. It is there specifically for that purpose, to handle risk management, and to also do the kind of examination, as far as counterparties are concerned, that minimizes any exposure we might have.

Mr. SCHRYVER. The CFMA did provide greater certainty to swaps, and as a result, more of our members are using them to hedge.

Mr. HIRST. Mr. Schrader, our main concern with the CMFA is the effect it had on the CFTC's jurisdiction over the nonexchange-traded futures markets and the impact that that has had, we think, on increasing speculative activity and causing volatility in the spot market for oil.

Mr. SCHRADER. I tend to agree with Mr. Hirst. I would think that is a critical element that needs to be readdressed, and hopefully we get to, to some degree, in legislation here.

Most of you have testified about the margin requirements being perhaps the most onerous of the potential changes you see coming down the road here, and some exemption for end-users. Could you define that a little bit more and assume you are trying to get to the middlemen that have no stake in the game, if you will, at any point in the process? Could you talk a little bit more about how you would exempt end-users?

Mr. HIXSON. In our testimony, I think we kind of characterize what we think the intent of the legislation is, to go after the hedger, the classical definition of somebody, like I said, the baker who has the underlying flour coming into their business and they need to run their plant. So that is kind of how we structured our test for what would be the proper terms of the exemption, would be whether or not, kind of like the folks at the table, you are a classical hedger. You have an underlying commodity; you are just trying to lay the OTC hedge on top of that to take out the volatility and to address the risk.

Mr. ENGLISH. I would agree.

Mr. SCHRYVER. Yes, we would also support an exemption for hedgers.

Mr. HIRST. I thought Mr. Hixson's articulation was clear. We agree with it.

Mr. SCHRADER. So you could come up with the language, I assume, to make that possible. I think the Committee would be interested in that.

I yield back my time, Mr. Chairman.

Mr. BOSWELL. Thank you.

Mr. Roe.

Mr. ROE. Thank you, Mr. Chairman. I have just a couple of quick questions.

Everybody always hates to pick up the phone the day your broker is on the line to let you know your margin call is in. And I guess, Mr. English, I am going to you because I live in a rural area of Tennessee. I wonder about the costs of this, added costs, we have, potentially, the carbon tax that is going to add cost to our consumers in these rural areas and then across America.

How much are you talking about for the individual customer or business out there? I mean, I know you are paying interest on the money you have to borrow and you have to find a line of credit and all that.

The same thing I guess would go for Mr. Schryver, too.

Mr. ENGLISH. I think you have to view this—what we are discussing here today is the world as it exists today. We would expect that you are going to see a significant change either through the Clean Air Act and the dealing of the issue of carbon through that mechanism or through any legislation.

And as we move forward in trying to deal with that—for instance, a lot of our members are going to be looking to natural gas in the short term. That is good news for Mr. Schryver. He is very happy with that.

But the point that I would make is, that brings a good deal more volatility in this whole issue, so there is a greater need to hedge. There is a greater risk that we are going to be facing. And depending upon how this legislation addresses this particular problem, obviously, it could very well be hundreds of millions of dollars very easily, just with regard to addressing this question. That's not counting additional costs we might have as we have to make a conversion, which is going to be very costly indeed.

Mr. ROE. If you are covering 12 percent of the population——

Mr. ENGLISH. That is correct.

Mr. ROE. It would be more than hundreds of millions if you are hedging.

Mr. ENGLISH. That is—again, it is difficult to estimate how risky, how much additional risk would be involved. But just looking at natural gas alone and the shift we would anticipate, obviously it is going to be far greater than what we are looking at today, without question.

Mr. SCHRYVER. Actually—and in terms of climate change legislation, we are actually a little concerned. I don't know how much Public Gas is going to benefit because we are concerned about more natural gas being used for electricity generation.

As Mr. English said, it will become the fuel of choice; it is going to increase demand and drive up the prices. And our members are the direct users of natural gas. So that actually is one of our concerns, largest concerns, about climate change is the price of natural gas being driven up.

In terms of the cost of margining, I will use one example. One of our members, that also generates electricity, will hold thousands of contracts at one time as part of a 3 year hedging program. They anticipate that it would increase their costs by about $25 million. They also did a prepay, which is a tool Congress endorsed as part of the Energy Policy Act of 2005. It allows the use of tax-exempt financing for natural gas contracts to allow public gas systems to provide natural gas for their consumers over the long-term at a lower rate.

And those prepaids are very large, over long periods of time, sometimes as long as 30 years. One prepay involved 15,000 contracts. And to clear that prepay at $5,000 a contract, you are talking $75 million, which, in effect, eliminates the ability of public gas systems and public power systems to do prepays.

Mr. ROE. Well, we know that natural gas companies are going to pay, consumers are. I mean, that is who pays the bill. When you talk about paying it, that is who is going to pay it.

And I guess what we want to do in the futures market—quite frankly, it seemed to work pretty well during this financial crisis, banking crisis and so forth that we had. It seemed to work fairly well because there is a buyer on each side of the trade. And I mean, it worked well.

I guess putting those requirements so high on what you are talking about adds another cost to the consumer, along with other costs that are heading along. And I know the co-ops in our area work as hard as any business I have ever seen to keep the costs down for consumers since they are nonprofits.

Thank you. I yield back my time, Mr. Chairman.

Mr. BOSWELL. Thank you.

Mr. Kissell.

Mr. KISSELL. Mr. Chairman, the couple of questions I had prepared basically have been asked. I am going to yield my time to Mr. Marshall from Georgia.

Mr. BOSWELL. Okay. Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Kissell.

You all can really help us out a lot, as you give us advice concerning how to modify the proposal so as not to unduly burden you, if you can really pin down what the cost of the burden would be.

And I am certain there are folks out there, right now, working up a business model where they are going to lend margin money. And so it is a matter—obviously, I am asking you to assume that that market will be there; and so let's say it is a billion dollars' worth of margin money that is needed.

What is going to be involved in the cost to carry for borrowing that money? What is the real cost of putting up margin? And then the typical swaps deal contemplates that as the price moves, money is going to get put up.

So that is the other thing. If we require clearing and if, in essence, the clearing organization is going to require the exact same money to be put up as the price moves, that doesn't really change anything at the moment. But what it would maybe tend to do from our perspective is give us greater comfort that there is less systemic risk on the other end since all this stuff seems to be packaged in just a few AIG-type entities.

And if you could help us think through that, I think it would be enormously useful to us because we just don't have the kind of expertise that you all have.

Now, it may be we can avoid the systemic risk that is our real focus here. I mean, as I said before, we all think, the Chairman is absolutely determined not to put any burden on you, or on your customers, or on American consumers that we don't view as really necessary to avoid systemic risk. So if you can come up with some other way that we can minimize the systemic risk that these big banks pose, that would really be helpful to us. And obviously to others who are listening in on the hearing with views on both sides, that would be enormously helpful as well.

With that, Mr. Chairman, Mr. Kissell, maybe I should yield back to you if you have some additional thoughts along those lines.

Mr. KISSELL. Thank you, Mr. Marshall.

Mr. Chairman, I yield back.

Mr. BOSWELL. Okay. I believe that you are next in line. Please.

Mr. CASSIDY. I moved up here without a sign. I am Mr. Cassidy.

You know, you guys think about this all the time, and I am trying to understand it now from your perspective. But in my mind, I think of those folks who would like to do an OTC, such as you collateralizing your capital to somehow interface with the folks that would do a monetized exchange.

I think of that kind of Greek myth of Janus, the god that looks both one way and the other. This legislation obviously is trying to create something to interdigitate the two systems, OTC and an exchange. How would you do it?

If you were running the exchange, Mr. Hirst, I guess Delta puts the value of their jets as collateral, I can imagine. How would you interdigitate this OTC market with the standardized exchange?

Mr. HIRST. Well, sir, again, our major concern is in the price of the commodity itself. And hedging is a luxury for us in relation to actually buying oil, which is a necessity.

The volatility that the market has experienced over the last several years has not only increased our fuel costs, but it has vastly increased our cost of hedging. And so my answer to that question really is to—is really the Administration's answer here. I think it is to give the authority to the CFTC to think through how that relationship should be managed.

Mr. CASSIDY. Mr. English, how would do you that? You have written legislation before, so——

Mr. ENGLISH. I think we are dealing with—and it was mentioned earlier—between the CFTC and the SEC. I haven't examined recently what the budget is of the CFTC. But historically speaking, CFTC has been viewed more as a stepchild from the standpoint of appropriations and resources. It came into being at a time in which regulation was not in vogue, didn't have the support, I don't think, of the Congress, political community in general.

I think, without question, in many of these areas, it is not just a question of what is in the law, it is a question of whether or not the regulatory agency is going to have the resources to be able to carry out the law in a fashion which is intended.

Mr. CASSIDY. So, you are suggesting that you wouldn't necessarily interdigitate the two. You would rather just strengthen the ability of the CFTC to monitor and create transparency and allow the market to continue somewhat as is?

Mr. ENGLISH. I think that is an area that I would certainly examine carefully. And as I said, I haven't reviewed where we are, from a resource standpoint, of what the strength is. And I am thinking about this from years ago, but I doubt that it has changed all that much, to be honest about it.

But I think that as we move forward on this, we have to keep in mind, keep in view that people such as ourselves, we are looking for a way in which we can deal with the risk.

Mr. CASSIDY. Let me move on just because I am going to run out of time.

Mr. ENGLISH. Right. If the cost gets too high then we are out of it, so it would defeat the purpose.

Mr. SCHRYVER. I believe Mr. Hixson discussed a dealer taking on that function, and that is something that we would support.

Mr. CASSIDY. So will you repeat that, sir?

Mr. HIXSON. I want to make sure I have clarity on your question too. If I understand it correctly, it is kind of what—how would you correlate the relationship, if you will, in the regulatory status of the over-the-counter side and the regulated exchange side?

Mr. CASSIDY. As I understand, the end-user would be exempt unless somehow—but on the other hand when you transfer into the standardized exchange, the exemption becomes threatened, if you will.

Mr. HIXSON. Correct. So that is why in our testimony and kind of our recommendation, what we—the modifications we made really steered it towards looking more at the what the transaction is.

If it goes back to that classical sense of, it is a hedge and there is an effective hedge on an underlying risk, then that is the nature of the transaction that should grant the exemption. That is a more appropriate standard in terms of what you are trying to prevent in the over-leverage and the types of things that would capture those under that metric, but would kind of allow the conventional hedging that we are talking about to continue.

So that is kind of how I think we——

Mr. CASSIDY. So would the utilities still be able to put up their capital assets as collateral for the purchase of a large amount of natural gas?

Mr. HIXSON. To the extent that is appropriate.

I mean, I guess the main kind of OTC contracts are generally secured in one of three ways. They either use a credit agreement, they use collateral or they use some kind of margining. And it is important to recognize that within the over-the-counter markets, the classical hedging side of the uses that were described here went through a very tumultuous year and performed well.

So the challenging side of the market was where it gets kind of split, leveraged, sold, far removed from the underlying product; and it is a little bit of a strain in our minds to call that necessarily a pure hedge anymore. So that is why we choose that area to draw the line.

Mr. SCHRYVER. Of those three options you laid out—collateral, margining—a public gas system, its constitutional documents would really prevent it from putting up its system as collateral. And I can't think of any of the city councils that regulate our members that would allow them to do that. So it is really not an option for us.

Mr. CASSIDY. Okay. Thank you.

The CHAIRMAN [presiding.] The gentleman from Ohio, Mr. Boccieri.

Mr. BOCCIERI. Thank you, Mr. Chairman.

Just a quick question, specifically to the testimony of Mr. English from the Rural Electric Cooperatives. How will OTC reforms affect or not affect states that have a very solid regulatory authority like Ohio with the Public Utilities Commission? And how, somehow, is that managed with respect to the risk associated, taking on derivatives?

Mr. ENGLISH. As far as the state regulatory body, I am not sure that that would have any impact. I am not sure on Ohio. I am not that familiar with it, but I don't believe it would have any impact as far as dealing with the risk issue in any particular specific way. It wouldn't vary from state to state whether regulated or not.

As you are probably aware, some states' electric cooperatives are regulated, other states' are not. But I don't believe in this case it would make any difference.

Mr. BOCCIERI. So no risk decisions are made based upon states that have regulatory authority with respect to derivatives that they take on?

Mr. ENGLISH. In this particular case, with regard to whether it is either dealing with interest rates or currency swaps done through our national association, or whether it is done through ACES, which your G&T in Ohio does participate in, if I recall correctly and is a member of, it would be done through that national association and not specifically through the local, I don't believe.

Mr. BOCCIERI. Specifically, I was referencing the section in your testimony that says, "OTC markets manage the price volatility risk for our consumers who expect affordable electricity prices and electric suppliers." I was just curious how you were drawing the connection between the OTC markets and electricity prices in states that have regulatory authorities.

Mr. ENGLISH. Well, what I was referring to and what the concern is, if we get into a situation between the regulatory body on the Federal level and FERC, we do have issues of concern with regard to getting regulated by two Federal bodies as opposed to state bodies. So that was a reference to FERC and the fact that they do, in fact, have jurisdiction over any physically settled transactions that—and under the Treasury proposal, as I understand it, there is an exemption, but it is not clear to our satisfaction that that would take care of the problem.

Mr. BOCCIERI. Okay.

I just want to be clear that I understand this. So you are suggesting that there would be an attempt to usurp state authority to help regulate and control prices?

Mr. ENGLISH. Well, there very well could be, under these circumstances, depending on how this transaction played out. But jurisdictional questions obviously are always of paramount interest, and the thing that concerns us is if there is confusion with regard to jurisdictions or if we are, in fact, regulated by competing bodies.

Mr. BOCCIERI. Okay.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentlelady from Ohio, Mrs. Schmidt. Did you ask questions already? No questions.

Mrs. SCHMIDT. No, not at this time.

The CHAIRMAN. Mr. Thompson.

Mr. THOMPSON. Thank you, Mr. Chairman.

I thank the panel for coming in and sharing your experiences. I want to back up a little bit for kind of a 35,000 foot look at this. We hear a lot about the driving force behind this; the keyword has been "volatility," and I was really interested in getting your impressions of the situation from your—and your observations.

In terms of trends by commodities, are there specific commodities that you see the risk of volatility?

You know, sometimes we see a one-size-fits-all-type approach to addressing problems, and it has a lot of unintended consequences. We have also heard that word here in the hearing. And so I was curious to see if, in your observations, your experience, are there specific commodities that really are within this risk of volatility to be impacted that way?

Mr. HIRST. Mr. Thompson, I don't claim to be a commodities expert from the airline business. But we have been focused on the price of oil over the last 2 years because we have seen so much volatility in the price that we have had to pay. And as I have tried to study it, it has become clear that oil is a commodity that is highly susceptible to the levels of speculative activity in the futures market.

Now, when I observe what is happening in other commodities, I can't say that the same factors that are affecting the price of oil work exactly the same way in, say, the gas market or in other markets. So I tend to agree with your observation that one-size-fits-all approaches probably won't work, and that there are different problems in different areas. There are different issues and different kinds of systemic risks presented by financial derivatives, financial markets *versus* derivative activity in commodity markets, for example.

Mr. THOMPSON. And I bring that up, because in listening to you reading your testimony and listening to your remarks, I have heard you talk about—when we talked about commodities, we have been talking about energy, energy, energy. And even Mr. Hixson, part of the testimony was energy—not all, but part of it. And so I wondered if there were any observations of other areas of commodities.

Mr. HIXSON. Maybe I could share one example, that it just highlights the challenge of tightly correlating volatility with speculation or whatever the activity is. And the example I would use is one of the more volatile commodity markets last year was the hard red spring wheat market in the Minneapolis Grain Exchange, not a large commodity market and has virtually no index money it. Wheat went to $25 a bushel last year and was by far one of the more volatile than probably Chicago or the other commodity markets that also traded other categories of wheat.

So it is not always easy to correlate strictly volatility, *per se,* with distribution of participants in the market.

Mr. THOMPSON. Thank you.

We have talked about petroleum, and of course we have a couple of witnesses that deal directly with natural gas. And obviously, that is not a world market, meaning that we can significantly influence its price here at home through supply and demand.

Mr. Schryver, in your view, what role has domestic supply played in the volatility of the natural gas prices?

Mr. SCHRYVER. In going back to what you said earlier in terms of volatility, natural gas has been one of the more volatile commodities out there. I think last year the price hit $13, and now it is down below $4. We are not complaining about that, but unfortunately, some of our members did buy $13 gas, and they should have because their hedging strategies would entail them buying gas at certain times, and just hoping the price will come down is not a viable hedging strategy.

And we are not opposed to all volatility. We understand commodities will have some volatility. It is just unwarranted volatility that has our members concerned.

In terms of natural gas, as you mentioned, it is domestically produced. And as Mr. English stated, as Congress anticipates climate change legislation, that demand for natural gas is going to be driven up even more. And that is one of our concerns. We would certainly—we have pushed for and we would be very supportive of Congress opening up more areas for production and allowing more production of natural gas. The more supply you have, to some extent you are going to reduce the volatility of the commodity.

Mr. THOMPSON. Well, I have 15 counties with Marcellus Shale I would love to offer for that.

Congressman, it is good to see you again. Just real quick—final—obviously, Pennsylvania relies really heavy on coal and oil and natural gas for energy demands. And I just wanted to get your impact on what effect this legislation, if it would go through, as it is at this point, would have on overall electricity costs.

Mr. ENGLISH. Well, for our members, and again, looking to the future and taking into account climate change, we could think it could have a huge impact. We think it could, in fact, increase electric bills and increase them considerably.

And we fully understand and appreciate where the Committee is going, appreciate the objective of the Committee, but this is a balancing act that we are looking at here. On one hand is the cost of the risk, on the other hand the cost of the regulation. And somewhere in here we have to find a way in which we can hedge and deal with the risk and still make it affordable for people like us.

Mr. THOMPSON. Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from Michigan, Mr. Schauer.

Mr. SCHAUER. Thank you, Mr. Chairman.

Mr. Hirst, I want to direct a question to you. Thanks for being with us. Thanks for all of you. Your airline has a major presence in my State of Michigan. I appreciate that. And I am studying your testimony very carefully.

Your airline, it indicates, eliminated nearly 10,000 jobs in 2008 as a result, at least in part, of oil price volatility. It is difficult to estimate how many jobs were lost overall in our country's economy due to that price volatility and the market. Consumers certainly experienced that at the gas pump, certainly in the price of groceries and a number of other areas.

You talked about how a certain level of speculative investment in commodity markets has the benefit of injecting liquidity into the market. But then you state that Congress should provide the Commodity Futures Trading Commission with the authority and guidance it needs to ascertain the proper level of speculative investment in the market.

Give me the best guidance you can. What is that proper level? I am very concerned about the impact on speculation driving up prices, costing us jobs, and hurting our economy. So can you expand upon your written testimony and give us some more guidance on that proper level?

Mr. HIRST. Well, I will do the best I can, sir.

Ten years ago, if you looked at various measures of the volatility of oil prices, spot prices, you would conclude that the level of volatility was not high. From 1998 roughly through 2003–2004, the years' high price *versus* the years' low price varied about $15 or $16, typically.

Since that time, as speculation in the market has gone from about 25 percent of the market, the oil futures market, to 70 or 75 percent, volatility has increased. So, on an annual average over the last 3 years it has been over $50. And so I would say, at least as a starting point, one ought to go back to a period of time, not so long in the past, before index funds became a huge factor of the market, and look at what the level of speculative activity was then and use that as a benchmark. And our estimate is that that was in the 25 percent range.

There was adequate liquidity. People who wanted to hedge could hedge. And airlines that needed to buy fuel could buy fuel without experiencing the kind of devastating impacts we experienced in 2008 that led directly to the loss, as you said, of 10,000 jobs.

Mr. SCHAUER. How do you do that from a regulatory standpoint? Do you set a cap?

Mr. HIRST. Yes, sir. There are two ways, and both—we think both techniques should be adopted. It is possible to put an aggregate limit on the level of speculative activity that is financial activity as opposed to activity by commercial users and producers at a level. And when I was speaking earlier of 25 percent, I meant that as an aggregate limit.

In addition, individual limits can be placed on participants in the markets to ensure that no individual participant has too much influence.

And both approaches have been given a lot of thought by the CFTC and others.

Mr. SCHAUER. Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from New York, Mr. Murphy.

Mr. MURPHY. I want to go in a little different direction.

As we have seen so many of the banks pull back and some consolidation in the financial sector, has that impacted liquidity for you as you have been trying to hedge? Have you guys been having trouble getting the bilateral contracts or getting as aggressive a pricing?

Mr. HIRST. We have had no problem hedging.

Mr. SCHRYVER. We have not heard any concerns from our members.

Mr. ENGLISH. We have heard concerns from our members about this, yes.

Mr. MURPHY. So they are seeing spreads widen?

The other piece that I hear a lot is, people say one of the problems with some of the bilateral stuff is that you may be able to get aggressive pricing getting in, but in a bilateral you don't have the ability necessarily to get as aggressive a price in getting out.

Do you guys see that if you ever tried to? Or maybe you guys don't actually try to, if you are using these hedges, you may never try to get out of some of these transactions, but I am curious if you have seen spread problems when you try to get out.

Mr. ENGLISH. Just about everything we are doing is hedging. We are strictly focused on hedging.

Mr. HIRST. Sir, in 2008, when oil spiked at $147 a barrel and then in September dropped very rapidly, a number of airlines, including Delta, were unable to unwind hedges and experienced very significant hedge losses as a result. And that kind of volatility, while it hasn't impacted the availability of hedging, has significantly increased the risk and the prices that we have had to pay.

Mr. MURPHY. Mr. Hixson, did you want to get in on either of those?

Mr. HIXSON. No, sir.

Mr. MURPHY. Okay. So some of the people that we see testimony from—and this is more on the financial side, but I am curious about how it would impact you guys. If we went to a clearing system and got away from some of the bilateral stuff or more of a fungible clearing system, that that might help with that you describe, Mr. Hirst, and make some of this stuff more easily transactible with other counterparties.

Is that something that you guys worry about at all? Or is that an issue that just doesn't seem to apply?

Mr. HIXSON. I don't think that seems to apply in our case. I think we have said it before. We kind of welcome the moves on transparency, but the tradeoff that you would get on the cost structure and the challenges on working capital would be farther off-site.

Mr. MURPHY. I follow that for sure.

That is all. I yield my time back.

The CHAIRMAN. I thank the gentleman.

Anybody else?

Mr. Marshall, do you have a follow-up?

Mr. MARSHALL. Mr. Kissell was kind enough to yield me some time. Thank you, sir.

The CHAIRMAN. Well, I think that will wrap it up for this panel. Thank you very much. I think we have gotten some good information that we need to focus on and figure out how we sort this out.

So I thank the panel for your testimony. Send us your ideas, and we will take a look at them and see what we can do. Thank you.

They were talking about having votes, but I guess we will call the next panel and, hopefully, see how far we can get here. And we have to switch around the nameplates, I guess, and so forth.

But while we are doing that, and to save time, I will announce the panel, panel two, which is Mr. Gary O'Connor, the Chief Product Officer of the International Derivatives Clearing Group of New York; John Damgard, the President of the Futures Industry Association in Washington; Mr. Terry Duffy, Executive Director, of the CME Group of Chicago; Mr. Robert Pickel, Executive Director, Chief Executive Officer, International Swaps and Derivatives Association, New York; Mr. Johnathan Short, Senior Vice President, Intercontinental Exchange of Atlanta; and Mr. Daniel Budofsky, Davis Polk & Wardwell on behalf of the Securities Industry and Financial Markets Association.

I think we have about 10 minutes, so we are going to have two of you give your testimony and then we are going to have to take a break to have votes and we will be back.

Does anybody know how many votes we have? Nine to ten. Well, we will get a couple of you guys' testimony in, and then it sounds like there will be time for you to go have lunch, because we have nine or ten votes, so it will probably be an hour before we get back. So let's make use of the time.

Mr. O'Connor, welcome to the Committee. We look forward to your testimony.

STATEMENT OF GARRY N. O'CONNOR, CHIEF PRODUCT OFFICER, INTERNATIONAL DERIVATIVES CLEARING GROUP, LLC, NEW YORK, NY

Mr. O'CONNOR. Chairman Peterson, Ranking Member Lucas, my name is Garry O'Connor, and I am the Chief Product Officer of the International Derivatives Clearing Group, or IDCG. IDCG currently offers a cleared solution to the OTC interest rate derivatives market through a CFTC-regulated clearinghouse. I appreciate the opportunity to appear before you to discuss the legislation proposed by the Treasury.

IDCG applauds the considered approach of all regulatory bodies who contributed to the proposed legislation. We believe that the goals of reducing systemic risk, promoting transparency and efficiency, and preventing market abuses are achieved by the proposed legislation without substantive change, but we think that they can made more effective in these three areas.

First, we believe that the test that an OTC derivative is standardized for the purpose of clearing should be different from the test that an OTC derivative is standardized for exchange trading; second, how the definition of major market participant is used; and finally, the importance of governance independence of clearinghouses and exchanges.

First, the issue of what is standardized: The term *standardized* itself has led to some confusion as it suggests the customized aspects of the contract need to be stripped away.

This is not the case. This has been particularly troubling to corporate America that sees tremendous value in these customized products. But if there exists a strong valuation backbone and sufficient liquidity to cure a default, then there is no good reason why these products cannot benefit from clearing.

There are some products, however, that while suitable for clearing, do not lend themselves to exchange trading. Essentially, you need a certain velocity of transactions in order to get the price transparency and market efficiency that an exchange can deliver.

We would suggest mandating exchange trading for an OTC derivative only if it is listed for trading by a regulated exchange. As with the presumption of standardized for clearing, this definition does not force the exchanges to do something they do not have the capability to do. It already is subject to regulatory overview and adapts dynamically to changes in the marketplace.

Now, to major market participants, we would urge caution in allowing exceptions for those who do not qualify for this designation. Many of the problems of the current crisis were caused by activities of institutions that slipped through regulatory cracks, the obvious example being AIG. We worry that by introducing exceptions into the legislation that these same cracks may be opened up.

Corporate America again has been very vocal to ensure their beneficial use of OTC derivatives is not impacted by regulatory reform. However, there is no reason, there is no technical reason why this legislation should curtail their use of these products.

While it is the task of legislators and regulators to limit the impact of failure of a systemically significant institution in the future, it should also be the obligation of our industry leaders to ensure that their institutions, customers and employees are also protected.

To simply assume that the government of the day will continue to support their counterparts in the financial system is not good enough. Central clearing is the tool that allows them to mitigate this exposure and to contribute to a stronger financial system.

Finally, the issue of independence, given the important role that clearinghouses and exchanges have to play in facilitating the change in structure of the OTC derivatives market and their role in determining what is standardized, I would encourage their substantial governance independence from any participant or group of participants. This will be essential to the development of open and competitive platforms and, without it, confidence will be eroded and the value provided by these tools will be lost.

Thank you, Mr. Chairman on behalf of IDCG and myself for the opportunity to appear here today. I would be happy to answer any questions you may have.

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

PREPARED STATEMENT OF GARY N. O'CONNOR, CHIEF PRODUCT OFFICER, INTERNATIONAL DERIVATIVES CLEARING GROUP, LLC, NEW YORK, NY

Chairman Peterson, Ranking Member Lucas, my name is Garry O'Connor, and I am the Chief Product Officer of the International Derivatives Clearing Group (IDCG). The objective of IDCG is to bring a centrally cleared solution to the largest segment of the over-the-counter (OTC) derivatives market, specifically interest rate derivatives. This is something that we do today through the operation of a U.S. Commodity Futures Trading Commission (CFTC) regulated clearinghouse. IDCG is independently operated with majority ownership held by the NASDAQ OMX Group and minority stakes held by Bank of New York, founders, and management. I have spent close to 2 decades in the OTC derivatives markets trading interest rate derivatives for large U.S. Investment Banks. IDCG appreciates the opportunity to appear before you and we look forward to discussing the proposed the Over-the-Counter Derivatives Markets Act of 2009 (the Proposed Legislation) put forward by the U.S. Department of the Treasury on August 11, 2009.

Today we will show our support for the form of the Proposed Legislation, highlight the urgency with which it should be introduced, and point out three areas where we feel that it can be made more effective.

First and most importantly we want to point out the urgent need for regulatory reform. It is perhaps becoming a worn out point, but we now stand 1 year on from the collapse of Lehman Brothers and we cannot look back with pride upon the changes we have made. There is no doubt that these are complex issues that require due consideration but at the same time we hold grave concerns that the further away from the trauma of the financial crisis that we move the less urgency will be felt to address the underlying faults in our system of regulation. We must not fall into this trap. The OTC derivatives markets currently represent a greater risk to our underlying economy than they did before the financial crisis began. They are failing to effectively fulfill their role as a venue for the efficient pricing and transfer of risk, are further exposed by the attrition amongst major banks who act as the major liquidity providers, resulting in tremendous levels of concentration, and finally are dominated by the world's largest banks, which are rapidly returning to the same levels of risk that drove them to the brink of collapse less than twelve months ago.

The OTC derivatives markets are failing to provide a venue for the efficient pricing and transfer of risk. Reduced competition within the banking sector, the traditional providers of liquidity to these markets, has allowed the major banks to increase their price for liquidity. A number of much respected individuals within significant market participants have made this observation;

- ➢ Larry Fink, Chief Executive of BlackRock, has highlighted the "luxurious" profits being enjoyed by Wall Street banks, reflecting their ability to take advantage of diminished competition.
- ➢ Mohamed El-Erian, Chief Executive of PIMCO, pointed out "bid-offer spreads have remained unusually wide, notwithstanding the normalisation of financial markets".
- ➢ Ken Griffin, Chief Executive of Citadel, commented in his testimony to the Senate Banking Committee on the egregious spreads being charged by traditional liquidity providers on OTC derivative transactions, in part because of the lack of price depth.

While the commercial interests of the major banks are clear the market structure in which this situation has been allowed to develop needs to be addressed. End users are desperate for a more diverse base of liquidity providers to bring transaction costs back to pre-crisis levels and to provide a buffer to the extreme volatility that has been present in financial markets since the summer of 2007. Only by allowing new and existing participants access to these markets in an open and competitive manner can this be addressed. All to all central clearing and exchange trading are the tools to achieve this.

In a market with a high concentration of participants, the risk of the failure of a single entity becoming a systemic event is increased. The Comptroller of the Currency indentified just such a situation in the OCC's Quarterly Report on Bank Trading and Derivatives Activities (2009 Q1). It was shown that derivatives activity in the U.S. banking system is dominated by five large commercial banks which represent 96% of the total industry notional outstanding and 83% of the industry net current credit exposure. 90% of this derivatives activity was reported as being OTC in nature. ***IDCG's own shadow clearing service, which has currently processed close to USD 600 billion in notional, has confirmed the presence of this kind of imbalance in the USD interest rate swap market.*** Further evidence of this concerning situation can be seen in the Bank of International Settlements (BIS) Semiannual OTC derivatives statistics (2008 Q4). The Herfindahl Index, which measures market concentration, is at its highest level in published history for USD OTC interest rate derivatives. Perhaps more concerning is how the U.S. market has fallen behind other major markets, notably Europe, in this regard and now demonstrates a higher concentration than much smaller markets such as Sweden and

Japan where one would expect a natural bias towards a smaller number of participants. Only by allowing new and existing participants access to these markets in an open and competitive manner can this be addressed. All to all central clearing and exchange trading are the tools to achieve this.

We can see through Regulatory Filings that Banks are increasingly and heavily reliant on their trading desks for revenue as their traditional banking revenues still struggle to recover from the financial crisis. Specifically, as Stevenson Jacobs has recently reported for the Associated Press, the same five largest banks which dominate the OTC derivatives markets average potential loss from a single days trading exceeded $1 billion in the second quarter. This represents a 75% increase over the past 2 years. When you consider large banks are taking more risk in markets that are more intertwined and less liquid than they were 2 years ago it is easy to see why we say the OTC derivatives markets currently represent a greater risk to our underlying economy than they did before the financial crisis began. Again the only solution is to allow new and existing participants access to these markets in an open and competitive manner. All to all central clearing and exchange trading are the tools to achieve this.

Urgency aside, IDCG applauds the considered approach of all the regulatory bodies who contributed to the Proposed Legislation. The stated goals of; guarding against activities in OTC derivatives markets that would pose an excessive risk to the financial system, promoting the transparency and efficiency of OTC derivatives markets, preventing market abuses and the inappropriate marketing of OTC derivative to unsophisticated parties, are an appropriate response to the financial crisis that we have all faced over the past few years. We believe that these goals are achieved by the Proposed Legislation without substantive change but think that they can be made more effective in three areas:

1. The test that OTC Derivates is "standardized" for the purpose of clearing should be different to the test that an OTC derivatives is "standardized" for the purpose of trading on a regulated exchange or alternative swap execution facility,
2. The definition of Major Market Participants, and
3. The importance of the independence of clearinghouses.

What is "standardized"?

The presumption in the Proposed Legislation that an OTC derivative that is accepted for clearing by a regulated central clearing house is "standardized" is a very simple solution to a difficult problem. The risk in a more traditional definition was a raft of unintended consequences and a definition which failed to adapt to changes in the marketplace. The term "standardized" itself however, can lead to confusion, as it suggests that the customized aspects of the contract need to be stripped away, which is not the case. This has been particularly troubling to corporate America who sees tremendous value in these customized products. In a traditional futures clearinghouse this may have been the case due to technology constraints, but as clearinghouses adapt OTC risk management systems and approaches they will be more than capable of offering cleared solutions for the vast majority of these products. If there exists a strong valuation backbone and sufficient market liquidity to cure defaults then there is no good reason why these products cannot be cleared.

Some products however are not suitable for exchange trading, even if they can be cleared. There is little reason to force an infrequently traded customized product onto an exchange. Doing so will only result in wide prices and potentially erroneous price information, effectively the opposite of the price transparency and efficient execution that an exchange is designed to deliver. If the price of this customized product can be easily implied from a pool of deeply liquid instruments, which are suitable for exchange trading, then the benefits of price transparency and market efficiency are more easily reached through central clearing without the potential misinformation generated by forcing them to an exchange.

We noted with interest the change in language from the original Administration white paper, which suggested the encouragement of exchange trading, to the final proposal which mandates it for all "standardized" contracts. There is no doubt this decision was not taken lightly, and motivated by significant benefits that exchange trading can bring and the difficulty in effectively defining what is suitable in legislation. We would discourage the mandating of exchange trading for products simply because they are suitable for clearing; we see this as restricting the amount of clearing that is done. Instead we would recommend a presumption of the same style that has been used to define "standardized" clearing products. ***If an OTC derivative is accepted for trading by a regulated exchange, then it should be considered "standardized" for that purpose.*** In the same way as the original definition, this prevents forcing the exchanges and clearinghouses into something they do not have the capability for and remains flexible enough to adapt to changes in the marketplace.

Who are Major Market Participants?

We would urge caution in allowing exceptions for those who do not qualify for designation as Major Market Participants. Many of the problems of the current crisis were caused by the activities of institutions that slipped through the regulatory cracks, the obvious example being AIG. We worry that by introducing exceptions into the legislation these same cracks may be opened up. There is no way to identify who the next systemically devastating organization may be other than by throwing a wide and thorough regulatory net. Corporate America has been very vocal to ensure their beneficial use of OTC derivatives is not impacted by regulatory reform. However, as detailed earlier in this testimony there is no reason why central clearing should curtail their use of these products. Nor do we see why Corporate America should be immune from being part of the solution to the crisis we find ourselves in.

One of the most frustrating aspects of the current financial crisis is that all the American people are paying the price for it, not just those who instigated the problem. While it is the task of Legislators and Regulators to limit the impact of failure of a systemically significant institution in the future, it should also be the obligation of our captains of commerce to ensure that their institutions are not exposed unduly to the same failure. To simply assume that the government of the day will continue to support their counterparts in the financial system is not good enough. Central clearing is the tool that allows them to mitigate this exposure and contribute to a stronger financial system.

We would encourage the adoption of CFTC Chairman Gensler's suggested enhancements to the Proposed Legislation which he outlined in a letter to the Chairman and Ranking Member of the U.S. Senate Agriculture Committee on August 17, 2009. In particular the categories dealing with removing the suggested exclusion of foreign exchange swaps and the removing of exceptions to the mandatory clearing and trading requirements. This last section especially demonstrates the CFTC's in depth understanding of the mechanics of the industry and how they impact the objectives of policy. As an aside, the major market participants that IDCG speaks to all identify a Futures Commission Merchant (FCM) cleared solution under the auspices of the CFTC as the most robust clearing model available and one that is easiest, cheapest, and fastest for them to adopt. This is something that the CFTC and its officers should take great pride in.

Why is independence important?

The final point we would make is regarding the independence governance of clearinghouses and exchanges. Given the important role that clearinghouses have to play in facilitating the migration of the OTC derivatives market into a centrally cleared and exchange traded environment and their role in determining what is "standardized" I would encourage their substantial independence from any single participant or group of like participants. This will be essential to the development, perceived or otherwise, of open and competitive platforms. Clearinghouses must navigate a fine line when establishing an appropriate price for risk. Charge too much and become uncompetitive, charge too little and fail at their mandate. When a market participant with a significant governance position has a clear interest for that balance to be tipped in their favor, regardless of how appropriate the price for risk is, confidence will be eroded and the value provided by central clearing will be lost.

In conclusion, we have highlighted the urgent need for change in our regulatory system to correct the imbalances in the current marketplace and prevent a repeat of the financial crisis that we find ourselves in today. IDCG supports the form of the Proposed Legislation that is before you and offers three suggestions where the effectiveness of this proposal may be enhanced; standardization, exceptions, and independence. Thank you, Mr. Chairman, on behalf of IDCG and myself for the opportunity to appear here today. IDCG looks forward to continue working with all branches and agencies of government to help develop the strongest and most competitive market place possible. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much.
Mr. Damgard.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. DAMGARD. Thank you very much, Mr. Chairman, for inviting me to testify.

Mr. Chairman and Ranking Member Lucas, Members of the Committee, I am John Damgard, President of the Futures Industry Association, and I am pleased to be here today to discuss the Treasury's proposals.

As our name implies, FIA's primary focus is futures trading. In last year's credit crisis, futures markets performed superbly; and I might add, this Committee can take a lot of credit for that. All positions were cleared; all customers were paid; no one had any cause for concern. FIA, therefore, believes it would be a mistake to use last year's crisis to increase regulation on futures markets. What has proven not to be broken under tremendous stress simply doesn't need fixing.

At the same time, last year's crisis did reveal gaps in the swaps regulation, and FIA strongly supports Treasury's efforts to close those gaps. While it is hard in 5 minutes to capture our views on over 100 pages of amendments to the Commodity Exchange Act, I would like to single out four areas for our comments.

First, jurisdiction: FIA believes that the Treasury has proposed a workable jurisdictional division in the general outline of swaps regulation. The SEC should focus on security-based swaps, including those involving a single company or a small basket of companies. All other swaps should be regulated by the CFTC, including swaps on agricultural and energy products, interest rates and broad-based security products.

Second, clearing: FIA is a strong proponent of the futures clearing system, as you might expect. Our member firms provide the capital that underwrites most of the credit risk in most futures transactions. Yet we do not recommend mandatory clearing for all so-called standardized swaps.

Any legal definition of *standardization* will be inherently fuzzy. Mandates based on fuzzy definitions lead to legal uncertainty, and that uncertainty would lead many to shift their swap transactions to other countries.

That migration could harm price discovery and the futures business in the United States. Worse yet, some businesses might simply not hedge their price risk. That could harm our economy in ways no one really wants to contemplate.

Third, position limits: FIA supports the Treasury bill's provision giving the CFTC standby position limited authority for certain OTC swaps. We believe this authority, if used wisely, could actually diffuse much of the misguided controversy surrounding speculation.

Swap dealers and index funds: In FIA's view, speculation doesn't cause artificial prices, manipulation does. The CFTC has ample anti-manipulation tools in its arsenal already.

And fourth, foreign boards of trade: My members compete every day in a global marketplace. Effective global regulation requires consultation and negotiation.

Treasury's bill takes a different stance. It imposes U.S. regulation on foreign exchanges. FIA believes that approach will boomerang. It will harm U.S. firms and exchanges without increasing market surveillance or transparency in any way.

FIA would prefer to see mandated negotiation by the CFTC and its foreign counterparts with linked contracts that are traded in different countries. Representative Moran's proposal along these lines deserves considerable merit.

FIA looks forward to working with the Committee to perfect the Treasury's legislative proposals in these and other areas of concerns. I am happy to answer questions and once again thank you for inviting me to be here.

[The prepared statement of Mr. Damgard follows:]

PREPARED STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Chairman Peterson, Ranking Member Lucas and Members of the Committee, I am John Damgard, President of the Futures Industry Association. Thank you for inviting FIA to testify on the legislation recently issued by the Treasury Department and entitled "Improvements to Regulation of Over-the-Counter Derivatives Markets."

FIA is the trade association for the futures industry.[1] Our traditional focus has been on exchange markets because our regular members comprise the major clearing firms that underwrite counterparty credit risk for the futures clearing system. In other words, our member firms provide the capital that is the lifeblood of the futures clearing system.

Some of our regular members are affiliated with swap dealers and SEC-regulated broker-dealers. Some of our regular members are not. Given the diversity of the membership we serve, FIA offers a broad perspective on the statutory changes embodied in the Treasury bill. In this testimony we will summarize our major reactions to the legislation, reserving the right to supplement the record after we have heard the views of the relevant regulators at next week's hearing.

Overview

The regulated U.S. futures markets performed admirably during last year's financial and credit crisis. This record is a credit to this Committee, the Commodity Futures Trading Commission, the futures self-regulatory organizations and our member firms. This record of success also supports retaining much of the existing regulatory mechanisms for futures. Treasury's legislation, however, uses the existence of gaps in regulation of off-exchange swap transactions as a reason to revamp many aspects of on-exchange futures regulation. FIA believes that trying to fix what isn't broke could actually weaken regulation in the U.S. We would urge this Committee to prune back the Treasury's bill in many of those areas. The one exception would be the proposal to enhance the public process for CFTC review of certain rules of self-regulatory bodies, which FIA supports.

Treasury's bill also focuses on areas of perceived regulatory gaps or weakness for swaps. FIA supports closing genuine regulatory gaps. As we read the bill, all derivatives will be subject to meaningful Federal regulation, whether traded on regulated exchanges and cleared through a clearing system, or not. In general outline, futures, options and standardized swaps will be regulated alike, while non-standardized swaps will be subject, for the first time, to a major regulatory scheme that will include transparency, registration and sales practices. FIA fully supports these different regulatory models in concept as well as the jurisdictional lines of responsibility the bill would assign.

As this Committee knows, futures regulation focuses primarily on promoting price discovery, preventing price manipulation, protecting customers and preserving financial integrity. Each of these goals would be undermined if, in attempting to fix regulatory gaps, Congress created inadvertent incentives for legitimate trading activity in any, or many, commodities, whether on exchange or OTC, to move overseas.

[1] FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of 30 of the largest futures commission merchants in the United States. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members serve as brokers for more than eighty percent of all customer transactions executed on United States contract markets.

Commodity and financial markets today are global, and much of the price discovery that today occurs in the U.S. could easily shift to foreign markets. To avoid that result, this Committee and Congress as a whole must establish a sensible balance in regulatory policy. We will identify for the Committee the major areas where we are concerned the Treasury's bill fails to meet that standard and threatens commodity and financial price discovery in the U.S.

One area the Treasury bill does not address is harmonization of securities and futures regulation. The CFTC and the SEC have held meaningful hearings to begin the process of reviewing the many complicated issues harmonization would entail. As this Committee stated 35 years ago, futures and securities regulation are "often erroneously viewed as twins." The Commissions' hearings confirmed that in many fundamental areas that statement is as true today as it was in 1974. Still each Commission can learn some regulatory lessons from the other in order to strengthen regulation, enhance competition and provide cost-efficiencies in both futures and securities markets. We are looking forward to working with the SEC and the CFTC as they move forward on the harmonization mission they have been assigned by President Obama.

Jurisdiction and Regulatory Duplication

Jurisdictional divisions are never perfect. Over time, however, even less than perfect jurisdictional divisions will work effectively if premised on generally sound principles. The Treasury bill's jurisdictional boundaries for swaps are grounded in current law as embodied in the 1982 Shad-Johnson Accord, as amended in 2000, and should be workable. Trading in securities-based swaps where company-specific disclosures and insider trading might be implicated should be of regulatory concern to the SEC. All other swaps should be regulated by the CFTC. It has the experience and expertise in regulating trading in macro-economic derivatives markets from agricultural products and energy sources to governmental debt and broad-based security indices.

Jurisdictional divisions of any kind may become problematic if combined with regulatory duplication and the threat of inconsistent regulatory standards. The Treasury's bill addresses this concern by requiring that the regulatory standards for entities subject to regulation for their swap transactions—whether security-based or not—should be adopted jointly by the SEC and CFTC. We agree. FIA also would recommend strongly that the uniformity of regulatory standards should not stop at the agency level, but should apply to the self-regulatory organizations that operate subject to each Commission's oversight. Otherwise the SROs could undermine the very uniformity of regulatory standards the Treasury sought to achieve for swap transactions.

Under current law, FIA members and many others, have worked with the Commissions to try to adopt a market neutral standard for portfolio margining that would provide risk-based efficiencies with customer protection. Over the years, the difficulties in achieving a joint SEC–CFTC portfolio margining system have been, at least in some respects, exacerbated by differences caused by established historical practice and entrenched legal standards. The Treasury's proposal tries to avoid that kind of difficulty by calling for joint regulatory action in implementing the new swap regulations. As the history of portfolio margining shows, it is easier to build that kind of common ground in a new regulatory system than an old one. FIA commends the Treasury for this important aspect of its proposal.

Legal Uncertainty and the Standardization Mandate

No regulatory system will be considered to be effective if there is no business activity to regulate. That may be the true definition of regulatory overkill.

Treasury's bill threatens to run afoul of this basic principle through its mandate that standardized swaps must be traded on regulated platforms (exchanges or alternative swap execution facilities) and submitted to regulated clearing organizations.

Aided by modest statutory guidance, the bill assigns to the SEC and CFTC the task to come up with definitive swap standardization rules that would govern all swap market participants. The bill also allows the SEC and CFTC, in sum, to prosecute any one who violates the spirit of this mandate, if not its letter.

There is no easily applicable standardization definition. No matter what words are used, the concept of standardization will be either fuzzy or elastic, depending on your perspective. The bill's exchange trading and clearing mandate will therefore subject swap market participants to substantial legal risk from a government prosecutor or a reneging counterparty claiming that an OTC swap was standardized and should have been traded on an exchange and submitted to a clearing system. This kind of legal risk is good for lawyers, not for market participants or regulators. Market participants will be able to avoid this legal uncertainty only by trading on U.S. exchanges or outside the jurisdictional reach of the U.S.

Treasury's bill tries to address that problem in part by granting some market participants that are not swap dealers or major swap traders an exemption from the exchange-trading mandate. That carve-out is sound and should be retained. But CFTC Chairman Gensler proposes repealing the carve-out. His proposal should not be adopted.

Some might say, Chairman Gensler is right, we don't want most, if not all, swap transactions to be done in the U.S. unless they are on an exchange. Some might also see this as a windfall for the U.S. exchange business. FIA is concerned, however, that forcing market participants to chose from either on exchange trading in the U.S. or OTC swaps overseas will lead to most legitimate OTC swaps activity migrating overseas and that related hedging of risk through exchange trading will follow that migration. The result would mean less liquidity and more price volatility in the U.S. for both exchange and OTC markets, where price discovery and hedging also would suffer.

The standardization mandate should be replaced by incentives to trade on exchanges and through a clearing system. But the bill should recognize that non-standardized swaps serve a legitimate role by reducing the basis risk hedgers face in their businesses every day. Under the Treasury's bill those non-standardized swaps would still, for the first time, be subject to substantial CFTC or SEC regulation in terms of registration, transparency and sales practices. That meaningful form of regulation should more than adequately protect the public interest.

Market Surveillance and Position Limits

Section 723 of the Treasury Bill expands the reach of the Commission's position limit power to include "swaps that perform or effect a significant price discovery function with respect to regulated markets."[2] FIA supports granting the Commission this authority and notes that as written it would apply whether a swap was standardized or not. This gives the CFTC adequate flexibility to apply its powers to preserve the integrity of the price discovery process as appropriate.

Just as importantly, Section 723 affords the CFTC broad exemption powers to exempt conditionally or unconditionally any person or class of persons, or any swap or class of swap, from the position limits it might impose. Granting the CFTC this flexible authority is an important improvement over the provisions of H.R. 977 which restricted the CFTC's powers to exempt persons or transactions from position limits. The only curious aspect of this provision in the Treasury bill is that it extends to swaps and apparently not to futures or options traded on designated contract markets. FIA can think of no reason for this disparity and urges the Committee to make certain that the exemption power in the bill treats futures, options and swaps alike.

The CFTC's expanded position limit authority to cover some swaps should reduce the controversy over the current exemptions from position limits for swap dealers, a controversy FIA believes is not based on a full understanding of the facts in any event.

First, swap dealers currently are not exempt for their speculative futures positions. Dealers are only currently exempt for futures positions they establish, like other hedgers, to reduce their price risks. Sometimes that price risk results from the net swaps positions dealers have established with OTC counterparties in various commodities. In other instances, some dealers incur price risks from existing or anticipated holdings of physical commodities or through complex hedge transactions for energy sources or materials that may be correlated with commodity prices, but are not traditionally understood to be commodities. In any event, dealers that have received those hedge exemptions still operate under specific position limits that are included as conditions for their exemptions.

Second, by equating in some instances, OTC swaps and on exchange futures for position limit purposes, the Treasury bill would reduce the need for the dealer exemption at all. For example, dealers that are net long a crude oil swap and then offset that long risk with a short futures position will not need to worry about position limits if the swap and futures are considered to be part of the same position limit basket; the dealer should not have any price exposure following the offset and no net long or short position. Thus, the legislation may remove the need for the dealer hedge exemption and certainly should remove any controversy about it.

As we have testified before, FIA continues to believe that speculation is essential to allow futures markets to serve their price discovery and hedging function. FIA

[2] FIA assumes the term "regulated markets" means designated contract markets or alternative swaps execution facilities as provided for in the bill.

also does not understand position limits to have ever been a cure for higher prices or lower prices. Instead, position limits have always played an important role to prevent congestion or squeezes in physically-delivered contracts during the delivery period. FIA would expect the Commission to use its new stand-by position limit authority consistent with this unassailable role for position limits. Moreover, as under current law, unless the Commission finds that the absence of position limits would lead to "sudden or unreasonable fluctuations or unwarranted changes in the price of [a commodity]," FIA believes the Commission should refrain from imposing position limits under its new authority in Section 723 of the Treasury bill.

Foreign Boards of Trade

Section 725 has two problematic provisions for foreign boards of trade.

First, if a foreign exchange provides U.S. persons direct access to its trading system, regardless of the nature of the contracts the exchange offers, the CFTC may require the foreign board of trade to register with the CFTC and comply with regulatory criteria the CFTC could impose at its discretion. For example, let's say an exchange in Brazil wants to allow U.S. persons direct computer access to trade futures on Brazilian government debt, the exchange would have to register first with the CFTC and comply with its registration criteria. While this provision is permissive in nature, and the CFTC hopefully would never use it, even the threat of a new FBOT registration could have ramifications for foreign exchanges and U.S. firms. Rather than running the risk of triggering the CFTC registration requirement, a foreign exchange could simply and rationally say "no intermediary in the U.S. or market participant in the U.S. may have direct access to our exchange." Foreign competitors and even affiliates of U.S. firms and market participants could access the exchange's markets directly, but not their counterparts in the U.S. That result would seriously hamper business interests in the U.S. and could even lead to exporting price discovery in certain commodities to overseas exchanges. It is unclear why such a Draconian requirement is thought to be necessary. It is also unclear what the ramifications would be, other than substantially higher costs, if foreign governments retaliated and required U.S. exchanges to register in every country where those exchanges provide now or in the future direct access to its citizens.

Second, Section 725 prohibits a board of trade located outside the U.S. from providing direct access to persons in the U.S. for contracts that settle against the price of futures contracts listed for trading in the U.S. unless the foreign exchange adopts U.S. mandated position limits as well as other substantial and invasive U.S. regulatory requirements. The Treasury bill does not have any provision for when a U.S. exchange seeks to compete with a foreign exchange by listing on the U.S. exchange contracts that settle against the foreign exchange's futures prices. Yet competition among exchanges is a two way street. There are instances, like the NYMEX Brent Oil contracts, where the primary contract is a foreign exchange traded contract (with no position limits) and the U.S. exchange is trying to challenge that exchange dominance. If foreign authorities adopted the Treasury's "our way or the highway" regulatory approach where the foreign markets are dominant, it could work to harm U.S. exchanges and their competitive interests.

The Treasury bill's failure to address this reciprocity ignores market realities and could spark trade war style retaliation or worse. The legislation proposed by Representative Moran in this area last year, H.R. 6921, offered a more balanced approach. Under the Moran approach, when a U.S. or foreign exchange link the pricing of a new contract to a contract traded on an exchange located in another country, the two country's regulators would need to consult with each other to negotiate common methods for addressing market surveillance and other regulatory needs of the linked markets. FIA believes the Moran proposal would be less likely to lead to regulatory gaps and more likely to lead to cooperative, effective solutions adopted by the CFTC and its foreign regulatory counterparts.

No one wants to see trading on foreign exchanges become regulatory escape havens. Everyone understands that the best regulatory solution for a global trading market would be uniform international regulatory standards fostered by international communication and mutual recognition. Treasury's bill takes just the opposite approach. This Committee should review Representative Moran's proposal and use it as a substitute for the Treasury's unfortunate attempt to mandate U.S. regulatory standards for the world.

Conclusion

Treasury's bill has many facets and would amend the Commodity Exchange Act in many different ways. In this testimony, we have touched on our major areas of current interest and concern. We look forward to answering any questions the Committee may have and to working with the Committee as it fashions legislation to close regulatory gaps and enhance regulatory safeguards where warranted.

The CHAIRMAN. Thank you.

I think we have time to squeeze you in, Mr. Duffy. We haven't gotten to the 5 minute vote yet, so we appreciate you being with us.

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

Mr. DUFFY. Thank you, sir. I am Terry Duffy, the Executive Chairman of the CME Group, and I want to thank you, Chairman Peterson, and Ranking Member Lucas for inviting us to testify today.

You asked us to discuss the Treasury's proposal, Title VII, Improvements to Regulation of Over-the-Counter Derivatives Markets. Of course, we were pleased that the proposed legislation preserves and extends to the OTC world the terms of the Shad-Johnson Accord. We also agree with the Administration's stated goals which are, one, to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency in price discovery and to prevent fraud and market manipulation.

While these goals are commendable, certain well-intended provisions of Title VII could have severe, adverse, unintended consequences for U.S. futures exchanges and clearinghouses. In the limited time available, I can briefly discuss only two of the many important issues raised by Title VII.

First, constraints on current business models: Under the proposed legislation, the CFTC would gain new prescriptive authority over margins, position limits, new rules and contracts. This conflicts with the Treasury's recommendation last year for the SEC to move towards the CFTC's principle-based regime. It also overlooks repeated testimony at the joint harmonization hearings by market participants and industry experts that a principles-based regime presents the appropriate framework for regulating futures exchanges.

We have said it before, but it bears repeating. Derivatives transactions conducted on a CFTC-regulated futures exchange and cleared by a CFTC-regulated clearinghouse did not—I repeat, did not—contribute to the current financial crisis.

CFMA, or Commodity Futures Modernization Act, has allowed U.S. futures exchanges to innovate, grow and compete effectively on a global playing field. U.S. futures exchanges are more efficient, more economical and safer and sounder under CFMA than at any time in their history.

Second, open access clearing for OTC *versus* mandated interoperability: Title VII prescribes that all swaps with the same terms and conditions are fungible and may be offset with each other. We understood that the purpose of this language was to ensure that clearinghouses for OTC derivatives would provide open access to all trading platforms and to privately negotiated OTC transactions. However, certain segments of the industry are lobbying to reinterpret the clause to force all clearing into a single clearinghouse or to force interoperability among clearinghouses.

The ostensible goals of mandating interoperability are to reduce costs, encourage innovation and foster competition. Interestingly, the same demand for interoperability among futures clearinghouses was eventually rejected by the industry, the CFTC and the Congress just a few years ago. That is because a fair examination of the proposal revealed that forced interoperability created risk that was not cost effective.

We do not want one clearinghouse having to assume another clearinghouse's credit risk. This would stop innovation and put the entire system at risk.

In contrast, all the benefits attributed to interoperability can be achieved privately at no cost and without creating individual or systemic risks for any participant in the system. CME Group proposed the following four principles to guide regulatory reform regulation respecting the CFTC, SEC and OTC derivatives.

Recommendation one: The CFTC and SEC should jointly adopt regulations in accordance with Title VII of the Administration's proposal, but a single agency should function as the primary regulator to administer those rules and regulations. Where an exchange clearinghouse or financial services enterprise is engaged in both commodities and securities businesses, its primary regulator should be based on a predominance test.

Recommendation two: The CFTC and SEC should avoid jurisdictional conflict respecting novel contracts and products that include both commodity and security futures by institutionalizing last year's Memorandum of Understanding for novel derivative products.

Recommendation three: The principles-based regulatory regime adopted by CFMA should provide the model for the joint regulations adopted by the CFTC and the SEC.

And finally, Recommendation four: The existing customer segregation regime for customers of a CFTC derivatives clearing organization should be preserved for all customers of that clearinghouse. The SEC's SIPA, Securities Investors Protection Act, regime should continue to apply to securities account holders. Legislation should be adopted to rationalize the treatment of the separate classes of customers in the event of a bankruptcy of a combined broker-dealer FCM.

My written testimony explains these recommendations in greater detail. And I thank you, Mr. Chairman and Ranking Member Lucas, for your attention today.

[The prepared statement of Mr. Duffy follows:]

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

I am Terrence A. Duffy, executive Chairman of CME Group Inc. Thank you Chairman Peterson and Ranking Member Lucas for inviting us to testify today. You asked us to discuss the Treasury's proposed **TITLE VII—IMPROVEMENTS TO REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS,** which I am sure we all recognize is far broader than its title implies. We will also discuss the ongoing efforts of the Securities Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC" or "Commission") to harmonize their regulatory regimes, as was suggested by the Treasury White Paper.

CME Group is the world's largest and most diverse derivatives marketplace. We are the parent of four separate regulated exchanges, including Chicago Mercantile Exchange Inc. ("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"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

CME Clearing, a division of CME, is one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter derivatives contracts through CME ClearPort®. Using the CME ClearPort® service, eligible participants can execute an OTC swap transaction, which is transformed into a futures or options contract that is subject to the full range of Commission and exchange-based regulation and reporting. The CME ClearPort® service mitigates counterparty credit risks, provides transparency to OTC transactions and enables the use of the exchange's market surveillance monitoring tools.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated CME ClearPort transactions.

I. Introduction

A. Title VII: The Department of the Treasury released the Administration's legislative language as "TITLE VII—IMPROVEMENTS TO REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS" (the "proposed legislation" or "Title VII"). The heading is not fully descriptive of the proposed legislation. Of particular interest to this Committee, Title VII: (i) proposes a major restructuring of the classes of regulated and exempt futures exchanges; (ii) grants the CFTC authority over new contracts and rules; (iii) eliminates exemptions and exclusions for certain OTC contracts; (iv) weakens the principles-based regulatory regime created by Commodity Futures Modernization Act ("CFMA"); grants the CFTC authority over foreign boards of trade; and (v) more comprehensively and proscriptively, regulates the operation of clearing houses by means of an expanded list of core principles.

The proposed legislation preserves the allocation of jurisdiction between the CFTC and SEC set forth in the Shad-Johnson Accord, and extends that allocation to credit default swaps ("CDS") and other OTC contracts. This is accomplished by dividing the OTC world into swaps, which include swaps on broad-based security indexes and exempt securities, which are regulated by the CFTC, and security-based swaps, which include swaps on securities and narrow-based indexes and are regulated by the SEC.

The Administration's stated goals are to reduce systemic risk through central clearing and exchange trading of derivatives; to increase data transparency and price discovery; and to prevent fraud and market manipulation. We support these overarching goals. We are concerned, however, that certain well-intentioned provisions of Title VII could have severe, adverse, unintended consequences on U.S. futures exchanges and clearing houses, including the following:

- **Constraints on Current Business Models.** Under the proposed legislation, the Commission gains new, direct authority over margins, position limits, new rules and contracts. Enhanced authority over approval of new contracts unnecessarily decreases exchanges' ability to be competitive in the global marketplace. Additionally, taking control of margin setting away from clearing houses and exchanges and placing it in the hands of legislators prevents those in the best position to make decisions about risk management from doing so and will potentially drive business to more favorable regimes. Similar concerns arise out of the Commission's new authority respecting position limits. Further constraining existing business models is the proposed legislation's move away from the CFMA's principles-based regulation towards prescriptive regulation.
- **Shifting Business Overseas.** The efforts to drive OTC transactions onto electronic trading platforms and into regulated clearing houses may dampen OTC business in the U.S. in a manner that will deny U.S. exchanges and clearing houses the opportunity to serve that market. If the proposed legislation's constraints—including the scope of mandated trading and clearing and increased capital requirements—are unacceptable to the major OTC dealers and hedge funds, they may choose to shift their OTC business operations overseas, substantially reducing the size of the U.S. OTC market and jeopardizing U.S. futures markets that are complemented by OTC markets.
- **Engender Retaliatory Action from Overseas Regulators.** The provisions to close the "London Loophole" require foreign boards of trade ("FBOTs") to register with the CFTC if there is direct access from the U.S. to the electronic trad-

ing system of such FBOTs. The definition of "direct access" is broad enough to permit the CFTC to capture every FBOT that can be accessed from the U.S. The proposed legislation does not include a carve-out from the registration requirements for exchanges registered and regulated in high quality regulatory venues. While the CFTC has discretion to exempt FBOTs from registration if certain conditions are met, this extension of U.S. jurisdiction could incite retaliatory actions requiring U.S. futures exchanges to register and be regulated in numerous jurisdictions.

B. Additional Harmonization Issues: Integral to the Administration's efforts to reform regulation of the financial sector is its mandate to the CFTC and SEC to submit to it by September 30 a document detailing the differences in agencies' regulatory regimes and including an explanation as to why these differences could not be "harmonized," should that be the agencies' determination. As part of this "harmonization" effort, the CFTC and SEC held joint hearings on September 2 and 3 (the "harmonization hearings") to discuss the myriad of issues presented by the harmonization process. During the harmonization hearings, CFTC Chairman Gensler stated that three issues should be addressed during the process of harmonization: (1) eliminating gaps in the current regulatory system to reduce risk, protect market integrity and promote market transparency by adopting comprehensive regulatory reform for OTC derivatives; (2) limiting overlapping regulation by the SEC and CFTC to only where it is beneficial, and eliminating opportunities for arbitrage or regulatory uncertainty; and (3) eliminating cases in which the SEC and CFTC regulate similar products, practices or markets in a different manner when those differences could stifle competition, increase costs or limit investor protection. SEC Chairman Schapiro was less specific as to the goal of the harmonization process, stating that the agencies needed harmonized regulation for similar financial products, unless it could be explained why differences between the two agencies' regulations were necessary.

During the course of the harmonization hearings, Chairman Gensler also listed 12 areas that he believes the two agencies should examine in their efforts to meet the harmonization goal, and then mentioned two more at the end of the meetings. These areas include: the process for approving new products; the process for approving new exchange and clearinghouse rules; the methods for setting margin in customer accounts (portfolio margining); market structure (fungibility and competition among exchanges); differences in manipulation standards; insider trading rules; customer suitability standards; the application of fiduciary standards to intermediaries; international mutual recognition; a review of the CFTC's principles-based approach to regulation *versus* the SEC's rules-based approach; differences in the two agencies' approaches to regulating investment funds; and differences in the various definitions of sophisticated investors embedded in SEC and CFTC regulations.

In addition to the harmonization hearings, the SEC and CFTC are meeting at the Commissioner and staff levels to further the harmonization process. We believe that a number of issues have surfaced to date in the harmonization process that pose potential risks to the U.S. futures industry.

As we testified during the harmonization hearings, in our view, "harmonization" should be defined by its goal, and that goal should be to assure that the regulatory regimes for derivatives, securities and security options avoid costly duplication, work together to produce a net welfare gain through efficiently operating markets and clearing houses and eliminate regulatory gaps. One concern we have, which was shared by almost every one of the thirty witnesses who testified at the harmonization hearings, is that the real goal of "harmonization" will be lost and we will be driven toward a merger of the existing regulatory structures into a single set of one-size-fits-all rules administered by separate agencies or a super agency, a result that would undermine the integrity of both the securities and the futures markets and add nothing in the way of reducing systemic risk.

We are also concerned that the harmonization process will invite each agency to attempt to expand its jurisdiction without warrant, although the public message is that the agencies will work together in a manner that serves the best interest of public customers, financial service industry intermediaries and other professionals and the market as a whole.

II. Fundamental Distinctions Between Securities and Futures Markets

Among other critical distinctions, futures markets and securities markets serve different purposes and different classes of customers.

Futures markets provide price discovery and an efficient means to hedge or shift economic risk for sophisticated market participants. Information is disclosed to the market through the trading of market participants and not through a disclosure regime.

In contrast, securities markets support capital formation by providing a secondary market for trading plain vanilla securities. Because the most relevant information is company specific, regulation focuses on creating a level playing field where insiders are precluded from taking unfair advantage of uninformed investors.

Treatment of customer funds is another critical difference between futures and securities markets. The CFTC's customer segregation rules and the consequent portability of customer positions in the event of an intermediary's bankruptcy are essential for the class of customers and type of contracts traded on futures exchanges. SIPA would not provide protection for derivatives participants because of payment limits and because it does not focus on portability or customer positions in the event of an intermediary's failure.

The competitive environments in which futures and securities markets operate are distinct. Derivative markets face global competition. Inappropriate levels of regulation in the U.S. invites major market participants to migrate business to their off shore offices and off shore markets. On the contrary, competition among securities markets is local. Securities markets are inherently domestic. The only issue posed by overregulation of securities markets is whether the regulator creates a distorted playing field among its regulated entities; there is no threat that our securities markets will shift to jurisdictions with more rational regulatory regimes.

These important distinctions between securities and futures markets are directly pertinent to the question of whether law or regulation ought to be directed at bringing the two regulatory regimes closer together, and are discussed in more detail in the testimony of CME Group's CEO Craig Donohue, submitted in conjunction with the harmonization hearings.

III. Title VII—Impact on Designated Contract Markets and Clearing Organizations

Although Title VII proposes changes that impact all aspects of and participants in the derivatives market, our testimony focuses on the provisions of Title VII that most directly impact designated contract markets ("DCMs") and derivatives clearing organizations ("DCOs"). Title VII grants extraordinary levels of discretionary authority to the CFTC and mandates that the CFTC and SEC jointly develop the regulatory regime applicable to trading and clearing OTC derivatives. This wholesale transfer of law making authority to the agencies makes it impossible to assess the consequences to the industry if Title VII were enacted.

A. Clearing of Swaps (Section 713; Section 3B)

Title VII divides OTC swaps into two categories—swaps and security-based swaps. It allocates jurisdiction of swaps to the CFTC and security-based swaps to the SEC. Although appealing on paper, we agree with the Futures Industry Association ("FIA") that the proposed legislation will require some revisions to avoid being unworkable. Specifically, Title VII calls for dual registration with both the SEC and CFTC by clearing houses, trading platforms, swap dealers, major swap participants, alternative swap execution facilities ("ASEF") and mixed swaps and permits each agency to fully and simultaneously regulate. Imposing duplicative and costly regulatory regimes on market participants without purpose, such as this, completely contradicts the purpose and intent of harmonization and is contrary to every reasonable principle of efficient regulation. Moreover, if this dual-regulatory structure remains in the final piece of legislation, we believe that it will perpetuate the continuing jurisdictional conflicts between the SEC and CFTC.

As we have previously testified, we are proponents of eliminating jurisdictional wrangling over the undistributed middle between the Securities Acts and the Commodity Exchange Act ("CEA"). Rather than imposing unduly and unnecessary burdens on the markets, however, we believe that the correct approach to resolving this issue is to grant primacy to the regulator that has primary regulatory authority over other aspects of the regulated entity's operations. The CFTC has effectively used its exemptive power to achieve such a result. Had the SEC granted a similar accommodation in respect of CME's efforts to create an effective clearing solution for credit default swaps it would have facilitated the process of bringing our offering to market. The arguments usually advanced against this option—that there will be a race to the lowest regulatory standard—should not be a concern where both regulators are agencies of the same government and are enforcing identical, effective regulatory regimes, as the CFTC and SEC would be under Title VII.

We believe that only minor revisions are necessary to correct the unworkable situation presented by the dual-regulatory regime embedded in Title VII. Indeed, the language of Title VII suggests that Treasury identified an effective means to accomplish the goals of harmonization, while permitting clearing houses to operate without costly, duplicative two-headed regulation. Specifically, Title VII requires the

SEC and the CFTC to "jointly adopt uniform rules governing persons that are registered as derivatives clearing organizations for swaps under this subsection and persons that are registered as clearing agencies for security-based swaps under the Securities Exchange Act of 1934 (15 U.S.C. 78a, *et seq.*)."[1] Title VII also creates a uniform set of core principles under which both forms of clearing house must operate. With this framework, regulatory arbitrage and regulatory gaps are completely eliminated, and both CFTC-regulated and SEC-regulated clearing houses are permitted to clear both swaps (province of the CFTC) and security-based swaps (province of the SEC). Thus, legislators need only add a provision to Title VII that permits the regulator with the most existing contacts with the regulated entity to have primary regulatory jurisdiction over the regulated entity. Such a change will, among other things, reduce legal uncertainty, minimize regulatory inefficiencies and speed bringing new products to the markets.

Finally, whether a drafting error or intentional, the CFTC is made the junior partner in this two-headed regulatory scheme. Specifically, Title VII authorizes the CFTC to defer to the SEC and exempt an SEC-registered clearing agency from registration with the CFTC. However, no comparable exemption authority is given to the SEC in Title VII. This uneven construct undoubtedly will steer clearing houses to "choose" the SEC as their regulator and seek an exemption from the CFTC, to avoid being dually regulated. Our preferred solution is to allocate responsibility to the primary regulator of the enterprise, as discussed above.

B. Position Limits (Section 723)

The CEA currently grants the CFTC sufficient authority to set limits for DCMs. Section 4a(a) of the CEA directs the Commission to fix position limits for a commodity traded on a DCM if it first finds that such action is "necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity." However, the Commission's direct use of the authority conferred in Section 4a(a) is neither required nor justified if the relevant designated contract market has acted effectively to avoid "excessive speculation." Indeed, as the Commission has previously noted, the exchanges have the expertise and are in the best position to set position limits for their contracts. In fact, this determination led the Commission to delegate to the exchanges authority to set position limits in non-enumerated commodities, in the first instances, almost 30 years ago.

Since that time, the regulatory structure for speculative position limits has been administered under a two-pronged framework with enforcement of speculative position limits being shared by both the Commission and the DCMs. Under the first prong, the Commission establishes and enforces speculative position limits for futures contracts on a limited group of agricultural commodities. Under the second prong, for all other commodities, individual DCMs, in fulfillment of their obligations under the CEA's core principles, establish and enforce their own speculative position limits or position accountability provisions (including exemption and aggregation rules), subject to Commission oversight.

Title VII permits DCMs and ASEF to continue to set position limits or position accountability levels, where appropriate. The core principles differentiate between the lead month and back months. (Section 719.) However, no guidance is provided as to how such limits or accountability levels should be calculated. (Section 723(a)(1).) We believe that each DCM and ASEF should be required to set its own position limits based on and in proportion to its liquidity, volume, open interest and other factors respecting trading for which it is directly responsible.

The proposed legislation also grants the CFTC authority to impose aggregate limits on contracts listed by boards of trade and on swaps that perform a significant price discovery function with respect to regulated markets; however, it does not provide clear guidance as to how aggregate limits will be calculated. (Section 723(a)(2).)

We support the provisions of Title VII that expand the CFTC's authority to impose and enforce position limits on positions taken in excluded commodities and other OTC transactions. We also agree with the elimination of the protected ECM category.

We urge, however, that the CFTC's power to set position limits be subject to explicit guidance comparable to the existing regime in that it should only act if the relevant regulated market has failed to act and only act for the purpose of avoiding "sudden or unreasonable fluctuations or unwarranted changes in the price of such

[1] Notably absent from Title VII, however, is any explanation as to how regulatory principles that should/would be applicable to security-based swaps will work with respect to swaps that are not security-based, making it difficult to understand how a harmonization of rules for these two regimes will succeed. (Section 713(h), Subtitle A.)

commodity." It is critical that position limits do not become a political issue that are imposed in the hope of controlling the underlying prices in the cash market. First, it will not work. Second, it will have a devastating impact on the U.S. futures industry and participants that rely on these markets to manage risk.

The United States has been the center of global futures trading because of its first mover advantage and its rational regulatory regime which has provided efficient and fair markets while encouraging innovation. If speculative traders and accumulators like swap dealers and index funds are restricted from trading global commodities such as oil and metals on U.S. exchanges and on the U.S. OTC market, their alternative is clear. They will turn to their foreign affiliates and the market will move offshore. For example, although Natural Gas delivered at Henry Hub is a natural U.S. product and it is not likely that that specific contract will move offshore, natural gas is a global product and it is certain that a new global benchmark contract will emerge on a foreign exchange if trading on U.S. markets is constricted by inappropriate limits. The likely chain of effects is predictable and unacceptable; liquidity of U.S. markets will be impaired, causing damage to the domestic natural gas industry and its customers.

Even if Congress or the Commission could find a legitimate basis to restrict or impede U.S. firms from participating in offshore markets, the only consequence will be to disadvantage U.S. firms and U.S. markets. World prices would be set without U.S. participation. Thus, precisely calibrated and properly administered position limits on energy contracts, along with a carefully managed exemption process, are critically important to the preservation of properly functioning markets.

C. Treatment of Foreign Boards of Trade (Section 725)

Title VII imposes a number of registration and compliance requirements on an FBOT that grants U.S. users "direct access"[2] to its systems for trading. Section 725(b)(1) provides, "The Commission may adopt rules and regulations requiring registration with the Commission for a foreign board of trade that provides the members of the foreign board of trade or other participants located in the United States direct access to the electronic trading and order matching system of the foreign board of trade, including rules and regulations prescribing procedures and requirements applicable to the registration of such foreign boards of trade." The proposed legislation, however, fails to define any criteria for determining whether or not to require registration. If the CFTC does require such registration, FBOTs must meet all requirements of the CEA.

Even if registration is not required, Section 725(b)(2) makes it unlawful for an FBOT to provide a member or other participant located in the U.S. with direct access to its trading and order-matching system with respect to an agreement, contract or transaction that settles against any price (including the daily or final settlement price) of one or more contracts listed for trading on a registered entity unless the FBOT complies with, among other things, information reporting requirements and positions limits requirements, which mirror those imposed on U.S. contract markets. There is substantial risk that if enacted as currently drafted, foreign countries in which U.S. DCMs and DCOs that have customers and physical facilities, may enact similar requirements that could subject U.S. DCMs and DCOs to registration and regulation in such countries.

D. Principles-Based Regulation, Self-Certification Process (Sections 721, 724 and 725)

Despite Treasury's recommendation last year that the SEC move towards the CFTC's principles-based regime, and the repeated testimony at the harmonization hearings by market participants and industry experts that this regime presents the appropriate framework for regulating futures exchanges, Title VII of the Treasury's proposal would grant the CFTC administrative authority to eradicate the advantages of the CFMA's principles-based regime. Specifically, whereas the CEA currently prohibits the CFTC from providing that its "Guidance On, and Acceptable Practices In, Compliance with Core Principles" (Appendix B to Part 38 of CFTC's Regulations) is the exclusive means to comply with core principles (CEA § 5c(a)(2)), Title VII expressly grants the CFTC the authority to state that an interpretation may provide the *only* means for compliance with core principles.[3] By eliminating

[2] "Direct access" is defined as an explicit grant of authority by an FBOT to an identified member or other participant located in the United States to enter trades directly into the trade matching system of the FBOT. (Section 725(b)(1), Subtitle A.)

[3] Section 5c(a)(2) is amended by striking "shall not" and inserting "may." All of the new core principles included in Title VII are modified by language similar to the following: "Except where the Commission determines otherwise by rule or regulation, a derivatives clearing organization

this option, Title VII substantially inhibits the ability of U.S. futures exchanges to develop innovative and potentially more effective ways of complying with the core principles.

The CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearing houses permitted U.S. exchanges to regain their competitive position in the global market. U.S. futures exchanges are able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA and thereby avoiding stifling regulatory review. U.S. futures exchanges operate more efficiently, more economically and with fewer complaints under this system than at any time in their history.

Unfortunately, instead of pursuing this successful regime, the reaction against excesses in other segments of the financial services industry appears to have generated pressure to force a retreat from the principles-based regulatory regime adopted by CFMA. The myriad of problems resulting in the financial services meltdown did not originate in futures markets and the exchanges performed impeccably throughout the crisis and should not be penalized by a return to a prescriptive regulatory regime. Moreover, this is exactly the regime that impaired the competitiveness of the U.S. futures industry pre-CFMA.

The benefits of CFMA's principles-based regulatory regime are easily overlooked in the turmoil following the collapse of the housing market and major investment banks. We have said it before, but it bears repeating: derivative transactions conducted on CFTC-regulated futures exchanges and cleared by CFTC-regulated clearing houses did not contribute to the current financial crisis. Moreover, it was not unintentional gaps in the regulatory jurisdiction of the SEC and the CFTC that caused the meltdown. To the extent that regulatory gaps contributed to the problem, those gaps existed because Congress exempted broad classes of instruments and financial enterprises from regulation by either agency.

Another aspect of Title VII that adversely impacts innovation and puts regulators in the position of making business judgments for market participants is the proposed amendments to Section 5c(c)(1) of the CEA, which will require a time consuming justification process for every significant new contract and new rule. This proposed amendment steers the CFTC closer to the product and rule approval process currently employed by the SEC, the very process about which those regulated by the SEC complained at the harmonization hearings. Indeed, William J. Brodsky of the Chicago Board of Options Exchange testified that the SEC's approval process "inhibits innovation in the securities markets" and urged the adoption of the CFTC's current certification process.

E. Margin (Section 722, Subtitle A)

Title VII includes explicit standards respecting the setting of collateral requirements, which are in accord with CME's processes and procedures. However, Section 722 of Title VII would amend Section 8a(7) of the CEA and grant the CFTC authority to alter or amend a DCM's rules respecting margin requirements. Previously, the setting of margin (except for equity index margin) was excepted from the Commission's authority to alter or amend exchange rules, but the Commission did have power to act in an emergency. We are deeply concerned that this grant of authority will politicize the process and move away from a regime where true experts in risk management are supplanted by an oversight agency with no experience and no incentive to set collateral requirements at appropriate levels.

It has been clearly demonstrated that the setting of collateral levels for derivatives, both at the customer and at the clearing house level, is purely a matter of safety and soundness. The operators of clearing houses that mutualize risk among their member firms have the clearest incentives and are most capable of doing the job correctly. The record of futures clearing houses in this country is unambiguous. In this regard, it is worth noting that, over a history of continuous operation dating back more than 100 years, no CME customer has ever lost funds as a result of the failure of a clearing member firm. There is no benefit to transferring this responsibility to government employees, only potential harm to DCMs as this is an invitation to politicize the margin-setting process.

F. Netting Swaps vs. Interoperability (Section 713(j)(1)(B))

Title VII prescribes that "all swaps with the same terms and conditions are fungible and may be offset with each other." We understood that the purpose of this

---

shall have reasonable discretion in establishing the manner in which it complies with the core principles."

language was to insure that clearing houses for OTC derivatives would provide open access to all trading platforms and to privately negotiated OTC transactions and that identical swap contracts, regardless of the execution venue, would be deemed fungible and could be offset against one another if the positions resided at the same clearing house. We have since learned that certain segments of the industry are lobbying to reinterpret the clause to force all clearing into a single clearing house or to force interoperability among clearing houses.

Mandated interoperability among swaps clearing houses is being promoted as a means to foster market entry by new clearing houses and encourage competition among existing clearing houses. Mandated interoperability forces all clearing houses to permit a customer with a position at clearing house A, for example, short a notional $1 billion in the XXX equity index, to direct that the position be transferred to clearing house B. Of course, in order to assure that the books of both clearing houses remain balanced, clearing house B must be substituted as the short on clearing house A's books. Clearing house A also becomes the long on clearing house B's books. Each of the clearing houses must post collateral with the other and each must make twice daily pays and collects. Each is exposed to the failure of the other. This system becomes increasingly complex as additional clearing houses are added to the chain, and ultimately, unworkable.

The ostensible goals of mandated interoperability are to reduce costs, encourage innovation and foster competition. The same demand for interoperability among futures clearing houses was rejected by the industry, the CFTC and Congress because a fair examination of the proposal revealed that forced interoperability was complex, risky and not cost effective. Specifically, it was demonstrated that:

- the linkages would subject each of the linked clearing houses to the failure of any of them and that fire breaks that ordinarily contain or limit such failures would be eliminated, thereby effectively creating significant specific and systemic risks;
- time and cost to market implementation were significant;
- the theoretical savings that might be generated by competition were outweighed by the costs of operating the system;
- innovation would be inhibited in that each linked clearing house would be required to limit its pace of innovation to the ability of the weakest;
- changes in contract specifications would require the consent of each market and clearing house; and
- genuine competition among clearing houses and exchanges would be eliminated.

At the most basic, technical level, in order to make interoperability feasible, each participating clearing house must agree on an identical set of operating procedures to coordinate collateral, variation margin and settlement flows. Each clearing house should insist that each other participating clearing house has financial resources at least equal to its own and that each conduct regular detailed financial and operational audits of each other member of the interoperability circle. Finally, no clearing house can permit changes in contract specifications that will distort future cross clearing house flows.

An important consideration is that the actual benefits of moving open positions among clearing houses can be achieved privately, at no cost and without creating systemic or particular risks to any participant in the system. The customer holding a swap position at clearing house A can close out that position and reestablish it at clearing house B in several ways. First, the customer can enter into an equal, but opposite swap position, on any swap platform or privately, and submit it for clearing to clearing house A. The customer's swap position is netted to zero the moment the new trade is accepted. The customer can reestablish that position at clearing house B by means of a second swap that is submitted to clearing house B. Second, because the swap market is not subject to the CFTC's wash trading rules, the customer can enter into a matched pair of swaps to move the position without market risk. Finally, if sufficient customer demand ever develops for the service, clearing houses can enter into agreements that permit the transfer of matched trades amongst themselves. In that case, any two traders with offsetting positions who wish to transfer could do so by means of an appropriate notification and fee. All of this can be accomplished without government intervention, without cost and without creating systemic risk.

The immediate impact of mandated interoperability is to force regulated exchanges and their associated clearing houses to truncate the services that they offer to their customers by giving up control over the clearing function that provides the financial, banking and delivery services that guarantee performance of futures contracts. Exchange control of these services—either in-house or through a dedicated third party—is at the heart of current efforts to improve the value of exchange services by offering straight-through, integrated processing to clearing member firms and their clients.

It is only through differentiation that product innovation is accomplished. Differentiation with respect to product and the delivery of that product has been a fundamental tenet of CME's business strategy and, intuitively, a prerequisite for product advancement. CME opposes any suggestions to impede its ability to explore new opportunities in non-generic, unique products—accessible through unique value added trading platforms—cleared and settled on an essentially "straight-through," integrated basis.

G. The CEA's Jurisdictional Preservation Clause

The CEA's exclusive jurisdiction provision mandates that CFTC regulation is the sole legal standard applicable to virtually all futures trading. This exclusivity provision was purposely included in the CEA decades ago to prevent duplication and inconsistency in regulating the industry; indeed, the phrase "except as hereinabove provided" was inserted in the original CFTC Act so that it would supersede all others in regard to futures and commodity options regulation. Despite the success of this jurisdictional delineation to date, Title VII proposes to disrupt it. Specifically, Section 712(b) states that the CFTC's exclusive jurisdiction does not supersede any other authority's jurisdiction under the proposed legislation and would be referenced in existing CEA Section 2(a)(1)(A) as an exception to the CFTC's exclusive jurisdiction clause. Moreover, Section 728 appears to give CFTC "primary" enforcement authority over Subtitle A matters but permits other regulators to take action if CFTC does not, the effect of which would be to subject market participants to potentially conflicting standards and multiple regulators. We strongly believe that the CEA's exclusivity provision should be retained as we move forward in the regulatory reform process.

IV. Additional Items Raised by Chairman Gensler for Potential Harmonization

As previously noted, Chairman Gensler raised a number of issues that he thought should be the focus of the harmonization process. Although CME has thoughts on each of those issues, we address only a few below. We are available at your convenience to discuss any of these further as well as those issues not addressed in this testimony.

A. Manipulation

Under the CEA, price manipulation constitutes acting with specific intent to create an artificial price. In the securities market, SEC Rule 10b–5, which applies to alleged manipulation, requires a showing of neither specific intent nor artificial price effects. Adoption of the specific intent standard of Rule 10b–5 would contradict the CFTC's jurisprudence and impose a significant threat to the proper functioning of the U.S. futures markets in crude oil and gasoline. Indeed, when the CFTC was asked years ago to consider abandoning the specific intent standard as the required *mens rea* for finding manipulation, the CFTC responded that it was "unable to discern any justification for a weakening of the manipulative intent standard which does not wreak havoc with the market place." *In re Indiana Farm Bureau Coop. Ass'n,* CFTC No. 75–14, 1982 WL 30249, at *5 (Dec. 17, 1982). Likewise, elimination of the requirement to show artificial price effects in the futures realm would seriously threaten the proper functioning of the U.S. futures markets.

B. Insider Trading

Adopting the SEC's insider trading prohibitions in the commodities markets could impair price discovery and efficient markets. Insider trading prohibitions in the securities markets are based upon the premise that corporate executives and other fiduciaries should not use their privileged access to information to trade when such material information is not available to the broader marketplace. In the commodities derivatives markets, however, market participants typically trade based upon their own informed self-interest, often hedging price risks that are, by definition, based upon information that is not available to the broader marketplace and which contributes to the futures price formation process. The price discovery function is optimized when all market information known to hedgers or to speculators is reflected in the market price of a given contract. Moreover, hedging depends upon knowledge of cash market positions, physical market conditions, and other manner of information to determine the appropriate position to take or hedge to place on a futures market. If such information were required to be publicly disclosed in advance of trading on futures markets, hedging would be impossible.

CFTC Rule 1.59(d) does, however, prohibit exchange governing board members, committee members, members, employees and consultants from disclosing or trading in any commodity interest on the basis of material, nonpublic information obtained through their official exchange duties. Furthermore, this rule also prohibits any person from trading in any commodity interest, whether for such person's own account or on behalf of another person, on the basis of material, nonpublic information that such person knows was obtained in violation of the CFTC rule from an exchange governing board member, committee member, member, employee or consultant.

C. Customer Suitability

As the National Futures Association ("NFA") testified during the harmonization hearings, in 1985 it adopted a Know-Your-Customer rule (NFA Compliance Rule 2–30) that provides protections comparable to the Financial Industry Regulatory Authority's ("FINRA") suitability rule but that are tailored to the unique requirements of the futures industry. NFA explained the necessary distinction between its rules and FINRA's: Since all futures contracts are highly volatile and risky instruments, a suitability determination should be made on a customer-by-customer basis, rather than trade-by-trade. We agree with NFA that it makes no sense to say that a customer is suitable for a recommendation to invest in heating oil futures but not in Treasury note futures. In general, NFA's rule requires its members to obtain basic information about each prospective customer and determine whether futures trading is appropriate for each customer. The rule imposes an affirmative obligation to inform customers in appropriate circumstances that futures trading is simply too risky for that customer.

IV. Guiding Principles of Harmonization

CME Group proposes the following five principles to guide regulatory reform legislation respecting the CFTC, SEC and OTC derivatives:

Recommendation One: The CFTC and SEC should jointly adopt regulations in accordance with Title VII of the Administration's proposal, but a single agency should function as the primary regulator to administer those rules and regulations. Where an exchange, clearing house, or financial services enterprise is engaged in both commodities and securities businesses, its primary regulator should be based on a predominance test. Where no segment of the firm's business clearly predominates, the firm should be free to pick its regulator. For example, the CME derivatives clearing organization should be primarily regulated by the CFTC even if it also clears security-based swaps. As many of the participants in the recent joint SEC/CFTC hearings noted, a primary regulator should take front-line responsibility for the oversight of the regulated enterprise, including oversight of its SRO responsibilities, where applicable. This primacy should extend to audits and enforcement.

Recommendation Two: The CFTC and SEC should avoid jurisdictional conflict respecting novel contracts and products that include both commodity and security features by institutionalizing last year's Memorandum of Understanding ("MOU") for Novel Derivatives Products. Such an approach would ensure the recognition of mutual regulatory interests while operating under principles designed to promote, among other things, innovation and competition as well as market neutrality.

Recommendation Three: The principles-based regulatory regime adopted by CFMA should provide the model for the joint regulations adopted by the CFTC and SEC. No retreat from principles-based regulation should be accepted without clear justification.

Recommendation Four: The existing customer segregation regime for customers of a CFTC derivatives clearing organization should be preserved for all customers of that clearing house. The SEC's SIPA regime should continue to apply to securities account holders. Legislation should be adopted to rationalize the treatment of the separate classes of customers in the event of a bankruptcy of a combined broker-dealer/futures commission merchant.

Recommendation Five: Interoperability among clearing houses should not be mandated by legislation or regulation. As has been previously demonstrated, forced interoperability is complex, risky and not cost effective. The actual benefits of moving open positions among clearing houses can be achieved privately, at no public cost and without creating systemic or particular risks to any participant in the system.

The CHAIRMAN. I thank the gentleman.

And we are going to be gone for a while. I think it will be at least 1 hour—we have a motion to recommit—so we will see the rest of you folks when we get back. Thank you.

[Recess.]

The CHAIRMAN. The Committee will come back to order. And we apologize for that, but that is part of the deal.

Mr. Pickel, welcome to the Committee. We appreciate your being here.

STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CEO, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., NEW YORK, NY

Mr. PICKEL. Thank you, Mr. Chairman, Ranking Member Lucas, we appreciate the opportunity to testify here.

ISDA, as you know, is an international trade association representing major dealers, end-users, government entities, investors in the privately negotiated derivatives business. We share the goals of the Administration and of this Committee for protecting the integrity of our financial system and promoting the stability of that system; and we support many of the principles contained in the Administration's proposal.

Specifically, we support appropriate oversight and regulation of all financial institutions that may pose a systemic risk to the financial system. We support stronger counterparty risk management, including clearing requirements, improved transparency through clearing and reporting requirements, and a resilient operational infrastructure that bolsters the system supporting the derivatives markets.

An example of our commitment is the industry's efforts to improve the clearing process by establishing counterparty clearing facilities. In the credit default swaps base alone, more than $2 trillion worth of contracts have been cleared, and early in this month, ISDA and 15 large derivatives dealers publicly committed to the Federal Reserve Bank of New York and regulators from other countries that the firms would submit 95 percent of new, eligible CDS trades for clearing by October 2009. Additional commitments have been made to clear interest rate swaps.

Today, however, we draw the Committee's attention to several provisions of the bill that are inconsistent with these goals.

The scope of U.S. companies that would be subject to these regulations would be overly broad and would include firms that are in no way systemically significant. The definition includes all dealers, regardless of their size or trading volume. A firm that acts as a dealer in ten swaps a year is treated the same as a dealer that does 10,000 swaps.

Major swap participants would include nonfinancial end-users of derivatives and financial firms that are not systematically significant.

The proposal's reliance on GAAP accounting for qualification for an exemption is misplaced.

Many end-users enter into economic hedges that do not meet the strict FAS 133 definition of an effective hedge.

The determination of when an OTC contract is standardized needs more scrutiny also. Standardization is an important goal, but equally important is the availability of customized derivatives products to end-users.

The privately negotiated derivatives business has grown because standardized contracts are only of limited use in hedging. Initiatives that would seek to standardize the terms of all OTC swaps are counterproductive. So long as the risk that businesses face are not fully standardized, the tools that allow them to manage those risks will not be fully standardized.

Product uniformity is not beneficial to American companies when they have risks unique to their business and need customized risk management tools to mitigate those risks. The industry is committed to standardizing the processes surrounding the product, such as clearing the settlement and confirmation. That will go a long way to reducing risk.

A third point is that mandatory clearing and mandatory exchange trading are not feasible in many circumstances. Not all standardized contracts can be cleared because the ability of a central counterparty clearing facility to clear a contract depends on such factors as liquidity, trading volume and daily pricing. Standardized illiquid contracts are hard to price daily, making it difficult for the clearinghouse to calculate collateral requirements consistent with prudent risk management.

Clearing of OTC derivatives contracts should not be mandatory. Nevertheless, commitments had been made regarding clearing, and the industry is delivering on those commitments.

Mandatory exchange trading should not be required in any circumstance because it would restrict the ability to custom tailor risk management solutions to meet the needs of end-users. End-users should not be subject to mandatory clearing or exchange trading because they are not systematically significant, and regulations intended to improve stability and decrease systemic risk should not apply to them.

Finally, the capital requirements in the proposal for cleared swaps are redundant. The proposal's imposition of a capital requirement on cleared swaps does not reflect the capitalization requirements of the clearinghouse, or its imposition of collateral requirements on its counterparties.

In closing, ISDA joins with thousands of American companies who rely on customized over-the-counter derivatives to manage the risks that they face in the normal course of their business. ISDA also will continue to work with this Committee, with Congress and the Administration, to ensure financial stability and reduce risk.

Thank you for your time, and I look forward to your questions.

[The prepared statement of Mr. Pickel follows:]

PREPARED STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CEO, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, NEW YORK, NY

Chairman Peterson and Members of the Committee:

Thank you very much for allowing ISDA to testify at this hearing to review proposed legislation by the U.S. Department of the Treasury regarding the regulation of over-the-counter derivatives markets.

About ISDA

ISDA, as you may know, represents participants in the privately negotiated derivatives industry. Today it ranks as the largest global financial trade association by number of member firms. ISDA was chartered in 1985, and today has over 850 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

A Broad Consensus for Key Reform Concepts

Let me state very clearly at the outset of my remarks: Today, there is a broad consensus for a comprehensive regulatory reform plan to modernize and protect the integrity of our financial system. ISDA and the privately negotiated derivatives business support many of the key public policy concepts contained in the Administration's proposal. This includes:

- Appropriate regulation for all financial institutions that may pose a systemic risk to the financial system;
- Stronger counterparty risk management, including clearinghouses;
- Improved transparency; and
- A strong, resilient operational infrastructure.

What's more, we are not waiting for legislation or additional regulation to demonstrate our support and commitment to these principles. We are actively doing so today. One example can be seen in the use of central counterparty clearing facilities. To date, more than $2 trillion of credit default swaps contracts have been cleared. And earlier this month, ISDA and 15 large derivatives dealers publicly committed in a letter to the Federal Reserve Bank of New York that the firms would submit 95% of new eligible credit default swap trades for clearing within 60 days, by October 2009. A copy of the letter is attached.

Mr. Chairman and Committee Members, let me assure you that ISDA and our members intend to maintain the scope and the scale of the progress that we have made thus far. Since its inception nearly 25 years ago, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Our focus is on continuing—and enhancing—our efforts in this area as we move forward. The depth and breadth of our activities in derivatives documentation, netting, collateral, risk management, capital, operations and technology underscore our intense global commitment to further reducing risk.

There are, however, certain aspects of the bill that work against its broad public policy goals. These include:

- The scope of firms that would be subject to the legislation;
- The parameters for determining when an OTC derivatives contract is standardized and when it can be cleared;
- Mandatory clearing and exchange trading of standardized OTC derivatives;
- Capital requirements for cleared swaps.

These provisions would reduce or restrict the availability of customized risk management tools without contributing in any significant positive way to the Treasury's goals of reducing risk and ensuring financial stability. As a result, they would make it more difficult for American companies to effectively manage their business and financial risks. Resources that could have been allocated more productively to generate growth in revenues and profitability would instead be devoted to less efficient and effective risk management activities.

The Need for Privately Negotiated Derivatives

As Secretary Geithner has previously testified before this Committee, "One of the most significant developments in our financial system during recent decades has been the substantial growth and innovation in the markets for derivatives, especially OTC derivatives." In his remarks, Secretary Geithner also noted that derivatives today play a critical role in our financial markets, and they bring substantial benefits to our economy by enabling companies to manage risks.

Today, privately negotiated derivatives are widely used by American companies. According to research we have conducted, nearly all of the Fortune Global 500 companies based in the U.S. use derivatives to manage their risks. A broader survey of non-financial firms in 47 countries was conducted earlier this decade by professors at Lancaster University and the University of North Carolina at Chapel Hill. Of the 2,076 U.S. companies in the survey, about 65 percent used OTC derivatives.

The reason why derivatives are so widely used is clear: American companies want and need these customized risk management tools to manage the risks that arise in the normal course of doing business. For companies that do business overseas, those risks include fluctuations in the relative value of foreign currencies. For companies that issue debt to fund their growth, the risks may include changes in interest rates and consequently in interest payments. For companies that rely heavily on commodities—such as airlines—those risks include changes in the current and future prices of fuel.

Key Issues in the Treasury's Proposal

While there is consensus regarding many of the key concepts in the Treasury's proposal, certain of its provisions raise serious questions for dealers in and users of derivatives. These provisions, as outlined below, would reduce or restrict the availability of customized risk management tools for American companies. At the same time, these provisions offer no significant offsetting benefit; in other words they would not meaningfully contribute to the Treasury's goals of reducing risk and ensuring financial stability.

(1) The scope of firms that would be subject to the legislation.

The legislation defines two types of firms that would be subject to its provisions: "swaps dealers" and "major swap participants." Both definitions are overly broad and would include firms that are in no way systemically significant. In so doing, the legislation would penalize such firms and may well prevent them from either dealing in or using derivatives.

Let me explain: in the proposal, a swap dealer is defined as including any person engaged in the business of buying and selling swaps for such person's own account, through a broker or otherwise. This definition includes all dealers, regardless of their size or trading volume. It treats a firm that acts as a dealer in ten swaps a year the same as a dealer that does 10,000.

Similarly, the term major swap participant is essentially defined as any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles. This definition is so broad that it would include financial entities that are not systemically significant.

It would also include non-financial end-users of derivatives. These corporate end-users would as a result be subject to the nation's banking and financial regulatory framework, which would impose significant costs, divert key resources and decrease the competitiveness of such firms.

(2) The parameters for determining when an OTC derivatives contract is standardized.

A key component of Treasury's proposal for OTC swaps is its requirement that standardized swaps be cleared. The proposal does not define the term standardized. Instead, it would require that, within 6 months of the proposal's enactment, the SEC and CFTC jointly define "as broadly as possible" what constitutes a standardized swap. Additionally, the proposal provides that acceptance of a product by a clearinghouse for clearing would create a presumption that the relevant product is standardized.

Both of the proposal's methods for determining if an OTC derivatives contract is standardized are flawed and need to be revised. With regard to the former method, the need for consistency amongst policymakers regarding what is standardized and what is not argues for broader participation by Federal regulators in this process. Regarding the latter method, because of commercial considerations, the willingness of a clearinghouse to accept a transaction for clearing should not create a presumption of standardization.

In addition, it's important to keep in mind that while standardization is an important goal in the OTC derivatives world, it's also important to retain customization of derivative products. American businesses pervasively use customized contracts to manage operational risks, and it is critical that Congress preserve these companies' ability to do so. Customized products exist only because end-users find them useful, and indeed *necessary*, in their day-to-day operations. In fact, the privately negotiated derivatives business has grown because standardized contracts are only of limited use in hedging. Initiatives that would seek to standardize the terms of all OTC swaps are counterproductive. Product uniformity is not beneficial to American companies when they have risks unique to their businesses and need customized risk management tools to mitigate these risks, and when accounting rules require customized products that are closely tailored to an end-user's specific risks.

(3) Mandatory clearing and exchange trading.

The Treasury proposal would require that standardized OTC derivatives contracts be cleared and traded on an exchange of alternative swap execution facility.

Not all standardized contracts can be cleared. Contracts that are infrequently traded, for example, are difficult if not impossible to clear even if they contain standardized economic terms. That's because the ability of a central counterparty clearing facility to clear a contract depends on such factors as liquidity, trading volume and daily pricing. Standardized, illiquid contracts are hard to price daily, which makes it difficult for the clearinghouse to calculate collateral requirements consistent with prudent risk management. As a result, clearing of OTC derivatives contracts should not be mandatory.

To the extent that policymakers do adopt mandatory clearing requirements, ISDA and our members believe that a clearly defined framework for so doing is essential. This framework should be constructed by Federal regulators, who should proceed by notice and comment and endeavor to ensure that the requirement would promote consistent international standards, choice of clearinghouses, economic efficiency, fungible treatment of cleared contracts, and clearinghouse interoperability. The framework for a mandatory clearing requirement should only include standardized inter-dealer transactions in which at least one of the dealers is systemically significant.

ISDA and our members believe that mandatory exchange trading should not be required in any circumstance. Mandating that OTC derivatives contracts trade on an exchange would undercut their very purpose: the ability to custom tailor risk management solutions to meet the need of end-users.

In addition, exchanges provide three general purposes, all of which the OTC derivatives industry is meeting in other ways. First and most important is central clearing, which the industry is now well along on and is committed to continued progress. Second is position and risk transparency, which we are achieving through centralized trade repositories as well as central clearing facilities. And the third is price transparency, which is also being achieved through a combination of increased cleared trading volume and electronic platforms.

Finally, ISDA and our members believe that end-users should not be subject to a clearing or exchange trading requirement, even if they are major swap participants or meet the eligibility requirements of a derivatives clearing organization. End-users are not systemically significant and regulations intended to improve stability and decrease systemic risk should not apply to them.

(4) Capital requirements for cleared swaps.

The Treasury proposal would impose a capital requirement on cleared swap transactions. ISDA and our members oppose this requirement for several reasons. First, the capitalization of the derivatives clearinghouse is designed to provide adequate protection to swap counterparties. That is the fundamental purpose of the clearing facility. In addition, the clearinghouse imposes its own layer of additional protection in the form of collateral requirements on its counterparties. So in effect there are already two layers of capital: that which with the clearinghouse is capitalized, and that which the clearinghouse imposes on its members when it trades with them.

Conclusion

Let me conclude by saying that ISDA and our members appreciate the opportunity to testify and answer your questions today. We recognize that policymakers today have real and legitimate concerns regarding their twin goals of ensuring financial stability and reducing risk.

We in the OTC derivatives industry share these goals. We have moved very quickly in recent months in a broad range of areas to allay policymakers' concerns. We know that we have more work ahead—and we are committed to taking on these challenges.

At the same time, we believe—and we are joined by thousands of American companies who also believe—that the customized nature of OTC risk management tools provides a substantial benefit . . . a benefit to our firms, our economy and our country. We must not lose sight of the important role that OTC derivatives play as we work together on financial regulatory reform.

Thank you.

ATTACHMENT

8 September 2009

Hon. WILLIAM C. DUDLEY,
President,
Federal Reserve Bank of New York,
New York, NY

Dear Mr. Dudley:

We are writing to inform you of our commitment to increase the usage of central counterparties for clearing, which we believe will significantly reduce the systemic risk profile of the OTC derivatives market. We have set the following initial performance targets as a demonstration of that commitment. We will increase these target levels, which are the first set for central clearing, as we improve our clearing capabilities.

For Interest Rate Derivatives:

- Each G15 member (individually) commits to submitting 90% of new eligible trades (calculated on a notional basis) for clearing beginning December 2009.
- The G15 members (collectively) commit to clearing 70% of new eligible trades (calculated on a weighted average notional basis) beginning December 2009.
- The G15 members (collectively) commit to clearing 60% of historical eligible trades (calculated on a weighted average notional basis) beginning December 2009.

For Credit Default Swaps:

- Each G15 member (individually) commits to submitting 95% of new eligible trades (calculated on a notional basis) for clearing beginning October 2009.
- The G15 members (collectively) commit to clearing 80% of all eligible trades (calculated on a weighted average notional basis) beginning October 2009.

Furthermore, we will issue performance metrics that address both new transactions and the outstanding trade population on a monthly basis. The first report will be issued on the 10th business day of October 2009 and will be in respect of September 2009, and for each month thereafter, the relevant report will be issued as part of the monthly metrics we currently report.

We will continue to work with the regulators to explore means by which we can look to improve submission levels and clearing yields. We will review the performance metrics and targets contained in this letter with the global regulators on a regular basis to ensure that the metrics and targets demonstrate the industry commitment to increased clearing of OTC transactions.

G15 members commit to actively engaging with CCPs and regulators globally to broaden the set of derivative products eligible for clearing, taking into account risk, liquidity, default management and other processes.

The G15 members also commit to work with eligible CCPs and regulators globally to expand the set of counterparties eligible to clear at each eligible CCP taking into account appropriate counterparty risk management considerations, including the development of buy-side clearing.

Of course, successful expansion of the sets of eligible products and counterparties is necessarily dependent on several factors, including ensuring proper risk management, CCP capabilities and business choices, regulatory treatment and decisions of non-G15 firms. We commit to work actively with our supervisors and other regulators to remove any of these impediments to our efforts.

Yours sincerely from the Senior Managements of:

Bank of America-Merrill Lynch;
Barclays Capital;
BNP Paribas;
Citigroup;
Commerzbank AG;
Credit Suisse;
Deutsche Bank AG;
Goldman, Sachs & Co.;
HSBC Group;
International Swaps and Derivatives Association, Inc.;
JP Morgan Chase;
Morgan Stanley;
The Royal Bank of Scotland Group;
Société Générale;
UBS AG;
Wachovia Bank, N.A.

Identical letters sent to:
Board of Governors of the Federal Reserve System;
Connecticut State Banking Department;
Federal Deposit Insurance Corporation;
Federal Reserve Bank of Richmond;
French Secretariat General de la Commission Bancaire;
German Federal Financial Supervisory Authority;
Japan Financial Services Agency;
New York State Banking Department;

Office of the Comptroller of the Currency;
Securities and Exchange Commission;
Swiss Financial Market Supervisory Authority;
United Kingdom Financial Services Authority.

Copies to:
Commodity Futures Trading Commission;
European Commission;
European Central Bank.

The CHAIRMAN. Thank you, Mr. Pickel.

Mr. Short, welcome to the Committee.

STATEMENT OF JOHNATHAN H. SHORT, VICE PRESIDENT AND GENERAL COUNSEL, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. SHORT. Chairman Peterson Ranking Member Lucas, I am Johnathan Short, Senior Vice President and General Counsel of IntercontinentalExchange, or ICE. We very much appreciate the opportunity to appear before you today to testify on the Department of the Treasury's Over-the-Counter Derivatives Markets Act of 2009.

ICE has an established track record of working with market participants and regulators alike to introduce transparency and risk intermediation into OTC markets. Along with the introduction of electronic trading to OTC energy markets, ICE pioneered the concept of cleared OTC energy swap contracts in 2002.

ICE recognizes that appropriate regulation of OTC derivatives is of utmost importance to the long-term health and viability of our financial system and to our broader economy. In this regard, the current Treasury proposal contains many provisions that will benefit both the derivatives markets and the broader economy as a whole.

We cannot summarize all of our comments on the OTCDMA in this oral testimony, but we will highlight several points in the proposed legislation which warrant further scrutiny and consideration by Congress in order to strike the proper balance between needed market reform, while maintaining the usefulness of OTC derivatives to the broader economy.

These three points in ICE's recommendations for improvement are:

One, while mandating clearing and electronic trading for most standardized swap transactions may be appropriate to achieve certain goals of the OTCDMA, Congress should consider appropriate exclusions for transactions involving commercial entities and transactions in illiquid contracts that may be difficult to clear.

Two, clearinghouses should not be forced to make clearing of swaps fungible or be forced to provide margin offsets for positions held in other clearinghouses, as such a mandate could increase rather than decrease the potential for systemic risk.

And, three, careful consideration should be given to the provisions requiring registration of foreign boards of trades and, in particular, the provisions giving the CFTC authority to set position limits on contracts traded on a foreign board of trade that do not have a linkage to a domestically traded contract. Such provisions will invite retaliation from foreign regulators and inhibit necessary global regulatory cooperation.

To elaborate on these three points, the OTCDMA recognizes the benefits of exchange trading and clearing by requiring all standardized swaps to be exchange traded and cleared. The OTCDMA instructs the CFTC and SEC to define the term *standardized* as broadly as possible and includes a presumption of standardization for any contract that a clearinghouse is willing to accept.

Clearing and electronic execution and trade processing are core to ICE's business model, and ICE would clearly stand to benefit from legislation that required all derivatives transactions conducted in the U.S. to be cleared and traded on exchanges or electronic trading facilities. However, such a provision may result in significant unintended consequences by attempting to force transactions that are not readily amenable to clearing into clearinghouses, or by forcing commercial market participants who would rather outsource their risk management to an OTC swaps dealer to incur the costs of expensive trading and clearing standardized contracts that may not perfectly fit their risk management needs.

Instead of forcing all derivative transactions to be exchange traded and cleared, Congress should require this for the segments of the market where risk is greatest like the inner dealer or major swaps participant derivatives market.

Mandating that inner dealer or major swaps participant trades be cleared would eliminate much of the bilateral counterparty risk that was central to the financial crisis last year, and achieved many of the risk reduction and transparency goals that the Treasury is seeking.

To address any potential for a gap in oversight, this step could be supplemented with enhanced prudential regulation of swaps dealers and major market participants to allow regulators to ensure that such entities were not engaging in trading conduct with commercial entities that exposed them to excessive counterparty risk.

On the issue of fungible clearing for swaps, the OTCDMA includes a provision that requires clearinghouses to prescribe that all swaps with the same conditions and terms are fungible and may be offset with one another. This provision could be interpreted to force clearinghouses to treat standardized swaps as fungible with positions held in other clearinghouses, and to offer margin risk offsets against positions in other clearinghouses. Such a requirement would be very difficult to implement across multiple clearinghouses, making it more difficult for the clearinghouse to do what the proposed legislation intends for them to do, which is to properly manage risk positions held in the clearinghouse and mitigate systemic risk.

A forced linkage of clearinghouses could perversely reintroduce the interconnectedness problem that we have all just experienced in the OTC markets among major financial institutions and allow problems in one clearinghouse to infect other clearinghouses.

Finally, on foreign boards of trade, careful consideration should be given to the provisions of the proposed legislation requiring registration of foreign boards of trade, and the provisions giving the CFTC the authority to set position limits on any contract traded on a foreign board of trade that is offered to U.S. market participants. The provisions requiring registration are likely to result in similar requirements being imposed by foreign regulators on domestic markets.

In addition, the provisions related to position limits are problematic as well. While placing position limits on U.S. market participants trading in a linked contract, one linked to a U.S. contract market are appropriate; providing that the CFTC could set position limits on other foreign contracts is not appropriate, would be repugnant to foreign regulators, and would likely inhibit the regulatory cooperation amongst regulators at a time when it is most needed.

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

[The prepared statement of Mr. Short follows:]

PREPARED STATEMENT OF JOHNATHAN H. SHORT, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Chairman Peterson, Ranking Member Lucas, I am Johnathan Short, Senior Vice President and General Counsel of IntercontinentalExchange, Inc., or "ICE." I very much appreciate the opportunity to appear before you today to testify on the Department of the Treasury's Over the Counter Derivatives Markets Act of 2009 ("OTCDMA").[1]

Background

ICE launched its electronic OTC energy marketplace in 2000. The ICE OTC platform was designed to bridge the void that existed between the voice brokered OTC markets which were bilateral and opaque, and the open-outcry futures exchanges, which were inaccessible or lacked the products needed to hedge in the power markets. Since then, ICE has acquired and operates three regulated futures exchanges through three separate subsidiaries, each with its own governance and regulatory infrastructure. The International Petroleum Exchange (renamed ICE Futures Europe), was a 20 year old exchange specializing in energy futures when acquired by ICE in 2001. Located in London, it is a Recognized Investment Exchange, or RIE, operating under the supervision of the UK Financial Services Authority (FSA). In early 2007, ICE acquired the 137 year old "The Board of Trade of the City of New York" (renamed ICE Futures U.S.), a CFTC-regulated Designated Contract Market (DCM) headquartered in New York and specializing in agricultural, foreign exchange, and equity index futures. In late 2007, ICE acquired the Winnipeg Commodity Exchange (renamed ICE Futures Canada), a 120 year old exchange specializing in agricultural futures, regulated by the Manitoba Securities Commission, and headquartered in Winnipeg, Manitoba. ICE also owns and operates five derivatives clearinghouses, each serving a distinct part of its trading business. These clearinghouses include:

- ICE Clear U.S., a Derivatives Clearing Organization located in New York and serving the markets of ICE Futures U.S.;
- ICE Clear Europe, a Recognized Clearing House located in London that serves ICE Futures Europe, ICE's OTC energy markets, and the European portion of ICE's credit default swaps clearing initiative;
- ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada;
- ICE Trust, a U.S.-based CDS clearing house which began clearing CDS transactions in March 2009, and which to date, along with ICE Clear Europe, has cleared over $2 trillion in notional value of credit default swaps; and
- The Clearing Corporation, established in 1925 as the nation's first independent futures clearing house. It provides the risk management framework, operational processes and clearing infrastructure for ICE Trust. The Clearing Corporation also provides clearing services to the Chicago Climate Futures Exchange.

ICE has an established track record of working with market participants to introduce transparency and risk intermediation into OTC markets. We have also worked

[1] Title VII, Improvements to Over-the-Counter Derivatives Markets (August 11, 2009).

closely with regulators to improve supervision and access to information from the OTC markets. Along with the introduction of electronic trading to energy markets, ICE pioneered the concept of cleared OTC energy swap contracts. These changes to a traditionally opaque, bilateral market structure were made in response to a crisis in the energy markets in 2002, and have dramatically transformed the way energy derivatives are traded and risks are managed by market participants.

Need for OTC Regulation

Appropriate regulation of OTC derivatives is of utmost importance to the long term health and viability of our financial system and to our broader economy. The current financial crisis has exposed a significant gap in market transparency and regulation that has allowed systemic risk to grow and for its effects to be felt beyond Wall Street to Main Street. However, in considering the need for OTC derivatives regulation, it is equally important to understand the true size and nature of OTC derivatives markets and their importance to the broader U.S. economy. Derivatives are commonly thought to be complex financial instruments that are only traded between large investment banks and hedge funds. However, derivatives are central to the U.S. and global economy: 94% of the world's 500 largest companies use derivatives to manage a broad variety of risks.[2] Use of derivatives is not constrained to the financial sector, but cuts across the entire spectrum of business and government, including manufacturing, airline, health care and technology companies, as well as a variety of state and local governmental entities. It also bears emphasizing that derivatives—both futures and OTC instruments—could play a central role in any "cap and trade" program to combat climate change.

ICE believes that increased transparency and proper risk and capital management, coupled with legal and regulatory certainty, are central to OTC market financial reform and to restoring confidence to these vital markets. In this regard, the current Treasury proposal embodied in the OTCDMA contains many provisions that will benefit the derivatives markets and the broader economy as a whole. However, several key points in the legislation warrant further scrutiny and consideration by Congress in order to strike the proper balance between needed market reform and maintaining the usefulness of OTC derivatives to the broader economy.

Mandating Clearing and Electronic Trading

The OTCDMA recognizes the benefits of exchange trading and clearing by requiring all standardized swaps to be exchange traded and cleared. The OTCDMA instructs the CFTC and the SEC to define the term "standardized" as "broadly as possible after taking into account" factors as (i) which terms of the trade, including price, are disseminated to third parties; (ii) the volume of transactions; (iii) the extent to which the swap is similar to other swaps that are centrally cleared; (iv) whether the swap is similar to other swaps in ways that are of economic significance; and (v) other factors that the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission think relevant.[3] This broad definition is designed to capture most derivative transactions.

Clearing and electronic execution and trade processing are core to ICE's business model. As a result, ICE would clearly stand to benefit commercially from legislation that required all derivatives transactions conducted in the U.S. to be cleared and traded on exchanges or electronic trading facilities. However, the mandated electronic trading and clearing provisions of the OTCDMA may result in significant unintended consequences by attempting to force transactions that are not readily amenable to clearing into clearinghouses, or by forcing commercial market participants—including those who would rather, for a price, outsource their risk management to an OTC swaps dealer—to incur the cost and expense of trading in standardized contracts that may not perfectly fit their risk management needs. In addition, many commercial market participants will be forced to post significant cash collateral to margin cleared positions when they historically have been able to use illiquid assets to back OTC bilateral swap positions that they have entered into with swaps dealers.

The critical factors for efficient clearing include not only the standardization of products, but also the availability of adequate pricing and market liquidity. Pricing is essential for the clearinghouse to mark open positions to market on a daily basis and to properly margin positions, which protects both the clearinghouse and market in the event of a clearing participant default. The depth of market liquidity and number of clearing participants or intermediaries impacts margin and guaranty

[2] Study by the International Swaps and Derivatives Association (April 23, 2009). *http://www.isda.org/press/press042309der.pdf.*
[3] OTCDMA, Section 713(a).

fund calculations, as well as the ability to efficiently mutualize risk across enough clearing participants to make clearing economically viable. Where market depth is poor, margin and risk mutualization cost is very high and can make it uneconomic from a market perspective for a product to be cleared given the necessary conservatism on the part of a clearinghouse.

Thus, while ICE certainly supports clearing and exchange trading of as many standardized contracts as possible, there will always be products which are not sufficiently standardized or which do not possess sufficient market liquidity for clearing to be practical, economic or necessary. Pursuant to the OTCDMA's broad definition of "standardized swap", many thinly traded instruments will be submitted for clearing and traded on exchange. This could increase risk to clearinghouses and to the financial system in general.

Finally, forcing all derivatives transactions and all market participants to trade through exchanges and to clear through clearinghouses will greatly increase cost to commercial companies and ultimately to consumers. Currently, many commercial entities address their risk management needs through trading with swaps dealers. The swaps dealers offset the risk they undertake through internal offsets, trading with other swaps dealers, or through trading on exchanges. Under these arrangements the commercial entities have the flexibility to post illiquid collateral (such as a pledge of hard assets or a pledge of future production) that could not be accepted by a clearinghouse. Forcing these transactions into clearinghouses will cause these companies to post their most liquid assets, impairing their ability to operate efficiently. This will put U.S. firms at a severe disadvantage to foreign competitors.

Instead of forcing all derivative transactions to be exchange traded and cleared, Congress should focus on the segments of the markets where risk is greatest, like the inter-dealer and major swaps participant derivatives market. Mandating that inter-dealer and major swaps participant trades be cleared would eliminate the bilateral counterparty risk that was central to the liquidity crisis that occurred last year, and achieve many of the risk reduction and transparency objectives that Treasury is seeking without impacting clearinghouse risk management and the competitiveness of U.S. commercial businesses. This step could be supplemented with enhanced prudential regulation of swaps dealers or major swaps participants that would allow regulators to ensure that such entities do not engage in trading conduct with other parties that poses any systemic risk.

Fungible Clearing for Swaps

The OTCDMA includes a provision that requires clearinghouses to "prescribe that all swaps with the same terms and conditions are fungible and may be offset with each other." [4] This provision would force clearinghouses to treat standardized swaps as fungible with positions held other clearinghouses and offer risk offsets against positions held in other clearinghouses. This could make proper risk management by clearinghouses extremely difficult, and inadvertently increase systemic risk—the very thing that clearinghouses are intended to eliminate under the OTCDMA.

Clearinghouses have been some of the few institutions that have operated well in the financial markets during this time of crisis. Clearinghouses perform a vital risk management function in margining derivative positions and performing real time risk management for their customers. Forcing clearinghouses to take contracts from other clearinghouses or to provide margin offsets with other clearinghouses could present significant systemic risk issues, making it more difficult to track positions and counterparty risk exposure, and creating significant problems in the event of a default of a major market participant. To understand this risk, consider what would have happened in the real world Lehman Brothers default scenario if Lehman's positions had been spread across ten different clearinghouses, none of whom may have had the full risk picture and all of whom might have been dependent on the risk management practices of the weakest link in the "offset" chain. In this regard, interconnected clearinghouses might not have been very different from interconnected banks, with problems in one competing clearinghouse impacting other clearinghouses.

Many important problems would need to be overcome to make fungible clearing and margin offsets workable. For example, what if rules at each clearinghouse are not exactly the same with respect to a default, which clearinghouses' rules would have precedent? What if one clearing house chose to adopt more stringent margin requirements than the minimum legally required—would it have to provide a margin offset for positions held at a second clearinghouse that only chose to adopt the minimum margin standards that are legally required?

[4] OTCDMA, Sections 713(a), 753(a).

It is important to note that fungible clearing is currently allowed, but not forced upon futures clearinghouses, pursuant to Core Principle E of the Commodity Exchange Act. Thus, clearinghouses have the ability to create netting and offsetting arrangements with other clearinghouses on a voluntary basis, with appropriate risk management considerations in mind. Congress should eliminate the fungibility requirement from the OTCDMA before passage.

Foreign Boards of Trade

The OTCDMA gives the CFTC greater authority over foreign boards of trade. Foreign Boards of Trade will need to register with the CFTC in order to provide electronic access to U.S. participants. In order to register with the CFTC, the foreign board of trade must adopt position limits for contracts that are linked to a contract traded on a U.S. DCM.[5] The OTCDMA goes further than linked contracts, however, and gives the CFTC the authority to set position limits on ***any contract*** traded on a foreign board of trade that is offered to U.S. market participants.[6]

While placing position limits on U.S. market participants trading in contracts ***linked to*** a contract traded on a U.S. exchange is appropriate, allowing the CFTC to place position limits on foreign exchange contracts that have no nexus or "linkage" to U.S. traded contracts presents serious issues. For example, if a foreign exchange offered access to U.S. market participants to a contract that was not linked to a U.S. traded contract, under the OTCDMA the CFTC rather than the foreign exchange regulator would set position limits. The provision would allow the CFTC to set aggregate position limits on traditionally sovereign contracts such as German bonds or Asian currencies. This would be unacceptable to the foreign government regulating a market, would invite retaliation by foreign regulators against U.S. exchanges, and would impede regulatory cooperation among governments in what is today a global financial market. Congress should eliminate this provision from the OTCDMA since it does not pertain to the stated goals of the proposal.

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. Subject to the foregoing considerations which should be addressed by Congress in any final legislation, the OTCDMA offers many improvements to the existing regulatory framework in enhancing market transparency and eliminating elements of systemic risk from the financial system.

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

The CHAIRMAN. Thank you very much Mr. Short.

Mr. Budofsky.

STATEMENT OF DANIEL N. BUDOFSKY, PARTNER, DAVIS POLK & WARDWELL LLP, NEW YORK, NY; ON BEHALF OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. BUDOFSKY. Thank you, Mr. Chairman. As you noted, I am Dan Budofsky. I am a Partner at the law firm of Davis Polk & Wardwell, and I am here today to testify on behalf of the Securities Industry and Financial Markets Association.

Thousands of Americans companies use over-the-counter derivatives to manage the financial risks inherent in their businesses. Many SIFMA members have built successful businesses by offering derivatives products to these companies. It is therefore in their interest, as well as in the interest of their customers, to support legislative and regulatory measures to improve the integrity, soundness and efficiency of the OTC derivatives markets.

[5] OTCDMA, Section 725. ICE's London-based subsidiary, ICE Futures Europe, complies a similar requirement through its "no-action" letter.

[6] OTCDMA, Section 723.

There is much in the Act that SIFMA supports. SIFMA supports comprehensive regulatory oversight of systematically significant derivatives dealers. SIFMA also supports regulatory transparency as a means to facilitate oversight of derivatives markets and the activities of individual market participants. The Act would accomplish these goals by requiring that swaps either be cleared through a derivatives clearing organization, or be reported to a swap repository, the CFTC or the SEC. And standardized swaps would be required to be cleared.

The Act goes much further than this, however, and I will briefly touch upon several aspects of the Act that concern SIFMA and its members.

First, SIFMA does not believe that legislation should mandate exchange trading rather than over-the-counter trading for derivatives. The Act seems to reflect the view that transparency and risk reduction are best achieved through exchange trading. SIFMA believes, instead, that these goals are achieved through regulatory access to market information and clearing, regardless of the trading environment. For example, the U.S. bond market is overwhelmingly over-the-counter, yet it is transparent and well regulated.

SIFMA is also concerned about the Act imposing burdensome regulatory requirements on end-users. For example, the Act could effectively force certain end-users to submit derivatives transactions to clearinghouses. Although there is an exception to the mandatory clearing requirement for standardized swaps, if one of the parties is neither a dealer nor a major swap participant, this is only available if that party also fails to meet the eligibility requirements of the clearinghouse, which could be unlikely for many large end-users.

Moreover, the definition of *major swap participant* is so broadly and vaguely drafted that it could easily pick up many end-users. Either way, an end-user might be compelled to submit particular transactions through a clearinghouse, thereby incurring significant costs including the not insignificant opportunity cost of posting margin in the form of cash or cash equivalents.

Another area of concern is margin. Under the Act, regulators may, but would not be required to impose a margin requirement on noncleared transactions, and would be required to if the end-user falls within the definition of *major swap participant* or the transaction does not qualify for hedge accounting under FAS 133. This means that an extension of credit created through a swap transaction must be collateralized under the Act even though most other extensions of credit between the parties could be made on an unsecured basis.

SIFMA is also troubled by the Act's requirements of additional capital for cleared transactions. Clearing reduces risk by creating a well-capitalized central counterparty and by requiring margin. Policymakers should be concerned about imposing unnecessary costs that could discourage prudent risk management.

I would also like to point out that the Act is written to preclude any use of exemptive authority by the agencies. This is unduly restrictive and would mean that legitimate practices arising in the future that were never intended to be covered by the Act might be affected, leading to unintended consequences. A better approach might be to permit the agencies to grant appropriate exemptions, but regularly report to Congress to ensure that they are granted in accordance with the intent of lawmakers.

Finally, SIFMA is concerned that the 180 day transition period would not give the market sufficient time to comply with the Act's complex and far-reaching provisions. SIFMA believes that the effective date should be no less than 1 year after enactment.

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

However, derivatives have become an integral part of our economy, and they play an important role in the risk management efforts of commercial companies across the country. As such, it is important that legislation intended to improve derivatives regulation and reduce systemic risk does not unnecessarily impair the usefulness of derivatives, and thereby, increase the risk exposure of many of the companies that have come to depend on them.

Thank you.

[The prepared statement of Mr. Budofsky follows:]

PREPARED STATEMENT OF DANIEL N. BUDOFSKY, PARTNER, DAVIS POLK & WARDWELL LLP, NEW YORK, NY; ON BEHALF OF SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Chairman Peterson, Ranking Member Lucas, and Members of the Committee:

My name is Dan Budofsky. I am a partner of the law firm Davis Polk & Wardwell LLP. I am appearing today on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1] and its members. Thank you for your invitation to testify today.

The membership of SIFMA is diverse and includes financial firms of different sizes as well as firms that are active in different parts of the financial services business. Although my testimony today is being presented on behalf of financial services firms, it also is focused on the interests and concerns of those firms' customers, the thousands of American corporations that benefit directly from the broad availability of derivatives transactions to manage various risks that arise in connection with their day-to-day business activities. These companies also benefit indirectly from the availability of over-the-counter derivatives (OTC derivatives) such as credit default swaps, which make credit more readily available to them and at lower cost because it permits those who extend credit to those companies to hedge their risks as well. SIFMA's members have built successful derivatives businesses by offering products that meet important needs of their customers, and it is in their interest to support legislative and regulatory measures that will improve the integrity, soundness and efficiency of the OTC derivatives markets on which their businesses are based. Such measures serve the interests of all market participants—the dealers and their customers—and the American public, as well.

Indeed, fifteen major OTC derivatives dealers, in a recent letter to the Federal Reserve Bank of New York, committed to clear 90% of all new eligible interest rate derivatives and 95% of all new credit default swaps through centralized counterparties by December and October 2009, respectively. This, along with working with lawmakers and regulators, will help achieve the laudable goals of increas-

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington, DC, and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at *http://www.sifma.org*.)

ing regulatory transparency and reducing systemic risk in the OTC derivatives market.

At the same time, SIFMA's members are concerned about legislative proposals that would unnecessarily diminish the usefulness of available derivatives or limit the availability of useful derivatives by imposing significant new costs or limitations in connection with their use.

There is much in the Over-the-Counter Derivatives Markets Act of 2009 (the "Act") that SIFMA and its members support. In particular, SIFMA supports legislative proposals to ensure that systemically significant derivatives dealers are subject to comprehensive regulatory oversight. The lack of meaningful regulation of AIG's derivatives affiliate allowed poor business practices to go unchecked and ended in a situation in which the Federal Government had to invest tens of billions of dollars in that enterprise. Legislation that implements comprehensive regulatory oversight of systemically significant firms would address this regulatory gap.

SIFMA also supports measures that will improve regulatory transparency and thereby facilitate oversight of derivatives markets and the activities of individual market participants. The Act would accomplish this by requiring that swaps either be cleared through a derivatives clearing organization (a "DCO") (in fact, if they are *standardized* they would be required to be cleared through a DCO) or be reported on a post-trade basis to a swap repository or the CFTC. Similar requirements, including reporting to the SEC, would be imposed under the Act with respect to security-based swaps. SIFMA believes that by combining regulatory transparency with oversight of systemically important firms, the Act addresses the regulatory shortcomings that allowed the AIG situation to threaten the global financial system.

The Act goes much further than this and, in so doing, could adversely affect the availability and usefulness of derivatives transactions. I will briefly describe several of the issues in the Act that SIFMA has identified as particularly problematic.

The Act mandates that all swaps that are standardized be traded on an exchange or an alternative swap execution facility. SIFMA believes that the legislation incorrectly views transparency and risk reduction as being achievable solely through exchange trading, but these goals can be achieved through other means. SIFMA does not believe there is any reason for the government to mandate that business be transacted in this particular manner. In the equity markets we have both exchange trading and over-the-counter trading. The policy goals of transparency and systemic risk reduction are achieved by timely post-trade price reporting and clearance of transactions effected by broker-dealers through registered clearing agencies. It has long been recognized that while an exchange is a facility for transacting business that provides buyers and sellers with a place to meet, it is by no means the only way for transactions to occur. Highly liquid, frequently traded products may benefit from exchange trading, whereas it may be more appropriate for products that trade less frequently to trade over-the-counter. For example, the U.S. bond market is an overwhelmingly over-the-counter market, yet it is transparent and well-regulated. Bond transactions are reported to trade reporting facilities that make the execution prices available to regulators for surveillance purposes. Bonds clear through clearing agencies such as DTCC that provide a central counterparty, and this performs an essential risk mitigation function.

SIFMA also is concerned about the application of the Act's many regulatory provisions to the customers of derivatives dealers, the corporations that use derivatives. For example, the Act would effectively require corporate end-users to become members of registered clearing agencies. Let me explain why. The Act includes an exception to the mandatory clearing requirement for standardized swaps in the case of transactions in which one of the parties is not a dealer or major swap participant (*i.e.,* is a corporate end-user), but only if that party *also* does not meet the eligibility requirements of the clearinghouse. The definition of major swap participant is so broad and vague that it could easily include many corporate end-users, and the eligibility requirements of clearinghouses will not necessarily constitute a significant hurdle, particularly insofar as they are profit-making entities eager to expand their businesses. If corporate end-users were required to clear their standardized swaps they would incur the very significant cost of posting margin in the form of cash or cash equivalents, which is the form of collateral required by clearing agencies. Because these funds would no longer be available for productive investment in the corporate end-user's business, a clearing requirement would create a significant disincentive to use swaps to manage risk. Today, in the OTC derivatives world, corporate end-users may be required by their dealer counterparty to post margin, but that margin may be in the form of assets other than cash or cash equivalents.

Although CFTC Chairman Gary Gensler recently suggested in a letter to Members of Congress that end-users could post margin in the form of assets other than cash, SIFMA does not believe that is a realistic or viable alternative, as it would expose the clearinghouse, which as the central counterparty must be highly liquid, to unacceptable levels of risk.

Another example of the Act's potential impact on end-users arises in connection with margin requirements. Although regulators are not required to impose a margin requirement on end-user transactions that are not cleared, the Act says they *may* do so, and *would be required to* if the end-user falls within the definition of major swap participant or the transaction does not qualify for hedge accounting treatment under FAS 133. This means that an extension of credit created through a swap transaction must be collateralized, even though most other extensions of credit between the parties could be made on an unsecured basis.

In short, SIFMA does not believe that corporate end-users, as opposed to professional market participants such as swap dealers, should be subject to burdensome new regulatory requirements in connection with their swap transactions. If they are, the result will likely be that they are exposed to more risk, not less.

SIFMA members also are concerned about the imposition of incremental capital requirements with respect to their cleared swaps. The clearing process makes these transactions less risky. Market participants benefit by gaining a well-capitalized clearinghouse as a counterparty and by the clearinghouse's requirement that all of its transactions be secured by margin. The addition of a further safeguard by imposing the requirement of additional capital for cleared transactions seems unnecessary, in particular because the cost of each of these layers of protection is directly borne by the dealers, and ultimately by their customers. Policymakers should be concerned about imposing a level of cost that discourages prudent risk management. Giving the CFTC, the SEC, and prudential regulators the general authority to establish capital requirements would seem to be sufficient.

SIFMA also has a practical concern about the short implementation time provided in the Act. Its provisions are to become effective 180 days after the date of enactment. SIFMA does not believe this would give derivatives dealers and other swap participants sufficient time to comply with the Act's complex and far-reaching provisions. SIFMA believes that the effective date should be no less than 1 year after the date of enactment.

In conclusion, Mr. Chairman, I would like to reiterate the support of SIFMA and its members for legislation to address weaknesses in the current regulatory framework for derivatives transactions. The events of the past year have made it clear that improvements are needed. However, derivatives have become an integral part of our economy and they play an important role in the risk management efforts of commercial companies across the country. As such, it is important that legislation intended to improve derivatives regulation and reduce systemic risk does not unnecessarily impair the usefulness of derivatives and thereby increase the risk exposure of the many companies that have come to depend on them.

The CHAIRMAN. Thank you.

I thank the panel for your patience in sticking with us here.

Mr. O'Connor, I was reading your testimony. I want to try to understand better what you are saying. From what I can gather, you are saying that what we heard from the end-users on the first panel was maybe more dramatic than you think it really is. Am I right about that?

You seem to think that clearing is not as big a problem as some people are make making it out to be. Am I reading that right?

Mr. O'CONNOR. I think there are two issues that people have with clearing, and the panel this morning dealt predominantly with the cost of clearing.

There is a cost to central clearing, but there is also great benefit to it. So, it is difficult to sit in this room and say, I would like to see more transparency in my markets, I would like to be protected from systemic risk, and I would like to see more done about abuses in the market that cause undue volatility, but I don't want to pay anything for it.

So there are benefits.

The CHAIRMAN. Sounds like the health care debate.

Mr. O'CONNOR. I will leave that alone.

So that is one concern. But that comes down to an assessment of the cost in benefits.

And the other concern you have heard, perhaps from this panel, is about concerns around standardization and the loss of the ability to use customized derivatives. That is what I spoke more to in my written testimony and—this morning that that is perhaps a historic perspective, and that as technology and talent is brought to bear on the problem by the industry, that what was once standardized is now a much broader aspect of the market.

The CHAIRMAN. And so in other words you are saying it is not—whatever the standardization, and I am not exactly sure I know what it is—but it is not as hard to do or complicated as some people make out?

Is that what you are saying?

Mr. O'CONNOR. It can be done.

The CHAIRMAN. Can be done?

Mr. O'CONNOR. Yes.

The CHAIRMAN. And the way that the Treasury has put out this proposal in terms of standardization and so forth, you seem to think it might be workable or close to workable?

Mr. O'CONNOR. I think it is a difficult thing to define in legislation, and you need to be careful that unintended consequences don't happen.

But, the presumption that if a regulated clearinghouse is able to offer a product for essential clearing, then it is standardized, I think is a good one. It doesn't force the industry to do something they don't feel they have the capability to do. It already falls within regulatory oversight, and it adapts dynamically to the marketplace. As new products comes on line and as new capability is developed, it tends to roll with the punches.

The CHAIRMAN. And the clearinghouses, I guess they have a business model and they do things a certain way. From what I can tell, some of these end-users, they put up collateral, but they do it a different way than they do it in clearinghouses, and that seems to be the bigger part of the problem than anything.

And that can't be dealt with?

Mr. O'CONNOR. I think it can be dealt with. There is a layer between the clearinghouse and the end-user.

The CHAIRMAN. That is what I was wondering. Couldn't you do that?

Mr. O'CONNOR. Yes, there is a clearing agent within sort of most CFTC-regulated clearinghouses; that is the futures commission merchant. They are able to offer secured financing to their customers to support margin requirements. A good majority of those futures commission merchants are banks, so there is certainly capability there for the industry to respond to the needs for financing secured—to support those positions.

The CHAIRMAN. So this idea that they are going to have to put up cash for the margins and that is inflexible is not necessarily true. There is some flexibility there; you could do it a different way.

Mr. O'CONNOR. There is flexibility there, yes.

The CHAIRMAN. It maybe isn't done that much now, but it could be done.

Mr. O'CONNOR. I think the people who participate in those markets, as they currently stand, probably are in a better position to provide cash. But secured financing does happen today, and there is no reason why that offering couldn't be expanded.

The CHAIRMAN. If they are making a deal in the swap market using this, and it works, and the people that are doing the deal think that they are covered, I don't see why it couldn't be done, or on a more organized clearinghouse order. That has been my question.

So you say it probably could be done?

Mr. O'CONNOR. Yes. There are a few more restrictions on it, so you can't finance it outright. You can't just lend them the money to support the transaction, but it is sort of a stronger system.

The CHAIRMAN. And in your testimony you said that five of the banks are now doing 96 percent of this customized business; am I right about that?

Mr. O'CONNOR. I think that the statistic is from the Comptroller of the Currency. In his latest statistical release it suggests that of the U.S. banking system, 96 percent of the current notional outstanding is held by the largest five banks.

The CHAIRMAN. We have actually concentrated the risk now into fewer banks, and we have actually—it sounds to me like we have gotten ourselves in a worse situation than we were in before.

Mr. O'CONNOR. I think that is true. I think that the OTC derivative markets pose a larger risk to our financial system now than they did before the crisis began. I think you have greater concentration in the markets; you have less liquidity in the market, some of which we have heard about this morning; and that is a bad situation.

The CHAIRMAN. Mr. Pickel.

Mr. PICKEL. If I may elaborate on that, the OTC's statistics include the banks, so it includes JPMorgan and Citi, Wells, Wachovia and Bank of America and that is four of the five; I forget what the fifth one is. But that is the U.S. banks, so it doesn't include Deutschebank, it doesn't include the foreign banks. It actually doesn't include Morgan Stanley or Goldman Sachs either, so there is a slightly larger—probably 10–12, especially in the interest rate swaps, where these banks are more than willing to step in and take over business from any of their competitors.

The CHAIRMAN. So if you take out the interest rates, is it all right if I go? The interest rate swaps, that stuff is more vanilla than these other customized things, or more exotic things. If you set that aside and these other CDSs and so forth, I am more concerned about what is the percentage, what number of banks are engaging in that process. The same 10 or 12 entities?

Mr. PICKEL. Yes, all of these institutions would be very active dealers in CDS, and CDS volumes are—we just published information this week—$31 trillion notional amount not the amount at risk, but the outstanding amount of trades, there has been a great effort to reduce those outstandings over the past year, year and a half.

But that is the same universe of institutions that would be offering those trades.

Mr. O'CONNOR. If I can just add something, I think Goldman Sachs, now that they are a bank holding company, they are in those numbers.

But it is true that there are other international banks that aren't captured by the OCC, but you see the same in the BIS statistics, which is—aggregation of all the central banking data on market concentration shows that concentration is higher than it has been. And of particular concern is, concentration in the U.S. market is much higher than it has been, and it has fallen behind other competitive marketplaces. So while it might overstate it slightly to talk just about U.S. banks, the U.S. market itself does demonstrate this.

The CHAIRMAN. Thank you.

The gentleman from Oklahoma.

Mr. LUCAS. Thank you Mr. Chairman, and to continue for a moment along this line, does anyone else on the panel have any comments about this subject?

Fair enough. Then let's visit for a moment about the Treasury proposal granting aggregate position limited authority to regulators to impose limits across all markets. Provide me with your insights, gentlemen. How many of you support that? How many have opinions about that, how it would work or not work?

It is a nice open-ended question, I promise.

Mr. PICKEL. I will jump in here.

Yesterday, the CFTC had their Energy and Environmental Market Advisory Committee meeting, and there was discussion of position limits there and obviously they are focused on that. As I pointed out, the OTC contract again is a bilateral contract tailored to the particular needs of the counterparty. To the extent it is mirroring an exchange traded contract, there may be some ability—effectively it is a look-alike contract, and you could aggregate those positions. But the reality is that the bilateral nature of it makes it very difficult, and the custom tailored nature of it makes it very difficult to compare it with the exchange trading contracts.

And there are also issues in terms of how you would aggregate those with the exchange traded world. And, there have been suggestions that it would be aggregated with overseas contracts also.

Mr. LUCAS. Anyone else?

Mr. SHORT. Speaking on behalf of ICE, we would support position limits across various venues and markets. We do have a view that the Commission should be the body that administers that in order to have a fair and competitive landscape amongst trading venues.

One particular piece of the proposed legislation that I think is problematic, I candidly think was an oversight. They actually had a provision that says that the CFTC could impose a position limit on a contract traded on a foreign board of trade that isn't a look-alike that is linked to a domestic market, and I think that is problematic.

Mr. DAMGARD. And I would agree with that. I think—we are going to need a lot of cooperation between foreign regulators, it seems to me. Both Europe and London have been on record as saying that they have a lot of different ways to detect manipulation, and they are pleased to know that the U.S. regulator is going to depend on position limits, but in each case they said that they are not. And it worries me that if we have position limits imposed on U.S. exchanges, but without the reach to do it outside the United States, we damage the opportunity for U.S. exchanges to continue to get the kind of business that they are getting today.

Mr. DUFFY. Mr. Lucas, also on that point, position limits; the CME Group has supported aggregated position limits as long as there is a formula based on how you come to those position limits. We believe that it has to have, and we have it spelled out in our white paper, that it has to be based off of certain criteria of open interest, which are open positions on the exchange at the time.

So the work that we put into development of all these products historically, just can't—you can come up with an arbitrary number that everybody gets the same number, and then that would literally disenfranchise a group like CME Group that has worked very hard to put these positions on its books and serve its clients.

So we would be at a huge disadvantage if the aggregation amongst position limits wasn't done at least on a formula base which made sense from a business perspective.

Mr. SHORT. I would just add that that is the issue that we think makes that proposal anti-competitive on its face, because if you were to apply an open interest test to the positions that could be held on an exchange, a new entrant to the market could never compete. It could never generate sufficient liquidity to compete with the incumbent.

Mr. DUFFY. That is totally not true. There have been many examples, sir, historically of competing exchanges listing other exchanges' product and becoming quite successful.

One of them is the IntercontinentalExchange listing the WTI contract of the New York Mercantile Exchange and gaining a 30 percent market share quite rapidly.

So there are many examples how new companies can come into this space and become quite successful. But we don't believe it should be at the expense of noncompetitive business. Thank you.

Mr. LUCAS. You have both made your points very well and clear.

Mr. Damgard, in your testimony, you mentioned about how the standardization mandate should be replaced by incentives on trade, on exchanges, and through clearing systems. Could you expand just a moment on this concept of incentives to cause behavior?

Mr. DAMGARD. Well, I mean, for the most part, we believe that the exchange traded world works extremely well. And we know that it works well because it takes on an awful lot of risk that is done in the OTC market.

Defining *standardization* is pretty tricky. What really constitutes standardization in a product is not something that we are totally comfortable can be done in a statute. We think the CFTC should have the authority to look at what is standardized and what is not standardized.

But to the extent that an OTC product is accepted by a clearinghouse, that, we believe, is Treasury's position, that therefore it should be considered standardized, and that is good enough for us. We are not sure that it is necessary to mandate that it be cleared, because, in some instances, clearinghouses and clearing members ought to be able to determine what they want to clear.

I mean, these are voluntary organizations. And if, all of a sudden, the clearinghouses are forced to clear products that they can't value and they can't margin, it seems to me the clearing members have almost an obligation to their own stockholders to withdraw from the clearinghouse, which would be catastrophic in the long run.

Mr. LUCAS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Iowa, Mr. Boswell.

Mr. BOSWELL. Well, thank you, Mr. Chairman. I want to just take a moment and thank you and Mr. Lucas for the personal effort and attention you are giving to this business that has got a lot of concern.

Earlier today, you made a comment, if I might remind us, not wanting to go back to the system that got us into the trouble that we are in. Last week, about a week ago Monday, talking to a constituent, a small-business owner, very successful small business but it is a small business, and talking about health care, and he said, "Well, are you aware that Wall Street is securitizing life insurance and doing a bundling, if you will, bundles of life insurance?" So we talked about it. I didn't think he probably knew what he was talking about, but he seemed like he does about everything else, so we did a little checking up on it. And almost the same day, *The New York Times* came out with an article called, *Wall Street Pursues Profit in Bundles of Life Insurance.*

And the idea is that you can buy up somebody's life insurance, a half-a-million-dollar policy or whatever policy for half or whatever they can agree on, and take the gamble that they are going to die, and then they can cash it in. But that is not good enough. That is good, just bundle them up and get a bunch of them.

And I would like, I guess, to have you comment on that, what your thoughts of it are. I am going to ask to put into the record this article.

But, the professor from Duke said, "It is bittersweet. The sweet part is there are investors interested in exotic products created by underwriters who make large fees and rating agencies who then get paid to confer ratings. The bitter part is it is a return to the good old days."

Now, I look at this panel—I was hoping Mr. Secretary would be here, but we will address this to him, too, I guess. But do you have an opinion on that? I would like to start with you, Mr. Budofsky, and just anybody else who wants to comment, and just tell us what you think about all that.

Mr. BUDOFSKY. I don't think that—well, I am not aware of SIFMA having a particular position on that particular instrument. So I would be happy to consult with them on that particular instrument.

However, I would say that this is an example of why SIFMA supports general improved regulatory oversight over the types of entities that would be selling these products. And, to the extent that there are issues with that type of instrument, then regulatory oversight would be a way of having the regulators express a view.

Mr. BOSWELL. Anybody else? Please.

Mr. PICKEL. Yes, I saw that article. I read it with interest.

I would point out that that is a—well, it is in the nature of a collateralized debt obligation, which is a security, not an over-the-counter derivative product, but a security that is bundled with taking those cash flows from those insurance policies and paying them out to the securities holders. So the securities laws would apply to the offering and distribution of those instruments.

As it relates to OTC derivatives, and it wasn't really discussed in that article, but there is an area, an emerging area of OTC derivatives that is potentially very useful for pension funds and insurance companies, and that is what are often called "mortality derivatives," "life derivatives," where there would be—again, there is the same concern.

A pension fund has a certain horizon, in terms of the expectations about how long somebody will live, and they may live longer than that, so there is a risk there that they need to manage. An insurance company is expecting somebody to live a certain length of time, and they might die sooner, and they would have to pay out sooner than they expected. And there are these instruments, and they are very effective, and they are very tailored to particular needs that allow pension funds, insurance companies to manage that risk in a very effective way.

Mr. BOSWELL. Good point.

I would just say this, Mr. Chairman, the article goes on to say that oftentimes these life insurance policies lapse before a person dies, for a variety of reasons: their children grow up, no longer need the financial protection, or the premiums become too expensive. And sometimes when this happens, the insured doesn't want to keep it going, so the insurer doesn't have to make a payout. But if it is purchased and packaged into a security, investors will keep paying the premium that might have been abandoned.

As a result, more policies will stay in force, ensuring more payouts over time and less money for insurance companies. And what does that do? Well, I guess, currently, when they set their premiums—and they have all these actuarial studies, which you know more about than I do—but they base them on assumptions that were wrong if this takes place.

So I think this needs a little more look. So I would ask if we could enter this into the record, and I would like to do so.

The CHAIRMAN. Without objection, so ordered.

[The document referred to is located on p. 99.]

Mr. BOSWELL. Thank you. I yield back.

The CHAIRMAN. Thank you.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. Thank you for holding the hearing, and thank you for a pretty practical approach to trying to get to the bottom of all this stuff.

All of you heard the first panel testify, I think to a person, that they weren't real thrilled by the notion of being forced to clear. And, Mr. Duffy and Mr. O'Connor, both of you were interested in clearing operations. And you heard them say that they just wouldn't be able to fund it, they wouldn't be able to finance it, they wouldn't be able to get—if they were able to borrow the money for margins, it would be at a very onerous cost.

And then you also heard the representative from Delta saying that, at least in the swaps area, as price moves, there are capital requirements, margining requirements. I guess I would like to hear your thoughts about how onerous this would be.

And then I would like to hear a little bit about tailored swaps. It seems to me there are probably plenty of swaps where the parties agree that they don't put up—it is individually tailored, so why would they be required to put up money as the price moves?

You know, if I am dealing with Goldman Sachs, at least 5 years ago, I probably wouldn't insist that they put something up. I would just assume that this is sort of like, they have the money. And that led us into the AIG mess. And that is the systemic risk we are trying to avoid here.

So, what about the clearing being too onerous? I know you testified, Mr. O'Connor, that there is value to this. But they are grownups; they can decide whether or not they need to have some third party stand good for their swap. If they choose to do a swap, free market, why shouldn't we just let them do a swap and just sort of try and deal with the systemic risk part of it?

Mr. DUFFY. I don't disagree with that. They are grownups, and they can do what they want as a third party. But, there are some misconceptions as it relates to clearing and the costs associated with clearing and collateral.

First of all, the collateral that you put up for margin is not too dissimilar than the collateral you are going to put up for an OTC transaction. So if you put up zero for an OTC transaction, I am assuming the risk around that trade of one person not paying off at the time of maturity could be an issue or a failure in the system.

In the regulated clearing model, you put up that margin money, and if the position goes obviously in your favor, you can take that excess funds and do with them as you see fit, as long as the position stays margined. So there are ways to utilize the capital in the clearinghouse during the point before maturity of the transaction.

So, that is the first and second misconception of what kind of collateral can be accepted for trade, OTC *versus* an exchange. And, second, if you don't put up any collateral for an OTC transaction, I am assuming that—what do you do at the end of maturity? How do you know that your counterparty is going to be good?

Mr. MARSHALL. Well, the counterparty is AIG, so everybody knew it would be good.

Mr. DUFFY. Right. That worked out well.

Mr. MARSHALL. But that is exactly what we are trying to figure out how to avoid that.

Mr. DUFFY. Well, basically, you need to have some kind of capital or margin up there to margin these positions. You just can't have zero up there and then, at the point of maturity, have a default. And then if you do that multiplied by the amount of times, you can see where you are at.

Mr. MARSHALL. Right. And forcing everything through clearing accomplishes that objective.

Mr. DUFFY. No, not everything through clearing.

Mr. MARSHALL. Well, obviously, you can't do—you wouldn't be able to force—but if you could put everything through clearing, you would accomplish the objective of making sure that people, as price moves, that they are required to follow that with appropriate experience.

Mr. DUFFY. That is the risk-management system that the CME deploys, sir, yes.

Mr. MARSHALL. Right. So we recognize that there will at least be custom swaps. It would be very helpful if you could help us understand what the real costs would be and whether or not there would be funding available for these businesses that don't have a lot of excess capital. I mean, you heard that testimony repeatedly. They want to hedge; they don't have excess capital to be tying up in a margin.

Mr. DUFFY. So they are not hedging at all, I am assuming then.

Mr. MARSHALL. No, they do hedge. They just don't have to put a margin up if they are swapping, is what I thought the testimony was earlier.

The CHAIRMAN. Would the gentleman yield——

Mr. MARSHALL. Yes, sir.

The CHAIRMAN.—on that point, if anybody knows?

So these guys that claim they don't have the money and they are doing these hedges, I don't know if they are putting up their equity or whatever they are doing. But the people that are doing the deal are going to, they are not going to do this for free. So what do they do? Do they charge a larger percentage fee then? Is that how they get their money out of this if they are not—how does that work?

Mr. PICKEL. Well, typically, it is a credit relationship, so they would do a credit analysis and determine what type of exposure they are willing to have. There would probably be some pricing element that would reflect the fact that if they are a high-quality counterparty, the pricing would be tighter than a lower-quality counterparty. But I think——

The CHAIRMAN. But the counterparty is actually putting up the money. The person that is hedging is not putting up any money. So they are going to charge for that, too, then, I suppose.

Mr. DUFFY. They are using the company's balance sheet, and the company is charging more for the transaction.

Mr. PICKEL. But I guess one thing, partly in response to you, Mr. Marshall, is that in situations where you have an active trading relationship, this two-way—this is in the bilateral world—the two-way movement of collateral back and forth is extremely common. So between dealers, between dealers and hedge funds, dealers and asset managers who are trading on a pretty regular basis, or even a company like Delta, which sounds like they are a pretty active user of the market, you would typically have collateral in the relationship.

For the occasional user that is maybe accessing the interest rate swap market when it occasionally issues a bond, often the dealer is willing to do that on an uncollateralized basis, where neither party would post collateral.

Mr. MARSHALL. I think the reason we are interested here is, we want to get a better handle on whether or not we actually are going to screw people up, somehow impair significantly their ability to hedge risk or burden them too much. And you can help us do that by helping us understand this.

And if, in fact, in the swaps world, effectively the same level of security is presented, as a result of margining going back and forth or collateral going back and forth in order to secure performance in the event of price changes, as things move forward, that is happening anyway, then what does clearing add? And here is what I suspect: is that it happens depending upon who the parties are.

I am Delta. It is 5 years ago or 10 years ago when Delta is blue chip, and I am dealing with AIG or I am dealing with Goldman Sachs, blue chip also. I am able to hedge at very little or no expense and with very little or no collateral moving back and forth as price changes. But I am able to say to my board or whoever, "Yes, we have hedged that."

Am I right? It is really dependent upon what the parties wanted to agree to as between themselves?

Mr. PICKEL. That is right. It is left to a bilateral negotiation.

Mr. MARSHALL. So where the systemic stuff is concerned, our concern is that we are concentrating this risk in these large banks, 5, 10, 12, something like that. You know, the sense that I get as I talk with the Chairman and others, and as we talk to our European regulators, all of us have the sense that there has to be something besides the inclination of the parties at that level to put up appropriate collateral, that we have to have something that assures that that occurs.

Now, if we were able to force everything to be cleared, then the clearing agency would wind up making sure that appropriate flows of collateral go back and forth, so that there is not any AIG-type event. Everybody concedes, though, that we can't do that, because there are just going to have to be custom swaps that won't fit in a clearing setting, and we don't want to force the clearing agencies to have to clear when they don't want to. So there is going to be a bunch of stuff out there.

So how do we, as regulators—how are we assured, as regulators, unless we have something like the President's proposal, that, in fact, appropriate collateral is moving back and forth so that the systemic risk stuff doesn't come up?

Mr. PICKEL. I think one of the key definitions is the definition of *major swap participant,* which when we have been discussing with the Treasury earlier in the summer that was kind of intended to be the AIG provision, the one that would capture the next AIG. And I think, therefore, it is a very important definition.

It is a bit unclear as to what it is intended to mean in the Treasury proposal, because it talks about a substantial net position. Well, AIG's situation was, yes, they had a large net position, but really they were just taking on one-way risk, and that was really the problem. And they didn't fully understand or analyze that risk, which augmented the problem.

I think that is a pretty important definition. But it is important to get it right so you don't sweep in institutions that really are just actively trading and may not be particularly long or short position at any particular point in time.

Mr. DUFFY. Congressman, if I may add when this crisis all happened, I think that—and I am just talking as a citizen now and as a taxpayer—that these transactions were going to be required to have more collateral associated with them so we would not have the risk with it. We wouldn't be using leveraged balance sheets for these transactions, as we have over the past, in the future. So I am assuming that is it.

So if people want to continue to trade customized swap transactions, which I think they should be able to do, I am assuming the government is going to have different capital requirements for people that want to participate in that type of venue *versus* what they were doing before.

And if you want to trade or clear your product on an exchange and let the exchange be the neutral facilitator or the buyer for every seller, the seller for every buyer, you could put up the margin and take the excess margin and do with it as you please to manage your business.

So I assume that is what the path was going down when this all happened.

The CHAIRMAN. Could I—we have Members who want to catch planes. So, the gentleman from Georgia, Mr. Scott

Mr. SCOTT. Thank you very much, Mr. Chairman. And I appreciate the panelists coming and your holding the hearing.

You know, we have basically three proposals here—you have Treasury's proposal; we have our own, H.R. 977; and then, again, in my Financial Services Committee, we have another bill—all working to increase regulation, transparency, and oversight of the over-the-counter market. I want to try to narrow mine into an issue within the Treasury Department's proposal.

It seems that Treasury intended to give clearinghouses the ability to allow end-users to move swaps transactions from one clearinghouse to another. But, as it is done currently, the CEA gives clearinghouses the ability to treat transactions as fungible. So it seems no change to current law would be necessary. However, the language in Treasury's proposal could be read to force—to force—clearinghouses to treat transactions as fungible, which could have a negative systemic risk implication.

Mr. Short, let me ask you—because I believe that you mentioned this as a part of your concerns over Treasury's proposal, if I am correct—would you mind elaborating on this point?

Mr. SHORT. Sure. I think the language in the Treasury proposal talks about fungible clearing and margin offsets for swaps. And I have heard some background information that that may not have been the true intent of that provision, that it may have actually just meant that if you were trading through one electronic avenue into a clearinghouse you could trade out on another.

But that language, as written, could provide for or be interpreted to require one clearinghouse to provide margin offsets in another clearinghouse. And what you run into there is, kind of, the linkage problem. I have to be confident that Terry's clearinghouse is run properly—not that I think his clearinghouse is a problem. But when you multiply that out over a number of clearinghouses, some of which may be domestic, some of which may be foreign, you can quickly see how this could, instead of isolating risk and allowing a clearinghouse to really do what it is supposed to do, it could actually increase systemic risk. And that is why I think that provision should be dropped or clarified.

Mr. SCOTT. And so how would you say it would be clarified or dropped? Is there specific language? Is there something that you would suggest in that?

Mr. DAMGARD. I actually think the language says that a clearinghouse has to accept trades from multiple execution facilities, which would create the fungibility at the clearinghouse.

Mr. SCOTT. Do you agree with that, Mr. Short?

Mr. Duffy, I would also like for you to comment on this. You are with the Chicago Mercantile Exchange.

Mr. DUFFY. Yes, sir.

Mr. SCOTT. So are you——

Mr. DUFFY. I agree with Mr. Short on this topic right now. And we actually have submitted language to the Committee, supplemental language, and to the Treasury on this issue because we agree with you, sir, it can be—I guess it is up to the person who reads it as to how they are going to determine it, and that is not good legislative language. So we think we want to have clarity.

We do not want to put the CME Group's clearinghouse at risk by accepting the credit risk of another clearinghouse, whether it be ICE or somebody else, as the same way they don't want to accept the credit risk of the CME.

So what the language says is, the fungibility should be amongst trading platforms, not among clearinghouses. But, as I said in my oral testimony, it could be interpreted that—and other people are trying to force it to a single clearinghouse, which is what Mr. Short is saying.

So we would love to see the language changed. And we have submitted it, and we would be happy to send it to your office, sir.

Mr. SCOTT. I agree with you. I think, Mr. Chairman, that that makes a lot of sense. I think you would agree to that.

Was there something else you wanted to say there?

Mr. DAMGARD. No, I understood the language, and I agree that it is confusing. But, what the Treasury was trying to do was say, any clearinghouse, not just one or not just two, but any clearinghouse would have to accept trades from all of the execution facilities if, in fact, it was the same product. And I am not sure if that is accurate or not.

Mr. DUFFY. No disagreement, as long as it is from the trading facility, not from the clearing entity. And that is the big distinction that we need to have clarity here, sir, because it is very fuzzy, as Mr. Damgard said earlier in his testimony.

Mr. SCOTT. Very good.

Let me ask a follow-up, if I may, Mr. Chairman, one little thing here.

The CHAIRMAN. We are running short of time, so be very brief.

Mr. SCOTT. I will be very brief.

Mr. Short, I believe you also expressed concern about the Administration's proposal covering foreign boards of trade and how position limits would apply to certain contracts, particularly those that are not tied to United States-based contracts.

Given your experience with foreign boards of trade at ICE, could you elaborate the concerns laid out in your testimony very briefly?

Mr. SHORT. Yes. Very briefly, we operate ICE Futures Europe, which is a London-based exchange. It was the former International

Petroleum Exchange. It is basically the European equivalent of the NYMEX.

While we understand the need for position limits on linked contracts, which we have several in that there is a price linkage to contracts traded on the NYMEX. I think the language in the Treasury proposal doesn't limit the CFTC's authority to set position limits across venues to link contracts.

So you could have, for example, our Brent Crude Futures contract subject to a CFTC position limit, and I think the FSA would have an issue with that, as the CFTC would have an issue with a foreign regulator attempting to set a position limit on a domestic contract.

Mr. SCOTT. All right. Thank you, Mr. Chairman. I appreciate that.

The CHAIRMAN. I thank the gentleman.

We have to move it along. So we thank this panel for their patience and for their testimony and the answers to our questions.

Now, before I adjourn, does the Ranking Member have any comments?

Mr. LUCAS. No, Mr. Chairman.

The CHAIRMAN. Okay.

Under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material, supplementary written responses from the witnesses and to any question posed by a Member.

And this hearing of the Committee of Agriculture is adjourned.

[Whereupon, at 3:12 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED MATERIAL BY HON. LEONARD L. BOSWELL

Wall Street Pursues Profit in Bundles of Life Insurance

The Wall Street Journal

September 6, 2009

By: JENNY ANDERSON

After the mortgage business imploded last year, Wall Street investment banks began searching for another big idea to make money. They think they may have found one.

The bankers plan to buy "life settlements," life insurance policies that ill and elderly people sell for cash—$400,000 for a $1 million policy, say, depending on the life expectancy of the insured person. Then they plan to "securitize" these policies, in Wall Street jargon, by packaging hundreds or thousands together into bonds. They will then resell those bonds to investors, like big pension funds, who will receive the payouts when people with the insurance die.

The earlier the policyholder dies, the bigger the return—though if people live longer than expected, investors could get poor returns or even lose money.

Either way, Wall Street would profit by pocketing sizable fees for creating the bonds, reselling them and subsequently trading them. But some who have studied life settlements warn that insurers might have to raise premiums in the short term if they end up having to pay out more death claims than they had anticipated.

The idea is still in the planning stages. But already "our phones have been ringing off the hook with inquiries," says Kathleen Tillwitz, a senior vice president at DBRS, which gives risk ratings to investments and is reviewing nine proposals for life-insurance securitizations from private investors and financial firms, including *Credit Suisse.*

"We're hoping to get a herd stampeding after the first offering," said one investment banker not authorized to speak to the news media.

In the aftermath of the financial meltdown, exotic investments dreamed up by Wall Street got much of the blame. It was not just subprime mortgage securities but an array of products—*credit-default swaps,* structured investment vehicles, *collateralized debt obligations*—that proved far riskier than anticipated.

The debacle gave financial wizardry a bad name generally, but not on Wall Street. Even as Washington debates increased *financial regulation,* bankers are scurrying to concoct new products.

In addition to securitizing life settlements, for example, some banks are repackaging their money-losing securities into higher-rated ones, called re-remics (re-securitization of real estate mortgage investment conduits). *Morgan Stanley* says at least $30 billion in residential re-remics have been done this year.

Financial innovation can be good, of course, by lowering the cost of borrowing for everyone, giving consumers more investment choices and, more broadly, by helping the economy to grow. And the proponents of securitizing life settlements say it would benefit people who want to cash out their policies while they are alive.

But some are dismayed by Wall Street's quick return to its old ways, chasing profits with complicated new products.

"It's bittersweet," said James D. Cox, a professor of corporate and securities law at *Duke University.* "The sweet part is there are investors interested in exotic products created by underwriters who make large fees and rating agencies who then get paid to confer ratings. The bitter part is it's a return to the good old days."

Indeed, what is good for Wall Street could be bad for the insurance industry, and perhaps for customers, too. That is because policyholders often let their life insurance lapse before they die, for a variety of reasons—their children grow up and no longer need the financial protection, or the premiums become too expensive. When that happens, the insurer does not have to make a payout.

But if a policy is purchased and packaged into a security, investors will keep paying the premiums that might have been abandoned; as a result, more policies will stay in force, ensuring more payouts over time and less money for the insurance companies.

"When they set their premiums they were basing them on assumptions that were wrong," said Neil A. Doherty, a professor at Wharton who has studied life settlements.

Indeed, Mr. Doherty says that in reaction to widespread securitization, insurers most likely would have to raise the premiums on new life policies.

Critics of life settlements believe "this defeats the idea of what life insurance is supposed to be," said Steven Weisbart, senior vice president and chief economist for the Insurance Information Institute, a trade group. "It's not an investment product, a gambling product."

After Mortgages

Undeterred, Wall Street is racing ahead for a simple reason: With $26 trillion of life insurance policies in force in the United States, the market could be huge.

Not all policyholders would be interested in selling their policies, of course. And investors are not interested in healthy people's policies because they would have to pay those premiums for too long, reducing profits on the investment.

But even if a small fraction of policy holders do sell them, some in the industry predict the market could reach $500 billion. That would help Wall Street offset the loss of revenue from the collapse of the United States residential mortgage securities market, to $169 billion so far this year from a peak of $941 billion in 2005, according to Dealogic, a firm that tracks financial data.

Some financial firms are moving to outpace their rivals. Credit Suisse, for example, is in effect building a financial assembly line to buy large numbers of life insurance policies, package and resell them—just as Wall Street firms did with subprime securities.

The bank bought a company that originates life settlements, and it has set up a group dedicated to structuring deals and one to sell the products.

Goldman Sachs has developed a tradable index of life settlements, enabling investors to bet on whether people will live longer than expected or die sooner than planned. The index is similar to tradable stock market indices that allow investors to bet on the overall direction of the market without buying *stocks*.

Spokesmen for Credit Suisse and Goldman Sachs declined to comment.

If Wall Street succeeds in securitizing life insurance policies, it would take a controversial business—the buying and selling of policies—that has been around on a smaller scale for a couple of decades and potentially increase it drastically.

Defenders of life settlements argue that creating a market to allow the ill or elderly to sell their policies for cash is a public service. Insurance companies, they note, offer only a "cash surrender value," typically at a small fraction of the death benefit, when a policyholder wants to cash out, even after paying large premiums for many years.

Enter life settlement companies. Depending on various factors, they will pay 20 to 200 percent more than the surrender value an insurer would pay.

But the industry has been plagued by fraud complaints. State insurance regulators, hamstrung by a patchwork of laws and regulations, have criticized life settlement brokers for coercing the ill and elderly to take out policies with the sole purpose of selling them back to the brokers, called "stranger-owned life insurance."

In 2006, while he was New York Attorney General, *Eliot Spitzer* sued Coventry, one of the largest life settlement companies, accusing it of engaging in bid-rigging with rivals to keep down prices offered to people who wanted to sell their policies. The case is continuing.

"Predators in the life settlement market have the motive, means and, if left unchecked by legislators and regulators and by their own community, the opportunity to take advantage of seniors," Stephan Leimberg, co-author of a book on life settlements, testified at a Senate Special Committee on Aging last April.

Tricky Predictions

In addition to fraud, there is another potential risk for investors: that some people could live far longer than expected.

It is not just a hypothetical risk. That is what happened in the 1980s, when new treatments prolonged the life of AIDS patients. Investors who bought their policies on the expectation that the most victims would die within 2 years ended up losing money.

It happened again last fall when companies that calculate life expectancy determined that people were living longer.

The challenge for Wall Street is to make securitized life insurance policies more predictable—and, ideally, safer—investments. And for any securitized bond to interest big investors, a seal of approval is needed from a credit rating agency that measures the level of risk.

In many ways, banks are seeking to replicate the model of subprime mortgage securities, which became popular after ratings agencies bestowed on them the comfort of a top-tier, triple-A rating. An individual mortgage to a home buyer with poor credit might have been considered risky, because of the possibility of default; but packaging lots of mortgages together limited risk, the theory went, because it was unlikely many would default at the same time.

While that idea was, in retrospect, badly flawed, Wall Street is convinced that it can solve the risk riddle with securitized life settlement policies.

That is why bankers from Credit Suisse and Goldman Sachs have been visiting DBRS, a little known rating agency in lower Manhattan.

In early 2008, the firm published criteria for ways to securitize a life settlements portfolio so that the risks were minimized.

Interest poured in. Hedge funds that have acquired life settlements, for example, are keen to buy and sell policies more easily, so they can cash out both on investments that are losing money and on ones that are profitable. Wall Street banks, beaten down by the financial crisis, are looking to get their securitization machines humming again.

Ms. Tillwitz, an executive overseeing the project for DBRS, said the firm spent 9 months getting comfortable with the myriad risks associated with rating a pool of life settlements.

Could a way be found to protect against possible fraud by agents buying insurance policies and reselling them—to avoid problems like those in the subprime mortgage market, where some brokers made fraudulent loans that ended up in packages of securities sold to investors? How could investors be assured that the policies were legitimately acquired, so that the payouts would not be disputed when the original policyholder died?

And how could they make sure that policies being bought were legally sellable, given that some states prohibit the sale of policies until they have been in force 2 to 5 years?

Spreading the Risk

To help understand how to manage these risks, Ms. Tillwitz and her colleague Jan Buckler—a mathematics whiz with a Ph.D. in nuclear engineering—traveled the world visiting firms that handle life settlements. “We do not want to rate a deal that blows up,” Ms. Tillwitz said.

The solution? A bond made up of life settlements would ideally have policies from people with a range of diseases—leukemia, lung cancer, heart disease, breast cancer, diabetes, Alzheimer’s. That is because if too many people with leukemia are in the securitization portfolio, and a cure is developed, the value of the bond would plummet.

As an added precaution, DBRS would run background checks on all issuers. Also, a range of quality of life insurers would have to be included.

To test how different mixes of policies would perform, Mr. Buckler has run computer simulations to show what would happen to returns if people lived significantly longer than expected.

But even with a math whiz calculating every possibility, some risks may not be apparent until after the fact. How can a computer accurately predict what would happen if health reform passed, for example, and better care for a large number of Americans meant that people generally started living longer? Or if a magic-bullet cure for all types of cancer was developed?

If the computer models were wrong, investors could lose a lot of money.

As unlikely as those assumptions may seem, that is effectively what happened with many securitized subprime loans that were given triple-A ratings.

Investment banks that sold these securities sought to lower the risks by, among other things, packaging mortgages from different regions and with differing credit levels of the borrowers. They thought that if house prices dropped in one region—say Florida, causing widespread defaults in that part of the portfolio—it was highly unlikely that they would fall at the same time in, say, California.

Indeed, economists noted that historically, housing prices had fallen regionally but never nationwide. When they did fall nationwide, investors lost hundreds of billions of dollars.

Both *Standard & Poor’s* and *Moody’s,* which gave out many triple-A ratings and were burned by that experience, are approaching life settlements with greater caution.

Standard & Poor’s, which rated a similar deal called Dignity Partners in the 1990s, declined to comment on its plans. Moody’s said it has been approached by financial firms interested in securitizing life settlements, but has not yet seen a portfolio of policies that meets its standards.

Investor Appetite

Despite the mortgage debacle, investors like Andrew Terrell are intrigued.

Mr. Terrell was the co-head of *Bear Stearns*’s longevity and mortality desk—which traded unrated portfolios of life settlements—and later worked at Goldman Sachs’s Institutional Life Companies, a venture that was introducing a trading platform for life settlements. He thinks securitized life policies have big potential, explaining that investors who want to spread their risks are constantly looking for new investments that do not move in tandem with their other investments.

"It's an interesting asset class because it's less correlated to the rest of the market than other asset classes," Mr. Terrell said.

Some academics who have studied life settlement securitization agree it is a good idea. One difference, they concur, is that death is not correlated to the rise and fall of stocks.

"These assets do not have risks that are difficult to estimate and they are not, for the most part, exposed to broader economic risks," said Joshua Coval, a professor of finance at the Harvard Business School. "By pooling and tranching, you are not amplifying systemic risks in the underlying assets."

The insurance industry is girding for a fight. "Just as all mortgage providers have been tarred by subprime mortgages, so too is the concern that all life insurance companies would be tarred with the brush of subprime life insurance settlements," said Michael Lovendusky, vice president and associate general counsel of the American Council of Life Insurers, a trade group that represents life insurance companies.

And the industry may find allies in government. Among those expressing concern about life settlements at the Senate Committee hearing in April were insurance regulators from Florida and Illinois, who argued that regulation was inadequate.

"The securitization of life settlements adds another element of possible risk to an industry that is already in need of enhanced regulations, more transparency and consumer safeguards," said Senator Herb Kohl, the Democrat from Wisconsin who is Chairman of the Special Committee on Aging.

DBRS agrees on the need to be careful. "We want this market to flourish in a safe way," Ms. Tillwitz said.

PREPARED STATEMENT OF FRANK KEATING, PRESIDENT AND CEO, AMERICAN COUNCIL OF LIFE INSURERS

September 17, 2009

Hon. COLLIN C. PETERSON,
Chairman,
Committee on Agriculture,
Washington, D.C.;

Hon. FRANK D. LUCAS,
Ranking Minority Member,
Committee on Agriculture,
Washington, D.C.

RE: Regulation of the Derivatives Markets

Dear Chairman Peterson and Ranking Member Lucas:

The American Council of Life Insurers (ACLI) respectfully provides its views on the important dialog in Congress about the appropriate regulation of the derivatives markets. Life insurers are significant end-users of derivative instruments and utilize them to prudently manage the risks of their assets and liabilities, as permitted under state insurance codes and regulations. The composition of life insurers' assets reflects the long-term commitments and stability necessary for life insurers to provide products, such as life insurance and annuities.

Life insurers' financial products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care and disability income insurance. The long-term nature of these products requires insurers to match long-term obligations with assets of a longer duration than most other financial institutions. Derivatives allow life insurers to prudently manage the credit and market risk of their significant portfolios, and concomitantly to fulfill their obligations to contract owners. The regulatory status of derivatives, therefore, is critically important to the life insurance industry.

Some basic background reflecting 2008 data [1] may provide useful scope and context:

- Life insurance industry assets were invested in: corporate bonds (42%); stocks (24%); government bonds (14%); commercial mortgages (7%); other assets (13%);
- Life insurers provide the single largest U.S. source of corporate bond financing;

---

[1] These calculations are based on data from the NAIC and the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S. See American Council of Life Insurers, *Life Insurers Fact Book* (2009).

- Approximately 56 percent of life insurers' $4.6 Trillion total assets in 2008 were held in bonds, with 42 percent composed of corporate bonds; and
- Over 41 percent of corporate bonds purchased by life insurers have maturities in excess of 20 years (at the time of purchase).

Through their investments, life insurers are indispensable to American businesses and governments in cost-effectively raising capital. Moreover, these investments support life insurers' obligations to provide retirement and financial security for millions of Americans. The derivatives markets are instrumental to both of these functions.

Accordingly, in legislative approaches to derivatives regulation, ACLI supports:

- Federal regulation of the derivatives markets and marketplace professionals;
- State insurance department (or any ultimate functional regulator) jurisdiction over life insurers' use of derivatives; and
- Federal preemption of any conflicts in state regulation of the derivatives markets and marketplace professionals.

As a primary source of long-term capital for American businesses and governments, life insurers must be able to responsibly manage portfolio risks within a rational regulatory environment. Life insurers can continue to successfully serve the nation's retirement and financial security with life insurance, annuities and other products through the implementation of a reasonable and responsible legislative approach to derivatives regulation.

We greatly appreciate your attention to our views. Please let me know if you have any questions.

Sincerely,

FRANK KEATING.

SUBMITTED REPORT BY MARK W. MENEZES, DAVID T. MCINDOE, R. MICHAEL SWEENEY, JR., HUNTON & WILLIAMS LLP; ON BEHALF OF WORKING GROUP OF COMMERCIAL ENERGY FIRMS

September 28, 2009

Hon. COLLIN C. PETERSON,
Chairman,
Committee on Agriculture,
Washington, D.C.

Re: Comments on Hearing to Review Proposed Legislation by the U.S. Department of the Treasury Regarding the Regulation of Over-the-Counter Derivatives Markets

Dear Chairman Peterson:

In response to the request for comments made by the House Committee on Agriculture ("Committee") at its September 17, 2009 hearing to review proposed legislation released by the U.S. Department of the Treasury reforming the regulation of over-the-counter ("OTC") derivatives markets, Hunton & Williams LLP hereby submits the enclosed position paper on behalf of the Working Group of Commercial Energy Firms (the "Working Group").

The Working Group is a diverse group of commercial firms in the domestic energy industry whose primary business activity entails the physical delivery of one or more energy commodities to customers, including industrial, commercial and/or residential consumers. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments affecting the trading and hedging of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group sincerely appreciates the opportunity provided by the Committee to present in writing as part of the public record the significant business and policy concerns raised by the Treasury Department's proposed OTC derivatives reform legislation. Should Committee Members or staff have any questions, or if the

Working Group can be of further assistance in any regard, please contact the undersigned at [Redacted].

Sincerely,

/s/ Mark W. Menezes

MARK W. MENEZES,
DAVID T. MCINDOE,
R. MICHAEL SWEENEY, JR.,
Counsel for the Working Group of Commercial Energy Firms.

ATTACHMENT

**POSITION PAPER OF THE
WORKING GROUP OF COMMERCIAL ENERGY FIRMS
WITH RESPECT TO THE
OVER-THE-COUNTER DERIVATIVES MARKETS ACT OF 2009**

I. INTRODUCTION.

The Working Group of Commercial Energy Firms (the "Working Group") is a diverse group of commercial firms in the domestic energy industry whose primary business activity is the physical delivery of one or more energy commodities to customers, including industrial, commercial and residential consumers (each, an "Energy Provider"). Members of the Working Group consist of energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

On August 11, 2009, the Obama Administration issued proposed legislation designed to reform the regulation of over-the-counter ("OTC") derivatives, titled the "Over-the-Counter Derivatives Markets Act of 2009" ("2009 OTC Act"). This legislation introduces a sweeping regulatory framework to prevent future crises in financial markets resulting from excessive risk taking and leverage through the use of complex OTC derivatives. The 2009 OTC Act, however, does not distinguish among the various unique markets in which OTC derivatives are traded, including energy markets. Of particular concern to the Working Group is how the "one-size-fits-all" approach to derivatives regulation embodied in the 2009 OTC Act will affect domestic energy markets.

If the 2009 OTC Act is enacted as currently proposed, U.S. consumers likely will face higher and more volatile prices for energy commodities. Consumers also may have fewer choices in the energy commodities they consume and the vendors from whom they purchase energy products, such as oil for their heating, electricity for their homes, gas for their vehicles, and propane for their stoves.[1] U.S. consumers are the direct beneficiary of (a) the deep, liquid and efficient domestic markets for energy commodities in the United States, (b) the ability of Energy Providers to both hedge and acquire commodities in those markets, and (c) the ability of Energy Providers to create customized bilateral products in various delivery locations. Regulation that imposes additional margin and capital costs, among other things, will adversely affect the liquidity, efficiency, price discovery and product variety in such markets as market participants either withdraw or can no longer participate to the same extent. As the markets become less efficient, the benefits to U.S. consumers erode.

Equally important, the 2009 OTC Act would create a drag on domestic energy markets and the overall U.S. economy. This economic drag runs contrary to the stated economic stimulus, environmental and energy policies of the Obama Administration. Specifically, the 2009 OTC Act would force Energy

---

[1] In his opening statement at hearings held by the Commodity Futures Trading Commission ("CFTC") addressing the imposition of speculative position limits and hedge exemptions in energy commodities markets, CFTC Chairman Gensler expressly recognized the impacts that increased costs can have on U.S. consumers:

> Gasoline prices, for example, can determine whether a family takes a summer vacation. Natural gas futures contracts can affect utility bills, and lack of convergence in the wheat market can shorten a grocery list.

Opening Statement of Chairman Gary Gensler, Hearing of the Commodity Futures Trading Commission, at 1 (July 28, 2009).

Providers to divert capital and operating cash flow away from other critical aspects of their business to support their trading activities.

As more resources are used to support trading activities, they will be unavailable for expansion of energy infrastructure, investment in renewable energy, the maintenance and operation of physical facilities, environmental controls, or research and implementation of new technology (including advances in emission reduction technology and technology designed to operate the electric grid in a smarter, more efficient and more secure manner). The entire U.S. economy will be affected as Energy Providers constrain their businesses to comply with the 2009 OTC Act.

The Working Group generally supports the efforts of the Obama Administration and Congress to reform the derivatives markets to prevent abuses that led to the current fiscal crisis. However, for reasons discussed herein, the Working Group urges the Administration and Congress to carefully tailor the 2009 OTC Act so that it achieves the benefits of market regulation, without imposing unwarranted burdens on domestic energy markets and undue costs on the U.S. economy.

II. DISCUSSION.

A. "ONE-SIZE-FITS-ALL" APPROACH TO DERIVATIVES REGULATION IS NOT APPROPRIATE FOR THE DOMESTIC ENERGY MARKET.

An express policy goal of the 2009 OTC Act is to "guard against activities in those markets posing excessive risk to the financial system." In furtherance of this goal, the 2009 OTC Act imposes regulation over the use of complex derivatives in financial markets, such as credit default swaps, that is designed to minimize "systemic risk" concerns created by the sheer size and the interconnectedness of the U.S. and global financial systems.[2] However, Energy Providers, particularly with respect to their day-to-day hedging of physical delivery obligations, do not create systemic risk to the financial system or within the energy industry of the type and nature that the 2009 OTC Act is intended to prevent.

Energy Providers typically do not play intermediary roles in energy markets. Rather, they function primarily as principals by transacting futures and energy-related derivatives on a daily basis, among other things, to hedge (*i.e.,* mitigate or off-set) the price risk associated with their core business of delivering electricity, heating oil, natural gas, propane, gasoline and other energy commodities at affordable prices to U.S. consumers. In general, the trading activity of an Energy Provider is bounded by its physical portfolio of energy commodities.

Moreover, the operation of assets and related trading activities of one Energy Provider are largely independent of other Energy Providers in the same product markets. A default by an Energy Provider is typically limited to a single firm. The risk that a default by an Energy Provider could result in a total collapse of the financial system itself is virtually non-existent. Also, the risk that a default by an Energy Provider could even result in a total collapse of a particular energy market is very low (if existent at all). This point is reinforced by recent bankruptcies of certain large energy companies during which markets continued to function and energy assets continued to operate and physical delivery obligations continued to be met despite the fact that such energy companies were experiencing financial distress.

Several federal and state agencies already have comprehensive regulatory oversight

---

[2] There is no widely accepted definition of "systemic risk." However, in general terms, "systemic risk" refers to potential harm to an entire system due to the actions or inactions by one or a small group of firms. It is characterized by inter-linkages and inter-dependencies in a system or market, which could potentially cause the entire implosion of that system or market.

responsibilities for energy markets. Thus, Energy Providers typically do not present systemic risk concerns either within or outside of such markets.

Energy Providers rely on a robust and efficient OTC market to mitigate specialized risks. The delivery of energy commodities is intimately tied to physical locations in a way that is different from financial commodities. For example, a provider of natural gas might hedge price volatility at the interconnection point of the local delivery company at which it delivers natural gas or electricity. This interconnection point may be far removed from a liquid trading hub where contracts might be said to be "standardized." If the OTC market diminishes as a result of legislation or agency regulation, firms like the energy provider will have greater difficulty entering into the unique hedges necessary for their businesses. Thus, such legislation and regulation of the OTC market may reduce counterparty risk but at the cost of increasing basis risk (differences between delivery point prices and prices realized at liquid trading hubs) on a systemic basis.

B. DEFINITIONAL CONCERNS.

1. THE DEFINITION OF "SWAP."

The application of the 2009 OTC Act to Energy Providers and other commercial firms that transact in derivative markets to hedge underlying physical commodity positions turns on the definition of the term "Swap" set forth in new Commodity Exchange Act ("CEA") Section 1a(35)(A). Subject to certain enumerated exemptions set forth in new CEA Section 1a(35)(B), this definition broadly captures any product commonly known as a "swap" and virtually any other derivative instrument, including, but not limited to, "energy swaps" and energy-related swaps, such as "weather swaps" and "emission swaps." Given its complex and convoluted nature, this definition creates uncertainty regarding whether a number of transactions that routinely take place in physical wholesale and retail energy markets are "Swaps" as defined in new CEA Section 1a(35) and, therefore, subject to CFTC jurisdiction.

a. Exclusion for Physically Settled Transactions.

The narrow exclusion from the definition of "Swap" set forth in new CEA Section 1a(35)(B)(ii) for "physically settling transactions" presents significant concerns. The express language of this exclusion is limited to "any sale of a nonfinancial commodity for deferred shipment or delivery, *so long as such transaction is physically settled*."[3] Additional clarity is required regarding its intended scope. Specifically, the Working Group is concerned that this definition could be interpreted by the CFTC for purposes of asserting jurisdiction over transactions that are otherwise subject to regulation and oversight by the Federal Energy Regulatory Commission ("FERC"), the Public Utility Commission of Texas ("PUCT"), and State regulators.[4] For example, it does not appear that (i) customized, non-exchange traded energy commodity contracts with an option for physical delivery <u>or</u> financial settlement, and (ii) financially settled contracts indexed to certain wholesale energy markets for cash flow hedge purposes,

[3] Emphasis added.

[4] The PUCT has regulatory oversight responsibility for the wholesale and retail energy markets operated within the Electric Reliability Council of Texas' ("ERCOT") service territory.

both of which are routinely transacted in physical energy markets are excluded from the definition of "Swap."[5]

In addition, it is not clear whether several other contracts essential to the efficient delivery of physical energy products to customers, including U.S. consumers, fall within the exclusion for "physically settling transactions" set forth in new CEA Section 1a(35)(B)(ii). Such contracts may include, but are not limited to, the following: (1) option contracts sold to end-users for the physical delivery of an energy product; (2) contracts (including option contracts) for the transmission or transportation of energy commodities; (3) contracts (including option contracts) with respect to generation capacity; (4) contracts (including option contracts) with respect to storage of energy commodities; and (5) contracts for energy commodities that entail intra-state delivery, transportation or storage.

The definition of "Swap" also creates uncertainty regarding the continued scope and application of the definition of "future delivery" set forth in existing CEA Section 1a(19) and the forward contract exclusion for transactions that are booked out and financially settled. Since its enactment, the CEA has made a distinction between "futures contracts" and contracts for "deferred delivery" (otherwise known as "forward contracts"). Although there has been lingering uncertainty in futures commodities markets regarding what is meant by an "expectation" of physical delivery, *i.e.,* whether the parties "intended" to settle by delivery, it has always been clear that end-users were not actually required to take physical delivery in order to fall within the forward contract exclusion.

Given the policy objectives of the 2009 OTC Act, particularly the goal of preventing systemic risk to the financial system, the Working Group does not believe that an intended consequence of the proposed legislation is to expand the CFTC's jurisdiction over transactions taking place in physical energy markets that are subject to the regulation and oversight of FERC, the PUCT and State regulators. In order to avoid any unintended jurisdictional consequences and to provide regulatory and transactional certainty in energy markets, the 2009 OTC Act should be amended to clarify that the contracts discussed above clearly fall within the physically settling transactions exclusion to the definition of "Swap" set forth in new CEA Section 1a(35)(B)(ii). Alternatively, if Congress were to conclude that such contracts do not come within this exclusion, the 2009 OTC Act should be amended to (a) provide a separate, statutory exclusion for such contracts, or (b) provide the CFTC with unequivocal authority to exempt such contracts from the definition of "Swap."

b. Financially-Settling Transactions Integral to the Operation of Organized Wholesale Energy Markets.

In addition to the foregoing, the definition of "Swap" set forth in new CEA Section 1a(35)(B)(ii) should be amended to expressly and unambiguously exclude **all** financially settling transactions taking place in organized wholesale electricity markets, such as financial transmission rights ("FTRs") and virtual bidding, that are subject to comprehensive regulation and oversight by FERC or the PUCT.[6] Because the definition of "Swap" is so broad, it is not clear whether or not such transactions fall within

---

[5] This issue is of particular concern since Energy Providers and other commercial firms regularly enter into contracts that provide the option of (1) taking physical delivery of a commodity, or (2) "cashing out" and financially settling the transaction as part of resource or supply management arrangements. For example, Energy Providers enter into such transactions in the physical wholesale electricity and natural gas markets, which are subject to FERC jurisdiction under Part II of the Federal Power Act ("FPA"), 16 U.S.C. §§ 824 *et seq*., and the Natural Gas Act ("NGA"), 15 U.S.C. §§ 717 *et seq*.

[6] Such markets are administered and operated by regional transmission organizations (each, a "RTO") or independent system operators (each, an "ISO") subject to FERC jurisdiction under the FPA or ERCOT which is subject to PUCT jurisdiction.

this definition and, thus, would be subject to CFTC regulation as "Swaps." Although these transactions are cash-settled, it is well-established that FTRs and virtual bidding are integral to the structure and efficient operation of FERC and PUCT regulated and organized wholesale physical electricity markets.[7]

The regulation of FTRs and virtual bidding transactions as "Swaps" under the 2009 OTC Act would create significant legal uncertainty and jurisdictional conflicts by exposing such transactions to dual regulation by (a) FERC and the CFTC or (b) the PUCT and the CFTC (as the case may be). If regulated as a "Swap," these transactions would be subject to applicable reporting and recordkeeping requirements proposed in the 2009 OTC Act and, if deemed to be "standardized," they would be subject to mandatory clearing requirements. If these transactions are not deemed to be "standardized," they could be subject to increased capital and margin requirements, as well as other reporting and recordkeeping requirements applicable to derivatives that are not "standardized." This would effectively ignore (a) the important clearing/credit function that RTO/ISOs and ERCOT currently play with regard to parties transacting in their markets and (b) the comprehensive regulatory oversight of FERC and the PUCT.

In light of the foregoing, the Working Group believes that the 2009 OTC Act should clearly and unambiguously state that the CFTC shall not have jurisdiction over transactions conducted in organized wholesale energy markets that are administered in accordance with the terms and conditions of tariffs approved by, and on file with, FERC or the PUCT including, but not limited to, any transactions involving the purchase and sale of (1) FTRs, (2) virtual bidding transactions, (3) physical electricity in organized real-time, hour-ahead, day-ahead, and ancillary service markets, and (4) open access transmission. Moreover, in order to more broadly clarify the scope of the CFTC's jurisdiction under the 2009 OTC Act, the proposed legislation should be amended to include a stand-alone provision that clearly and unambiguously recognizes, without limitation, (a) FERC's exclusive jurisdiction under the FPA and NGA to regulate (i) the sale of physical electricity and natural gas at wholesale in interstate commerce and (ii) the transmission of electricity and transportation of natural gas in interstate commerce, (b) the PUCT's exclusive jurisdiction to regulate similar transactions taking place within the ERCOT market and (c) the exclusive jurisdiction of State regulators (outside of ERCOT) over certain physical energy commodity transactions.

2. DEFINITION OF "SWAP DEALER."

The Working Group is concerned that, when read in conjunction with the definition of "Swap," the definition of "Swap Dealer" set forth in new CEA Section 1a(39) could be broadly construed to cover Energy Providers transacting OTC derivatives to address price risk associated with the purchase, sale and delivery of physical energy commodities.[8] Without greater clarity in the 2009 OTC Act, Energy

---

[7] *California Independent System Operator*, 108 FERC ¶ 61,254 at p. 74 (2004) (explaining that "the virtual bidding system proposed by the CAISO will be integral to the bidding process that is part of the operation of the wholesale market . . . . [T]he virtual bidding process will yield significant benefits as it will protect customers by curbing potential exercises of market power and reduce financial risks associated with real-time deviations from each customer's day-ahead schedule, among other things. We also note that virtual bidding is a feature of some other electricity markets . . . where it has widely been accepted as an important feature of market operation."). *See also California Independent System Operator*, 89 FERC ¶ 61,153 at p. 61,436 (1999) (concluding that "FTRs are an integral part of the transmission service provided by the ISO.").

[8] The 2009 OTC Act amends the CEA to add new Section 1a(39) which sets forth the following broadly drafted definition of "Swap Dealer:"

(39) SWAP DEALER.—

Providers may be required to register as a "Swap Dealer" and be subject to comprehensive CFTC regulation under the CEA. This would result in the imposition of unnecessary and burdensome operating costs on Energy Providers, such as new capital and margin requirements. In order to cover such additional costs, Energy Providers will be forced to divert resources away from investment in innovation, infrastructure, growth and jobs. This will adversely affect liquidity, efficiency and price discovery in energy markets as market participants either withdraw or can no longer participate to the same extent. This, in turn, will likely result in higher energy prices for customers, including U.S. consumers.

Although new CEA Section 1a(39)(B) excepts from the definition of a "Swap Dealer" a party that buys and sells swaps for its own account if such trading activity is not undertaken "as a part of a regular business," the 2009 OTC Act provides no guidance whatsoever regarding the scope of this exception. Moreover, neither the term "Swap Dealer" nor the critical phrase "as a part of the business" are defined in the CEA, the Commodity Futures Modernization Act of 2000, the 2008 Reauthorization Act, or the CFTC regulations set forth in Title 17 of the Code of Federal Regulations ("CFR"). Although the phrase "as a part of a regular business" is used sparingly in the text of the CEA and Title 17 of the CFR, the CFTC has not issued any interpretive guidance specifically addressing it. Consequently, the applicability of new CEA Section 1a(39)(B) to Energy Providers is uncertain.[9]

The Working Group believes that the definition of "Swap Dealer" should be revised to clarify the meaning of the phrase "as a part of a regular business" in new CEA Section 1a(39)(B) in a manner that distinguishes the activities of a "Swap Dealer" from the transactional activities of commercial firms, such as Energy Providers. In this regard, guidance issued by the Securities and Exchange Commission ("SEC") interpreting the definition of "dealer" set forth in Section 3(a)(5) of the Securities and Exchange Act of 1934 ("1934 Act") is instructive.[10]

Specifically, SEC interpretive guidance under Section 3(a)(5) distinguishes the activities of dealers (*e.g.,* entities which buy and sell securities as part of a regular business) from the activities of traders (*e.g.,* entities which buy and sell securities for investment and not as part of a regular business).[11] This guidance is commonly referred to by the SEC as the "Dealer/Trader Distinction."[12] The

---

> (A) IN GENERAL.—The term 'swap dealer' means any person engaged in the business of buying and selling swaps for such person's own account, through a broker or otherwise.
>
> (B) EXCEPTION.—The term 'swap dealer' does not include a person that buys or sells swaps for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

9 Energy Providers do trade for their own account. However, such trading is part of their regular business which is the delivery of energy commodities, not trading. Thus, it is not clear that Energy Providers fall outside the proposed definition of "Swap Dealer."

10 *See* 15 U.S.C. § 78c(a)(5). The statutory language of the definition of "dealer" set forth in Section 3(a)(5) of the 1934 Act is nearly identical to the definition of "Swap Dealer" in new CEA Section 1a(39).

11 *See Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Final Rule, SEC Release No. 34-47364 (Mar. 2003)("SEC Dealer Final Rule"); *Definition of Terms in Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Proposed Rule, SEC Release No. 34-46745 (Dec. 2002)("SEC Dealer NOPR").

12 *See id*. The SEC employs a two-part analysis for determining whether an entity is a "dealer" under the 1934 Act. The first part of this analysis addresses two factual questions:

- Whether an entity is "buying and selling securities for its own account;" and

Dealer/Trader Distinction recognizes that "dealers" normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory (or participate in the sale or distribution of new issues, such as by acting as an underwriter), and generally provide liquidity services in transactions with investors (or, in the case of dealers who are market makers, for other professionals).[13] In contrast, the SEC also recognizes that traders have a less regular volume, do not handle others' money or securities, do not make a market, and do not furnish dealer-type services such as rendering investment advice, extending or arranging for credit, or lending securities.[14]

Energy Providers, with respect to a common understanding of "Swap Dealers," are analogous to "traders" under the "Dealer/Trader Distinction." They are not engaged in the business of being dealers. Instead, their trading activity, though frequent, is but a part of a much larger overall business. As a consequence, Energy Providers are not "engaged in the business" of being a "Swap Dealer," as that term is defined in new CEA Section 1a(39). Set forth below are some examples of why the trading activity of Energy Providers are more analogous to "traders" than "Swap Dealers:"

- Energy Providers typically do not hold themselves out to be dealers.
- Most Energy Providers do not, as a general matter, "make markets" by quoting a market in or publishing quotes for OTC derivatives in energy commodities.
- Energy Providers do not trade OTC derivatives on behalf of unaffiliated third-parties or, as a general matter, provide services that market professionals or the public look to for liquidity.
- Because their trading and hedging activities are tied to obligations to physically deliver energy commodities, Energy Providers can have trade volumes in OTC derivatives markets that are distinguishable from entities like dealers that are willing to buy or sell OTC derivatives on a continuous basis.
- Energy Providers do not, as a general matter, engage in other financially-related, dealer-type activities, such as rendering investment advice, extending or arranging for credit, or lending securities.

Therefore, in addition to revising the definition of "Swap Dealer" set forth in new CEA Section 1a(39) to distinguish the activities of a "Swap Dealer" from the trading and hedging activities of commercial firms such as Energy Providers, the 2009 OTC Act should require that the CFTC issue

---

- Whether that entity is "engaged in the business" of that activity "as part of a regular business."

An entity is not a "dealer" subject to SEC regulation under the 1934 Act, unless **both** of the factual questions set forth above are answered in the affirmative. The second stage of the analysis focuses on whether an entity can take advantage of any applicable exceptions or exemptions from the definition of "dealer" set forth under the 1934 Act or applicable SEC regulations. When determining whether an entity falls within the definition of "dealer," the SEC has made clear that all relevant factual circumstances must be considered.

13 The SEC takes the view that an entity may generally satisfy the definition of "dealer" under the 1934 Act, and therefore, be acting as a "dealer" in the securities markets by conducting various activities, such as: (1) underwriting; (2) acting as a market maker or specialist on an organized exchange or trading system; (3) acting as a de facto market maker whereby market professionals or the public look to the firm for liquidity; or (4) buying and selling directly to securities customers together with conducting professional market activities such as providing investment advice, extending credit and lending securities in connection with transactions in securities, and carrying a securities account. *See* SEC Dealer NOPR at II.B; SEC Dealer Final Rule § IV.

14 *Id.* (citing L. Loss & J. Seligman, Securities Regulation, §§ 8-A-2 and 8-A-3 n.115 and 143 (3d ed. 2001)).

guidance to the market establishing the "Dealer/Trader Distinction" for purposes of determining whether a party is (or is not) a "Swap Dealer." Such guidance will help ensure legal certainty as the industry transitions to a new framework for derivatives regulation.

3. DEFINITION OF "MAJOR SWAP PARTICIPANT."

When interpreted in conjunction with the proposed definition of "Swap," the definition of "Major Swap Participant" set forth in new CEA Section 1a(40) could be broadly read to include Energy Providers and other commercial firms that transact OTC derivatives primarily for the purpose of hedging underlying physical energy commodity positions.[15] Such an interpretation would effectively result in Energy Providers and other commercial firms being required to register as a "Major Swap Participant" and would be subject to comprehensive regulation, including capital and margin requirements, imposed by the CFTC under the CEA.

The use of the phrase "an effective hedge under generally accepted accounting principles" in the definition of "Major Swap Participant" is significant. This phrase appears to reference the generally accepted accounting principles ("GAAP") standard for "effective hedge" transactions set forth in FAS 133.[16] Given its highly technical and complex nature and cumbersome documentation requirements, companies often have difficulty satisfying the technical requirements for an "effective hedge" under this standard or forgo hedge accounting treatment. In addition, a hedge transaction structured to comply with FAS 133, because of the need to fulfill all of the technical requirements of FAS 133, may be more expensive than hedging transactions that adequately address the economic exposure.

The definition of "Major Swap Participant" should be amended to clearly and unambiguously exclude commercial firms engaged in the hedging of underlying physical commodity positions. The reference to GAAP standards for an "effective hedge" should be removed from this definition. Rather, the exclusion from the definition of "Major Swap Participant" should be internally consistent with the CEA and the general definition of "bona fide hedge transaction or position" set forth in Section 1.3(z)(1) of the CFTC regulations, 17 C.F.R. § 1.3(z)(1) ("Rule 1.3(z)(1)").[17] Adopting an exception based in

---

15 The definition of "Major Swap Participant" set forth in new CEA Section 1a(40) is as follows:

> (40) MAJOR SWAP PARTICIPANT.—The term 'major swap participant' means any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles, as the Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.

16 *See* Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*; *see also* Financial Accounting Standards Board, Accounting Standards Codification, Topic 815, *Derivatives and Hedging* (codifying and restating FAS No. 133). FAS No. 133 has a corollary provision in International Accounting Standards 39.

17 The general definition of "bona fide hedging transactions and positions" set forth CFTC Regulation 1.3(z)(1) states:

> Bona fide hedging transactions and positions shall mean transactions or positions in a contract for future delivery on any contract market, or in a commodity option, where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:

concept on Rule 1.3(z)(1) is a more practicable solution as it is generally consistent with business practices of Energy Providers and many other commercial firms that hedge underlying physical commodities on a portfolio basis rather than on a transaction-by-transaction basis, which is required by FAS 133.

Further, in addition to exempting a firm that enters into bona fide hedges, the definition of "Major Swap Participant" should exclude "swap traders," meaning firms not primarily in the business of trading "Swaps." It is important that Congress recognize that not all contracts entered into by Energy Providers and other commercial firms are done for hedging purposes. However, as long as the primary business of any such firm is not trading "Swaps," trading other than for hedging should not automatically cause a commercial firm to become a "Major Swap Participant."

The Working Group is concerned that the adoption of an exclusion that is tied to an effective hedge under GAAP will likely reduce liquidity in energy markets and could have the unintended consequence of turning a back-office financial reporting function into a front-office business strategy, and turning the Financial Accounting Standards Board, a non-regulatory institution, into a forum for determining whether an entity engaged in hedging activities in derivatives markets is a "Major Swap Participant" under new CEA Section 1a(40). Moreover, depending on how the phrase "substantial net position of outstanding swaps" is interpreted by the CFTC, an Energy Provider engaged in limited hedging activity who fails to meet the requirements for an effective hedge under FAS 133 could be subject to comprehensive CFTC regulation as a "Major Swap Participant." Entities that cannot meet the applicable financial and regulatory burdens applicable to "Major Swap Participants" would effectively be forced out of derivatives markets for energy commodities. The resulting reduction in liquidity would, in turn, likely have an adverse impact on U.S. consumers in the form of higher prices for physical energy commodities.

C. MANDATORY CLEARING OF "STANDARDIZED" DERIVATIVES.

1. EXEMPTIONS FROM CLEARING.

New CEA Section 2(j) imposes a requirement that "Swaps" that are deemed to be "standardized" must be centrally cleared. New CEA Section 2(j)(8) contains two limited exemptions to this requirement. Specifically, a "Swap" need not be cleared through a derivatives clearing organization ("DCO"), under the 2009 OTC Act as proposed, if (a) no DCO will accept the "Swap" for clearing, or (b) one of the counterparties to the "Swap" (i) is not a "Swap Dealer" or "Major Swap Participant," and (ii) does not meet the eligibility requirements of the DCO that clears the "Swap" (hereinafter, "Unique Swap Participants"). However, the proposed exemptions from the clearing requirement raises issues that should be addressed by Congress before the 2009 OTC Act is enacted into law. In particular, the 2009 OTC Act should be amended to include an exception from the clearing requirement for sufficiently creditworthy parties.

The exemption applicable to Unique Swap Participants partially reflects an important practice in the energy markets of accommodating the unique credit profiles of some market participants. The

(i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;

(ii) The potential change in the value of liabilities which a person owns or anticipates incurring; or

(iii) The potential change in the value of services which a person provides, purchases, or anticipates providing or purchasing.

inclusion of such counterparties promotes a more efficient market. Unlike centralized clearing arrangements that demand uniformity of credit support based upon each underlying exposure, current market practices recognize that participants are creditworthy either as a going-concern or through the use of alternative collateral support.

Several creditworthy Energy Providers use asset-based collateral arrangements (*i.e.,* first liens in generating facilities) to preserve capital and operating cash flow. These collateral arrangements are accepted in energy markets as an appropriate form of credit support for liabilities and derivatives exposures. Although "Swaps" using asset-based collateral arrangements may not be eligible for central clearing by a DCO, it does not make sense to adopt legislation that would effectively exclude such "Swaps" from the market for standard commodity derivative contracts. *See* Section C.2. below regarding alternative forms of collateral support.

Unlike H.R. 977 (proposed legislation submitted by House Agricultural Committee Chairman Collin Peterson (D-MN)) and H.R. 2454 (which was passed by the House of Representatives on June 26, 2009), there is no exemption from the mandatory clearing requirements for "well capitalized" market participants. The Working Group recognizes that "well capitalized," when measured against the concern for systemic risk, should be understood as "creditworthy" for purposes of trading. An Energy Provider should be considered "creditworthy" if it can demonstrate financial strength to mitigate counterparty risk (a) on an unsecured basis (based upon objectively determinable criteria, such as unsecured credit ratings) and/or (b) through the use of alternative collateral arrangements.

The 2009 OTC Act already recognizes the role of well capitalized entities in imposing capital and margin requirements. If a trading counterparty is required to meet such requirements, then the requirement for centralized clearing is redundant. Moreover, the provisions of the 2009 OTC Act will provide for reporting requirements. Reporting should provide regulators with the market transparency necessary to address systemic risk concerns. As such, the requirement of centralized clearing imposes costs on the market place with no discernable benefit. Thus, an exemption from the clearing requirement for creditworthy counterparties should exist.[18]

Finally, there is an issue whether a "Swap" which no DCO will accept to clear can be said to be "standardized" in the first instance. A potentially significant conflict arises to the extent that a "Swap" comes within whatever definition the CFTC and SEC fashion for the term "standardized," but the "Swap" is not accepted for centralized clearing which, in turn, creates the implication that the contract is not "standardized." Thus, it is possible that two "Major Swap Participants" might enter into "Swaps" that are "standardized," but are not subject to the mandatory clearing requirement by virtue of this exemption. This situation does not appear to comport with the apparent intent of the 2009 OTC Act.

2. <u>ALTERNATIVE FORMS OF COLLATERAL SUPPORT</u>.

As described above, Energy Providers often use several forms of collateral support, many of which are not accepted as collateral when transactions are centrally cleared. For example, an Energy Provider may grant liens in their physical assets or provide letters of credit or guarantees in lieu of posting

---

[18] Energy Providers often trade through intermediaries like "Swap Dealers." If a trade between an Energy Provider is exempt from the central clearing requirement, then the intermediary's offsetting trade also should be exempt from the central clearing requirement. Otherwise, the intermediary will likely pass the funding cost of its margins requirements for the offsetting trade through to the Energy Provider. This practice will increase the cost of trading activity by Energy Providers, particular for hedging transactions, potentially reducing liquidity in the energy markets.

cash or cash equivalents. The use of alternative collateral arrangements allows counterparties to effectively address the unique credit needs of other market participants.

Alternative collateral arrangements are often quite effective in mitigating counterparty risk because such risk is "right way risk." That is, the value of the collateral support improves at the same time derivatives exposure increases. In this way, alternative collateral arrangements might be characterized as reducing systemic risk as counterparty risk is diminished.

If enacted without modification, the provisions of the 2009 OTC Act requiring centralized clearing likely will force Energy Providers to collateralize "Swaps" only with cash or cash equivalents. This requirement will cause significant cash management issues for some Energy Providers and will result in an inefficient allocation of internal resources. This issue has received some recognition from regulators. In his August 17, 2009 letter, CFTC Chairman Gensler advocates that "end users should be permitted by regulators to use non-cash collateral to satisfy their margin obligations in appropriate circumstances."[19]

In order to prevent chilling liquidity in derivatives markets, particularly for derivatives in energy commodities, the 2009 OTC Act should be amended to (a) identify certain permissible alternative collateral arrangements and (b) provide relief from the central clearing requirement for trades supported by such enumerated alternative collateral arrangements. If "right way risk" can be demonstrated, parties also should be permitted to trade unsecured up to a threshold amount that is appropriate for the identified risk exposure. Furthermore, letters of credit should be deemed a permissible form of alternative collateral. To adjust for financing costs related letters of credit, the 2009 OTC Act also should be amended to offer an offsetting feature, such as relief from any applicable capital requirements. Finally, the 2009 OTC Act should also provide that parties can seek guidance from the CFTC or SEC (as applicable) in a no-action letter with respect to any particular collateral support arrangement.

3. DEFINITION OF "STANDARDIZED."

As proposed in the 2009 OTC Act, new CEA Section 2(j) requires that "Swaps" designated as "standardized" must be cleared through a DCO. The Working Group is concerned that mandating centralized clearing for "Swaps" that are "standardized" will impose additional and potentially unnecessary costs on transacting parties, particularly if the DCO has margin requirements that are higher than those associated with bilateral trading. Accordingly, the development and implementation of the term "standardized" is an issue of the utmost importance that must be thoughtfully and carefully addressed by Congress and regulators.

Despite the importance of this issue, the 2009 OTC Act wholly avoids the critical issue of defining the term "standardized" when applied to swaps and other derivatives transactions. Instead, the 2009 OTC Act (a) creates a presumption for determining whether a "Swap" is "standardized," and (b) delegates the responsibility for formulating the legal definition of "standardized" to the CFTC and the SEC. In doing so, the 2009 OTC Act directs the CFTC and SEC to fashion a definition of "standardized" as broadly as possible. In addition, the 2009 OTC Act also grants authority to the CFTC and SEC to designate any class of "Swaps" as "standardized."

The Working Group is concerned that the lack of definitional clarity with regard to the term "standardized" will create significant regulatory and transactional uncertainty. It may also introduce risk into the system (which is directly contrary to the stated purpose and intent of the 2009 OTC Act).

---

[19] See August 17, 2009 letter to Congress from CFTC Chairman Gary Gensler.

Centralized clearing is done today with derivatives contracts with identical or "fungible" terms. This allows a clearing organization, such as a clearing corporation for options, to match trades and limit counterparty risk. However, a broad definition of "standardized" or even the designation of a class of "Swaps" as "standardized" could encompass transactions with similar terms, but not necessarily identical or nearly identical terms. With potential discrepancies among "Swaps," even relatively minor ones, it is not clear how a DCO will operate efficiently. It will require a great deal of government and private resources to discern and analyze differences among "Swaps" (including the difficult job of understanding the credit implications of such differences). Moreover, the DCO will have to adjust margin requirements based on such differences (or, with uniform pricing, the DCO's customer must accept higher margin costs than are warranted). Perhaps most troubling is that differences among contracts, even small ones, represent basis risk. Accordingly, if a definition of "standardized" is over-inclusive (by design or interpretation), then DCOs will incur basis risk, a type of risk they are not intended to take.

Other than "standardized" derivative products already trading on designated contract markets, the vast majority of "Swaps" involving energy commodities are not "fungible," as they have several nuanced and non-standard terms, such as unique geographic locations, odd durations, unusual volumes or unique credit support arrangements. Certain "Swaps" involving energy commodities may have common terms, such that they could be deemed to be "standardized" in the common sense, but they have the option to settle by physical delivery of the commodity. This settlement option prevents such "Swaps" from being treated in a fungible manner. Furthermore, similar energy trades can be documented on several different, industry-accepted master agreements. Accordingly, imposing a central clearing requirement on the energy markets without a clear and operationally practical definition of "standardized" could prove unworkable and/or have disastrous unintended consequences on energy markets -- both financial and physical.

In light of the foregoing, new CEA Section 2(j) should be amended to require that any definition of "standardized" adopted by the CFTC and SEC must contain objective criteria for which compliance can be readily determined. With respect to "Swaps" involving energy commodities, the 2009 OTC Act should be amended to clearly state that the CFTC shall not designate any class of Swaps as "standardized" given the potential variations in such class of Swaps. Finally, the determination of a "Swap" as "standardized" should take place be on a case-by-case basis, as was proposed in legislation recently introduced by Senator Jack Reed (D-RI).[20]

4. PRESUMPTION OF "STANDARDIZATION."

As noted in Section II.C.1, above, new CEA Section 2(j)(2) contains a presumption that any "Swap" that is accepted for clearing by a DCO is "standardized." The single criteria for the presumption to apply is that the "Swap" is cleared. This single criteria approach, however, does not capture a common, industry-accepted understanding of the term "standardized." Given this deficiency, the presumption set forth in new CEA Section 2(j)(2) should be stricken from the 2009 OTC Act. Alternatively, if this presumption is maintained, then additional, mandatory qualifying criteria should be incorporated in this provision. The criteria currently specified in new CEA Section 2(j)(3) are instructive in this regard. These criteria set forth factors the CFTC and the SEC must consider in fashioning a definition of "standardized" such as trade volume and information dissemination. However, these factors for consideration, any of which may be ignored, should become mandatory criteria which must be satisfied.

Without the incorporation of additional, objective criteria to new CEA Section 2(j)(2), a thinly traded "Swap" that is accepted for centralized clearing by a DCO will be presumed to be "standardized."

[20] *See* S. 1691, introduced September 22, 2009 by Senator Jack Reed, 111th Congress.

To impose the additional costs of centralized clearing on top of pricing considerations for a “Swap” transacted in a thinly traded market may dry up liquidity in that market. This in turn will impair market efficiency and any available limited price discovery. Moreover, it would likely place upward pressure on underlying physical energy commodity prices incurred by customers, including U.S. industrial, commercial and residential consumers.

Finally, the presumption set forth in new CEA Section 2(j)(2) fails to provide parties with appropriate due process rights and should be amended to permit a party to appeal to the CFTC or the SEC, as applicable, for guidance on whether or not the presumption can be overcome with respect to a particular “Swap.” This is particularly important for “Swaps” transacted in thinly traded markets. Procedurally, an appeals process must provide for notice and an opportunity for a hearing, provide for a trier of fact that has a strong substantive background in the derivatives and the underlying industry, and provide deadlines that facilitate a quick resolution as the market can move quickly away while a party waits for regulatory certainty regarding the applicability of the presumption.

D. CAPITAL AND MARGIN REQUIREMENTS.

1. CAPITAL REQUIREMENTS.

Pursuant to new CEA Section 4s(e), non-bank “Swap Dealers” and “Major Swap Participants” will be required to maintain certain minimum amounts of capital established by the CFTC and the SEC. Such minimal capital requirements must be “as strict or stricter” than those established by bank regulators with respect to bank “Swap Dealers” or bank “Major Swap Participants.”

The Working Group believes that all or a portion of the capital requirements presented by the 2009 OTC Act should be removed, particularly if the mandatory clearing requirement remains. Specifically, the language directing that minimal capital requirements be established at a level “as strict or stricter” should be removed. Alternatively, the 2009 OTC Act should be amended to add a process by which Energy Providers and other commercial firms can seek relief from the mandatory capital requirements.

The requirement to maintain minimum amounts of capital will have dramatic consequences for many Energy Providers and other commercial firms if required to register as a “Swap Dealer” or “Major Swap Participant.” For some Energy Providers, the imposition of mandatory minimum capital requirements will effectively preclude them from hedging price exposure or significantly reduce their ability to hedge such exposures. Specifically, it could force such Energy Providers to choose between taking additional price risk in energy markets or selling physical energy commodities at their marginal cost. If the former option is elected, customers, including U.S. industrial, commercial and residential consumers, will likely bear the impacts associated with decreased competition in energy markets and increased volatility in the form of higher energy prices. The election of the second option could adversely impact certain Energy Providers’ business models and provide unintended regulatory incentives for mergers and acquisitions activity which, in turn, could create market power concerns.

At the very least, the imposition of minimum capital requirements will result in a less efficient use of capital by Energy Providers as assets are redeployed to satisfy such requirements. Energy Providers also will be indirectly affected as “Swap Dealers” increase pricing to compensate for the increased capital charges that result from complying with another set of capital requirements. Requiring Energy Providers to reserve capital for their trading activity likely will constrain their business operations as they necessarily must limit investments that could otherwise effectively facilitate the implementation of other major economic stimulus, environmental and energy policy objectives identified by the Obama

Administration. This constraint will be a drag on the entire U.S. economy as it will affect the prices paid by U.S. industrial, commercial and residential consumers for physical energy products.

The provisions of the 2009 OTC Act that minimal capital requirements for "Swap Dealers" and "Major Swap Participants" be at a level at or above the level set by bank regulators creates a subtle shift in regulatory power away from the CFTC and the SEC and towards bank regulators. The shift is the result of the bank regulators effectively establishing a floor under the "as strict or stricter" standard for capital and margin requirements set forth in new CEA Section 4s(e). Consequently, Energy Providers could find a regulator that otherwise does not have jurisdiction over them or have a fundamental understanding of energy markets sets a critical parameter in the operation of their business. Moreover, non-bank "Swap Dealers" and "Major Swap Participants" could face minimal capital requirements that are more severe than levels applied to banks, which is an odd result given that the systemic risk concerns that capital requirements address originated with the financial sector.

If counterparty credit risk is addressed through the implementation of a mandatory clearing requirement, then the proposed minimal capital requirement is wholly redundant. In addition, the requirements for reporting by "Swap Dealers" and "Major Swap Participants" also is redundant.

Given the broad purview of the CFTC and the SEC, it is not clear what resources or expertise these agencies will use to establish minimal capital requirements applicable to Energy Providers. Moreover, evaluating compliance with the capital requirements may be extraordinarily difficult, as Energy Providers often have assets that are not readily valued.

2. MANDATORY MARGIN REQUIREMENTS.

a. Bank "Swap Dealers" and "Major Swap Participants."

A stated goal of the 2009 OTC Act is to facilitate the substantial migration of OTC derivatives onto central clearinghouses and exchanges by encouraging the greater use of "standardized" derivatives and by imposing higher capital requirements and higher margin requirements for all derivatives that are not "standardized" (*e.g.,* customized transactions not appropriate for clearing by a registered DCO). New CEA Section 4s(e)(4) sets forth the rules for the establishment of mandatory initial and variation margin requirements for "Swaps" that are not cleared by a registered DCO. New CEA Section 4s(e)(4)(A) specifically applies to transactions where one counterparty to a transaction is a bank "Swap Dealer" or "Major Swap Participant." The Working Group is concerned that the imposition of mandatory margin requirements would significantly increase transactional costs and, ultimately, the price of physical energy commodities.

Under Section 4s(e)(4)(A), "Prudential Regulators" have the discretion to waive mandatory margin requirements if one of the counterparties (i) is not a "Swap Dealer" or "Major Swap Participant," (ii) uses the "Swap" as part of an effective hedge under generally accepted accounting principles, and (iii) is predominantly engaged in activities that are not financial in nature, as defined under Section 4(k) of the Bank Holding Company Act of 1956, 12 U.S.C. § 1843(k).[21] Given the lack of clarity regarding the scope and application of the proposed definitions of "Swap Dealer" and "Major Swap Participant," "Swaps" transacted by an Energy Provider and a bank "Swap Dealer" or "Major Swap Participant" that are not cleared by a DCO may not be eligible for exemption from mandatory initial and variation margin requirements.

---

[21] These criteria are set forth in new CEA Section 4s(e)(4)(A)(i)-(iii).

The policy basis for the discretionary exemption set forth in new CEA Section 4s(e)(4)(A) is not entirely clear, as the conditions do not seem closely related to the risks associated with the particular "Swap." In addition, the reference to the GAAP standard for an "effective hedge" in Section 4s(e)(4)(A)) should be removed. As discussed in Section II.B.3, above, the concept of an "effective hedge" should be consistent with the general definition of "bona fide hedge transaction or position" set forth in CFTC Rule 1.3(z)(1).[22] Finally, in order to avoid increasing the cost of doing business, "Swaps" that meet the requirements of the discretionary exemption under Section 4s(e)(4)(A) should be automatically exempt from the imposition of mandatory margin requirements. This determination should not be left to the discretion of Prudential Regulators.

b. Non-Bank "Swap Dealers" and "Major Swap Participants."

New CEA Section 4s(e)(4)(B) sets forth the rules for the imposition of mandatory margin requirements involving "Swaps" with a non-bank "Swap Dealer" or "Major Swap Participant" that are not cleared by a DCO. Under this provision, mandatory margin requirements are established by the CFTC or SEC and must be "as strict or stricter than margin requirements set by the Prudential Regulators applicable to non-DCO cleared "Swaps" involving bank "Swap Dealers" and "Major Swap Participants." This provision appears to be intended to facilitate the substantial migration of OTC derivatives onto central clearinghouses and exchanges.

The Working Group is concerned that the use of the "as strict or stricter than" standard could lead to the inconsistent regulation of "Swaps" and subject Energy Providers and other commercial entities that do not present systemic risk concerns to more stringent requirements than those presented by bank "Swap Dealers" and "Major Swap Participants." Additionally, this provision provides the CFTC and SEC with authority to eliminate any exemption to mandatory margin requirements for "Swaps" involving non-bank "Swap Dealers" and "Major Swap Participants" that are not cleared on DCOs.

New CEA Section 4s(e)(4)(B) should be amended to provide regulators with the discretion to waive mandatory margin requirements similar to the discretion afforded bank regulators in new CEA Section 4s(e)(4)(A). Further, any exemption for mandatory margin requirements should be automatic and should not be left to the discretion of the CFTC and SEC. In addition, an exclusion should be placed into the 2009 OTC Act for "well capitalized" firms and alternative forms of credit support that sufficiently collateralize liabilities and derivative exposures.

Finally, although an ulterior purpose for this provision may be to effect a significant "de-leveraging" of all participants in OTC derivatives markets, including Energy Providers and other commercial firms that may be subject to regulation under the proposed definitions of "Swap Dealer" or "Major Swap Participant," similar to other provisions in the 2009 OTC Act discussed herein, the imposition of mandatory margin requirements will inhibit the efficient use of capital and assets by Energy Providers.

E. EXPLICIT SAFE HARBOR FOR EXISTING TRADES.

The 2009 OTC Act appears to apply on a prospective basis. There are no requirements to migrate existing bilateral trades to central clearing. The prohibition set forth in new CEA Section 2(j) pertains to the entry into new contracts, not the performance of existing contracts. This provision is critical as it attempts to provide some regulatory and transactional certainty for existing contracts such that the

[22] As discussed in Section II.A.3., above, it is important that an "effective hedge" exemption from mandatory margin requirements recognize and include firms that trade "Swaps" other than for hedging purposes, but not as a part of their primary business.

enactment of the 2009 OTC Act will not give rise to triggering of "regulatory outs" or "illegality" clauses in trading contracts. However, to provide the energy market with complete legal certainty regarding any implementation of the 2009 OTC Act, the 2009 OTC Act should be amended to include a provision that explicitly grandfathers in existing transactions or subjects them to minimal regulatory oversight similar to the approach taken in the transition rule set forth in Title VII, Subtitle E, of H.R. 2454.

SUPPLEMENTAL MATERIAL SUBMITTED BY ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CEO, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION

September 23, 2009

Hon. COLLIN C. PETERSON,	Hon. FRANK D. LUCAS,
Chairman,	*Ranking Minority Member,*
Committee on Agriculture,	Committee on Agriculture,
Washington, D.C.;	Washington, D.C.

RE: Submission for the Record of the Committee's Hearing on September 17, 2009.

Dear Chairman Peterson and Ranking Member Lucas:

Thank you for the opportunity to represent ISDA before the Committee at last week's hearing on the U.S. Treasury proposals for the regulation of the OTC derivatives markets. Today, there is a broad consensus for comprehensive regulatory reform to modernize and protect the integrity of our financial system and we support many of the concepts for improved regulation of the derivatives markets. The Committee's hearing highlighted several aspects of the Treasury's proposal that need further consideration. One of these issues is the imposition of margin requirements.

Thank you for the opportunity to represent ISDA before the Committee at last week's hearing on the U.S. Treasury proposals for the regulation of the OTC derivatives markets. Today, there is a broad consensus for comprehensive regulatory reform to modernize and protect the integrity of our financial system and we support many of the concepts for improved regulation of the derivatives markets. The Committee's hearing highlighted several aspects of the Treasury's proposal that need further consideration. One of these issues is the imposition of margin requirements.

During the hearing, the issue of requiring end-users to post margin as a result of mandatory clearing or as a result of the proposed requirement that regulators impose margin requirements on all non-cleared derivatives was raised. The suggestion that an end-user could enter into a margin financing arrangement whereby another firm, possibly a member of a clearinghouse, would lend the end-user the money to meet the clearinghouse's margin requirements was offered as a possible response to the difficulties some end-users will have in meeting margin requirements. Margin financing was presented as a means to facilitate end-user access to clearinghouses so that more trades can be cleared.

(1) Margin financing does not eliminate or reduce the credit risk associated with the OTC derivative transaction, rather it simply shifts the risk from the OTC derivative to a debt instrument. Either the clearing member or the lender would be exposed to the risk that the end-user will not be able to repay the money borrowed to satisfy the margin calls.

(2) Margin financing would subject the end-user to additional clearing fees and fees associated with the borrowing. In some cases, borrowing end-users would be subject to a commitment fee whereby the end-user would pay even before drawing on the line-of-credit.

(3) Margin financing may entail a floating rate of interest on a line-of-credit, subjecting end-users to more interest rate risk. In most cases, it is the need to mitigate or eliminate interest rate risk that leads the end-user to use OTC derivatives in the first place.

(4) Margin financing would result in end-users taking on more debt, increasing their leverage.

(5) Margin financing loans would work like revolving credit facilities wherein the end-user would draw down amounts as its needs more margin and repay previously drawn amounts when its positions move back in the money. The loan to the end-user would be subject to greater risk in bankruptcy than an OTC derivative contract with the end-user. The bankruptcy code's protections for OTC derivative contracts do not apply to credit facilities, leaving the lender more exposed to an end-user default.

Once again, we appreciate the opportunity to testify before the Committee on this important topic and to add to the hearing record these additional points.

Please do not hesitate to call on us if we can be of further assistance.

Yours Sincerely,

Robert G. Pickel

ROBERT G. PICKEL,

Executive Director and Chief Executive Officer,
ISDA.

Cc: Members of the House Committee on Agriculture.

SUPPLEMENTAL MATERIAL SUBMITTED BY JOHNATHAN H. SHORT, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, INTERCONTINENTALEXCHANGE, INC.

The IntercontinentalExchange, Inc. (ICE) respectfully submits the following to supplement the testimony of Johnathan Short before the Committee at the September 17, 2009 hearing on the Over the Counter Derivatives Market Act (OTCDMA).

Position Limits

On September 16, the Chicago Mercantile Group (CME) released its white paper, "Excessive Speculation and Position Limits in Energy Derivatives Markets." The paper made two recommendations for setting position limits: (1) Exchanges should set position limits; and (2) position limits should be set as a relative percentage of an exchange's open interest. ICE disagrees with these recommendations.

The OTCDMA properly gives the Commission the power to set position limits and accountability levels. ICE agrees with this provision of the OTCDMA as the Commodity Futures Trading Commission (CFTC) has the experience, systems, and budget to administer this regime. Only the CFTC would be in a position to have broad and regular access to all position data regardless of trading venue, and is therefore uniquely able to determine appropriate limits and monitor compliance with limits. It should also be noted that the CFTC has a similar regime in place for enumerated agricultural contracts that has proven to be effective.[1] Furthermore, one of the most contentious issues surrounding position limits has been the circumstances under which hedge exemptions should be granted to market participants. Here again, the CFTC would be in a better position to administer such exemptions than individual exchanges given competitive considerations and the CFTC's superior access to information.

All position limits and accountability levels should be aggregate (market-wide) in nature. The limits set by the CFTC should not be exchange-specific, but rather marketwide to govern the sum total of all positions that a market participant may hold for all economically equivalent contracts, including those traded on a Designated Contract Market (DCMs), an Exempt Commercial Market offering significant price discovery contracts, Foreign Boards of Trade offering linked contracts, and other OTC market venues. The CFTC has already successfully implemented the most challenging aspect of such a system: collection and aggregation of daily position data from the first three of these sources.

Imposition of position limits and accountability levels by the Commission should promote competition by being market and venue agnostic. Setting position limits in the manner suggested by the CME, as a percentage of an exchange's open interest, would be contrary to the CFTC's statutory mandate to "promote competition among exchanges and seek to regulate the futures markets by the least anti-competitive means available." Imposing smaller limits for smaller exchanges by applying a "percentage of open interest" test for each individual exchange would restrict competition by making it difficult for competing exchanges to offer tight enough markets and build sufficient liquidity in a contract to compete with an incumbent exchange. End market users and consumers would ultimately suffer from the lack of competition, bearing increased hedging costs and a lack of new product innovation.

It is important to note the significant benefits of preserving competition in the exchange sector. Competition in the futures industry has spurred significant product and technological innovation, including transparent electronic trading, straight through processing, the introduction of clearing for OTC swap products, and significantly tighter trading markets into which commercial entities can hedge their risk. As Benn Steil, Director of International Economics at the Council of Foreign Relations recently noted, "the U.S. activities of one [competitor] alone, Eurex (formerly DTB) have had a tremendous effect in accelerating the move to more efficient electronic trading, in motivating exchanges to demutualize, . . . in reducing trading fees, and in stimulating new product development."[2]

Today, futures markets are more robust and less susceptible to manipulation than they were a decade ago, greatly reducing transactional costs to market participants and the cost of risk management to commercial entities. Regulation to promote fair

[1] Section 15(b) of the Commodity Exchange Act, 7 U.S.C. § 19.
[2] Testimony of Benn Steil before the Commodity Futures Trading Commission (June 27, 2006).

and level competition for the benefit of end-users, rather than regulation that would entrench dominant incumbents, should be the goal of financial market reform legislation.

ICE would be pleased to answer any questions of the Committee or staff on this important subject.

SUBMITTED STATEMENT OF ROGER PLANK, PRESIDENT, APACHE CORPORATION

Chairman Peterson, Mr. Lucas and Members of the Committee, thank you for this opportunity to provide testimony regarding reform of the Over-the-counter (OTC) derivatives markets. I am Roger Plank, President of Apache Corporation, an independent oil and gas exploration and production company with operations in the United States and five other nations and estimated proved reserves of 2.4 billion barrels of oil equivalent. Apache, established in 1954, is listed on the New York Stock Exchange with market capitalization of approximately $30 billion.

For the past fifteen years, Apache Corporation has been an outspoken proponent of greater transparency and a return to integrity in the natural gas markets, often finding ourselves at odds with significant portions of the oil and gas industry. I have attached as *Appendix D* the testimony of Apache Founder Raymond Plank, given to the U.S. House Committee on Energy and Commerce on February 13, 2002, in the wake of the Enron scandal. In his testimony, Mr. Plank made several statements that reverberate today.

> ". . . (many) have worked hard to introduce competition into the nation's energy markets. But deregulation has been hijacked by traders, hedge funds and others who profit from volatility and scorn the hard-working men and women who produce these important resources."

> ". . . Enron is gone, but the damage has been done to a vital element of the nation's economic security. In some ways, this is a homeland security issue: There is a ticking time bomb set to wreak havoc when the economy comes back and energy demand increases."

I hope you agree that those statements were remarkably prescient when they were made more than 7 years ago. Yes, Enron and others are gone, but problems in the energy commodity markets persist. Even with a serious recession, fundamentals of gas supply and demand cannot explain the wild ride of natural gas futures from $12.62 per thousand cubic feet (Mcf) in July 2008 to less than $3 per Mcf in recent weeks.

So, as you can see Apache does not object to the regulation of OTC derivatives in philosophy or concept. In fact, we applaud the efforts of the Administration and of Congress to rein in the unwarranted and harmful speculation rampant in the markets. However, we believe the Treasury Department proposal is overbroad where it negatively impacts the legitimate financial transactions to manage the price risk inherent in producing or consuming natural gas, crude oil and other commodities.

Apache, like most independent oil and gas producers and indeed most producers of tradable commodities, is not a "speculator." Our job is providing natural gas and crude oil essential to economic growth. Independent oil and gas producers and other commodities producers did not contribute to the financial problems caused by the unchecked speculation that occurred in the derivatives markets—that was the realm of financial traders and middle-men speculators. Yet restricting producers' financial flexibility could diminish our ability to help the nation achieve important objectives, including expanded use of natural gas to achieve our shared goal of reducing emissions of carbon dioxide and increasing our nation's energy independence.

This legislation, as proposed, will reduce access to customized transactions, will increase transaction costs and will impair, in Apache's case, our ability to invest capital in finding additional natural gas and crude oil by requiring producers to tie up their capital unnecessarily in financial reserves or margins. We have worked exclusively with the draft bill circulated by the U.S. Treasury Department to simplify matters and preserve producers' ability to manage risk as they seek to expand the nation's resources.

While we believe that an effort was made to exclude legitimate hedgers and legitimate hedges from the dragnet, we don't believe the exclusions as defined in the Treasury bill quite accomplish that goal.

We took a different and hopefully simpler approach to the problem by attempting to exempt specific transactions rather than to define broad categories of entities which would or would not be regulated. Our suggestion is to exempt transactions that involve at least one party that owns, produces, distributes, consumes, manufactures, processes, or merchandizes a product from what amount to punitive margin requirements and from the requirement that the transaction must clear through an authorized exchange.

We believe that this approach allows true industry participants to manage the risks inherent in commodity markets, while still allowing for appropriate oversight and regulation of the paper market that always follows physical transactions. By targeting these paper transactions, it is our belief that excessive speculation will be discouraged and price volatility dampened to the point that producers and consumers of all commodities will at long last be able to see real price signals from the market. This will improve our ability to make sound investment decisions and deliver the energy necessary for economic growth.

Thank you for your time, and for seizing the initiative to rein in the excessive speculation and volatility that have plagued energy and other markets far too long.

The following are Apache's recommendations for specific changes to the Treasury Department's proposed legislation:

Proposed Change No. 1—Add definitions of "*Bona Fide* Hedges" and "*Bona Fide* Hedgers" and excepting *Bona Fide* Hedgers from the definitions of "swap dealer" and "major swap participant."

Justification—The Treasury legislation contains definitions for "swap dealer" and "major swap participant" and excepts from these defined terms, persons who enter into hedges that are effective under generally accepted accounting principles (GAAP). This exception however is limited as some legitimate hedges may not be effective under GAAP. Apache proposes to expand the exception by adding an exception for persons who enter into "*bona fide* hedges". Generally, Apache would define a "*bona fide* hedge," similarly to the definition used in H.R. 3300 as a hedge that arises from a potential change in the value of a commodity that is owned, produced, distributed, consumed, manufactured, processed or merchandized by the person entering into the hedge. Expanding the exception is important because the status of a person entering into a swap affects whether a swap must be cleared and traded on an exchange and whether margin must be required. A person entering into a *bona fide* hedge or a hedge that is effective under GAAP, should be excepted from being a "swap dealer" and "major swap participant" so that the swaps entered into by such person will not have to be cleared or traded on an exchange as Apache proposes in Proposed Change No. 2 below and such person will be excepted from the requirement that margin be posted as Apache proposes in Proposed Change No. 3 below.

Specific Amendatory Language—See the proposed definitions of "*Bona Fide* Hedge" and *Bona Fide* Hedger) in *Appendix A*. Also in *Appendix B* and *C*, see changes to the definitions of "swap dealer" and "major swap participant" found on page 8, lines 3 through 15 of the Treasury legislation.

Proposed Change No. 2—Except *bona fide* hedges and those hedges that are effective under GAAP from the mandatory clearing and mandatory trading requirements.

Justification—The Treasury legislation requires that all "standardized" swaps—a term the Treasury legislation says must be defined "as broadly as possible"—must be cleared and traded on exchanges.

There is an exception from this requirement when (i) no clearing organization will accept the swap for clearing or (ii) when one party to the swap is not a swap dealer or major swap participant and such party does not meet the "eligibility requirements" of any clearing organization that clears swaps.

The Treasury's proposed exception is unclear. If all swaps must be cleared and traded on exchanges, producers' ability to enter into customized swaps will be limited and will result in less flexibility in their ability to meet risk management objectives in finding, developing and producing natural gas and crude oil. In addition, requiring that all swaps be cleared and traded on an exchange will increase producers' transaction costs, including clearing and exchange-related fees and costs associated with the posting margins.

Specifically, Apache proposes to change the Treasury legislation to expressly exclude from the definition of "standardized" swaps, both *bona fide* hedges and hedges that are effective under GAAP and expressly exclude *bona fide* hedges and those hedges that are effective under GAAP from the clearing and trading requirements.

Specific Amendatory Language—To accomplish this objective, see *Appendix B* and *C* for Apache's propose

Proposed Change No. 3—Except *bona fide* hedges and those hedges that are effective under GAAP from the mandatory capital and margin requirements.

Justification—It is not enough to except *bona fide* hedges and those hedges that are effective under GAPP from the clearing and trading requirements because the Treasury legislation requires the imposition of capital requirements and margin on all swaps not cleared by a clearing organization.

Apache is a producer of oil and natural gas; its oil and gas assets have substantial value and require substantial capital to discover and produce. When Apache enters into a swap, it is not doing so as a naked speculator. The Treasury's proposed legislation would require Apache to reserve capital in all cases and post margin unless Apache entered into a swap with a bank and the bank's regulator did not require margin. If Apache is required to tie up its capital, Apache will have less capital available to invest in finding and producing oil and natural gas. There are no exceptions to the requirement that capital requirements be imposed. Our physical ownership of the commodity is our asset, our capital and our collateral. Physical ownership of the commodity should not be subject to this double hit when a producer enters into a legitimate hedge transaction.

The Treasury's proposal provides for one limited exception to the margin requirement which may apply when a bank is a swap counterparty and the other party is (i) not a swap dealer or major swap participant, (ii) is entering into an effective hedge under GAAP, and (iii) "predominantly engaged in activities that are not financial." This one margin exception is not adequate. It does not apply when Apache's counterparty is not a bank and even when Apache's counterparty is a bank, the bank's regulator may still require the bank to require margin from Apache.

The mandatory nature of the capital and margin requirements is problematic to producers. Apache proposes that persons that enter into *bona fide* hedges and those hedges that are effective under GAAP be excepted from the imposition of capital and mandatory margin requirements whether the counterparty is a bank or non-bank. Apache proposes to make it clear that regulators may not impose capital requirements and margin requirements on persons that enter into *bona fide* hedges and those hedges that are effective under GAAP. Specifically, Apache proposes to add an exception to the requirement that capital requirements be imposed and expand the existing exception to include *bona fide* hedges and to apply this exception to non-bank counterparties.

Specific Amendatory Language—See *Appendix B* and *C* for Apache's proposed changes to page 39, beginning on line 13; page 39 at the end of line 17; page 39 at the end of line 21; page 40, line 3; page 40, line 8; and page 40, beginning on line 16.

APPENDIX A

Proposed Definition of "*Bona Fide* Hedge" and "*Bona Fide* Hedger"

"(51) BONA FIDE HEDGE.—The term *bona fide* hedge means a swap that—

(i) arises from the potential change in the value of physical assets that a person owns, produces, distributes, consumes, manufactures, processes, or merchandises as its primary business or anticipates owning, producing, distributing, consuming, manufacturing, processing, or merchandising as its primary business; and

(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."

"(52) BONA FIDE HEDGER.—The term *bona fide* hedger means a person that—

(i) owns, produces, distributes, consumes, manufactures, processes, or merchandises physical assets as its primary business; and

(ii) enters into *bona fide* hedges or other effective hedges under generally accepted accounting principles."

APPENDIX B

Apache Corporation Proposed Changes to the "Over-the-Counter Derivatives Markets Act of 2009" as Submitted by the Treasury Department August 11, 2009

The Treasury Department's "Over-the-Counter Derivatives Markets Act of 2009" is amended—

(1) by adding on page 7 between line 2 and line 3 the following:

"provided the term 'narrow-based security index' shall not include the Henry Hub, West Texas Intermediate or any other price point or index for commodities."

(2) by adding on page 8 line 7 the words "*bona fide* hedger or" between "a" and "person" and deleting on page 8 line 9 the following:

"but not as a part of a regular business" and replacing with the following:

"provided such person is not buying and selling, quoting prices, and making a market in swaps."

(3) by adding on page 8 in paragraph (40) line 11 before "The term" the following:

"(A) IN GENERAL.—"

(4) by deleting on page 8 in paragraph (40) line 13 the following:

"other than to create and maintain an effective hedge under generally accepted accounting principles,".

(5) by adding on page 8 into paragraph (40) at the end of paragraph (40) the following:

"(B) EXCEPTION.—The term 'major swap participant' does not include a person that is a *bona fide* hedger."

(6) by adding on page 12 after paragraph (50) the following:

"(51) *Bona fide hedge.*—The term *bona fide* hedge means a swap that—

(i) arises from the potential change in the value of physical assets that a person owns, produces, distributes, consumes, manufactures, processes, or merchandises, as its primary business or anticipates owning, producing, distributing, consuming, manufacturing, processing, or merchandising, as its primary business; and

(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."

"(52) BONA FIDE HEDGER.—The term *bona fide* hedger means a person that—

(i) owns, produces, distributes, consumes, manufactures, processes, or merchandises physical assets as its primary business; and

(ii) enters into *bona fide* hedges or other effective hedges under generally accepted accounting principles."

(7) by adding on page 17 between line 1 and line 2 the following:

"; provided however, the term 'standardized' shall not include *bona fide* hedges or other effective hedges under generally accepted accounting principles."

(8) by deleting on page 18 line 10 the following:

"or".

(9) by deleting the "." at the end of line 14 on page 18, and adding between line 14 and 15 the following:

"; or (C) the swap is a *bona fide* hedge or other effective hedge under generally accepted accounting principles."

(10) by adding to page 39 between lines 13 and 14, at the end of lines 17 and 21 the following:

"provided however, capital requirements shall not be imposed for swaps that are *bona fide* hedges or other effective hedges under generally accepted accounting principles."

(11) by deleting on page 40 line 3 the following:

"may, but are not required to," and replacing with the following:

"shall not"

(12) by adding to page 40 line 8 after "part of" the following:

"a *bona fide* hedge or"

(13) by adding on page 40 line 16 the following:

"; provided however, margin shall not be required with respect to swaps in which one of the counterparties is—

"(i) neither a swap dealer, major swap participant, security-based swap dealer nor a major security-based swap participant;

"(ii) using the swap as part of a *bona fide* hedge or an effective hedge under generally accepted accounting principles; and

"(iii) predominantly engaged in activities that are not financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k))."

Redline Changes

(A) redesignating subparagraph (E) as subparagraph (G);

(B) in subparagraph (D), by striking "and"; and

(C) inserting after subparagraph (D) the following:

"(E) an alternative swap execution facility registered under section 5h;

"(F) a swap repository; and"; and

(7) by adding after paragraph (36) (as redesignated by subsection (c)) the following:

"(37) BOARD.—The term 'Board' means the Board of Governors of the Federal Reserve System.".

(8) by adding after paragraph (37) the following:

"(38) SECURITY-BASED SWAP.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'security-based swap' means any agreement, contract, or transaction that would be a swap under paragraph (35) (without regard to paragraph (35)(B)(xii)), and that—

"(i) is based on an index that is a narrow-based security index, including any interest therein or based on the value thereof;

"(ii) is based on a single security or loan, including any interest therein or based on the value thereof; or

"(iii) is based on the occurrence, non-occurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event must directly affect the financial "provided the term "narrow-based security index" shall not include the Henry Hub, West Texas Intermediate or any other price point or index for commodities."

statements, financial condition, or financial obligations of the issuer.

"(B) EXCLUSION.—The term 'security-based swap' does not include any agreement, contract, or transaction that meets the definition of security-based swap only because it references or is based upon a government security.

"(C) MIXED SWAP.—The term 'security-based swap' includes any agreement, contract, or transaction that is as described in subparagraph (A) and also is based on the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(iii)).

"(D) RULE OF CONSTRUCTION REGARDING MASTER AGREEMENTS.—The term 'security-based swap' shall be construed to include a master agreement that provides for an agreement, contract, or transaction that is a security-based swap pursuant to subparagraph (A), together with all supplements to any such master agreement, without regard to whether the master agreement contains an agreement, contract, or transaction that is not a security-based swap pursuant to subparagraph (A), except that the master agreement shall be considered to be a security-based swap only with respect to each agreement, contract, or transaction under the master agreement that is a security-based swap pursuant to "provided such person is not buying and selling, quoting prices, and making a market in swaps."

subparagraph (A).".

(9) by adding after paragraph (38) the following:

"(39) SWAP DEALER.—

"(A) IN GENERAL.—The term 'swap dealer' means any person engaged in the business of buying and selling swaps for such person's own account, through a broker or otherwise.

"bona fide hedger or"

"(B) EXCEPTION.—The term 'swap dealer' does not include a person that buys or sells swaps for such person's own account, either individually or in a fiduciary capacity, ~~but not as a part of a regular business~~.".

(10) by adding after paragraph (39) the following:

"(A) In General.—"

"(40) MAJOR SWAP PARTICIPANT.—The term 'major swap participant' means any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, ~~other than to create and maintain an effective hedge under generally accepted accounting principles,~~ as the Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.";

(11) by adding after paragraph (40) the following:

"(41) MAJOR SECURITY-BASED SWAP PARTICIPANT.—The term 'major security-based swap participant' means any person who is not a security-based swap dealer and who maintains a substantial net position in outstanding security-based swaps, other than to create and maintain an effective hedge under generally accepted accounting principles, as the Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.".

(12) by adding after paragraph (41) the following:

"(B) Exception.— The term "major swap participant" does not include a person that is a bona fide hedger."

See definition of "bona fide hedge" and "bona fide hedger" to be inserted here on the following page.

collects and maintains the records of the terms and conditions of swaps or security-based swaps entered into by third parties.".

(b) JOINT RULE-MAKING ON FURTHER DEFINITION OF TERMS.—

(1) IN GENERAL.—The Commodity Futures Trading Commission and the Securities and Exchange Commission shall jointly adopt a rule further defining the terms "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant" no later than 180 days after the effective date of this Act.

(2) PREVENTION OF EVASIONS .—The Commodity Futures Trading Commission and the Securities and Exchange Commission may prescribe rules defining the term "swap" or "security-based swap" to include transactions that have been structured to evade this Act.

(c) JOINT RULEMAKING UNDER THIS ACT.—

(1) UNIFORM RULES.—Rules and regulations prescribed jointly under this Act by the Commodity Futures Trading Commission and the Securities and Exchange Commission shall be uniform.

(2) TREASURY DEPARTMENT.—In the event that the Commodity Futures Trading Commission and the Securities and Exchange Commission fail to jointly prescribe uniform rules and regulations under any provision of this Act in a timely manner, the Secretary of the Treasury, in consultation with the Commodity Futures Trading Commission and the Securities and Exchange Commission, shall prescribe rules and regulations under such provision. A rule prescribed by the Secretary of the Treasury shall be enforced as if prescribed jointly by the Commodity Futures Trading Commission and

Proposed definition of "bona fide hedge" and "bona fide hedger":

"(51) BONA FIDE HEDGE. — The term bona fide hedge means a swap that —

(i) arises from the potential change in the value of physical assets that a person owns, produces, distributes, consumes, manufactures, processes, or merchandises as its primary business or anticipates owning, producing, distributing, consuming, manufacturing, processing, or merchandising as its primary business; and

(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."

"(52) BONA FIDE HEDGER. — The term bona fide hedger means a person that —

(i) owns, produces, distributes, consumes, manufactures, processes, or merchandises physical assets as its primary business; and

(ii) enters into bona fide hedges or other effective hedges under generally accepted accounting principles."

"(B) the rules of the derivatives clearing organization described in subparagraph (A) prescribe that all swaps with the same terms and conditions are fungible and may be offset with each other.

"(2) STANDARDIZATION IF CLEARED.—A swap that is accepted for clearing by any registered derivatives clearing organization shall be presumed to be standardized.

"(3) SWAPS DESIGNATED AS STANDARDIZED.—

"(A) Within 180 days of the enactment of the Over-the-Counter Derivatives Markets Act of 2009, the Commission and the Securities and Exchange Commission shall jointly adopt rules to further define the term 'standardized.' In adopting such rules, the Commission and the Securities and Exchange Commission shall jointly define the term 'standardized' as broadly as possible, after taking into account the following factors:

"(i) the extent to which any of the terms of the swap, including price, are disseminated to third parties or are referenced in other agreements, contracts, or transactions;

"(ii) the volume of transactions in the swap;

"(iii) the extent to which the terms of the swap are similar to the terms of other agreements, contracts, or transactions that are centrally cleared;

"(iv) whether any differences in the terms of the swap, compared to other agreements, contracts, or transactions that are centrally cleared, are of economic significance; and

"(v) any other factors the Commission and the Securities and

"; provided however, the term "standardized" shall not include bona fide hedges or other effective hedges under generally accepted accounting principles."

Exchange Commission determine to be appropriate.

"(B) The Commission may separately designate a particular swap or class of swaps as standardized, taking into account the factors enumerated in subparagraph (A)(i)-(v) and the joint rules adopted under paragraph (3)(A).

"(4) PREVENTION OF EVASION.—The Commission and the Securities and Exchange Commission shall have authority to prescribe rules under this subsection, or issue interpretations of such rules, as necessary to prevent evasions of this Act provided that any such rules or interpretations must be issued jointly to be effective.

"(5) REQUIRED REPORTING.— Both counterparties to a swap that is not accepted for clearing by any derivatives clearing organization shall report such a swap either to a swap repository described in section 21 or, if there is no repository that would accept the swap, to the Commission pursuant to section 4r within such time period as the Commission may by rule or regulation prescribe.

"(6) TRANSITION RULES.—Rules adopted by the Commission under this section shall provide for the reporting of data, as follows:

"(A) swaps that were entered into before the date of enactment of the Over-the-Counter Derivatives Markets Act of 2009 shall be reported to a registered swap repository or the Commission no later than 180 days after the effective date of the Over-the-Counter Derivatives Markets Act of 2009; and

"(B) swaps that were entered into on or after the date of enactment of the Over-the-Counter Derivatives Markets Act of 2009 shall be reported to a registered swap repository or the Commission no later than the later of—

"(i) 90 days after the effective date of the Over-the-Counter

"; or (C) the swap is a bona fide hedge or other effective hedge under generally accepted accounting principles."

Derivatives Markets Act of 2009; or

"(ii) such other time after entering into the swap as the Commission may prescribe by rule or regulation.".

"(7) MANDATORY TRADING.—Except as provided in paragraph (8), a swap that is standardized shall be traded on a board of trade designated as a contract market under section 5 or on an alternative swap execution facility registered under section 5h.

"(8) EXCEPTIONS.—The requirements of subsection (j)(1) and (7) do not apply to a swap if—

"(A) no derivatives clearing organization registered under this Act will accept the swap for clearing; ~~or~~

"(B) one of the counterparties to the swap—

"(i) is not a swap dealer or major swap participant; and

"(ii) does not meet the eligibility requirements of any derivatives clearing organization that clears the swap.".

(b) DERIVATIVES CLEARING ORGANIZATIONS.—

(1) Subsections (a) and (b) of section 5b of the Commodity Exchange Act (7 U.S.C. 7a-1) are amended to read as follows:

"(a) REGISTRATION REQUIREMENT.—It shall be unlawful for a derivatives clearing organization, unless registered with the Commission, 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 described in section 1a(10) of this Act with respect to—

"(1) a contract of sale of a commodity for future delivery (or option on such a contract) or option on a commodity, in each case unless the contract or option is—

capital and margin requirements under this subsection for swap dealers and major swap participants for which there is no Prudential Regulator.

"(3) CAPITAL.—

"(A) BANK SWAP DEALERS AND MAJOR SWAP PARTICIPANTS.—In setting capital requirements under this subsection, the Prudential Regulators shall impose:

"(i) a capital requirement that is greater than zero for swaps that are cleared by a derivatives clearing organization; and

"(ii) to offset the greater risk to the swap dealer or major swap participant and to the financial system arising from the use of swaps that are not centrally cleared, higher capital requirements for swaps that are not cleared by a registered derivatives clearing organization than for swaps that are centrally cleared.

"(B) NON-BANK SWAP DEALERS AND MAJOR SWAP PARTICIPANTS.—Capital requirements set by the Commission and the Securities and Exchange Commission under this subsection shall be as strict as or stricter than the capital requirements set by the Prudential Regulators under this subsection.

"(C) BANK HOLDING COMPANIES.—Capital requirements set by the Board for swaps of bank holding companies and Tier 1 financial holding companies on a consolidated basis shall be as strict as or stricter than the capital requirements set by the Prudential Regulators under this subsection.

"(4) MARGIN.—

"(A) BANK SWAP DEALERS AND MAJOR SWAP PARTICIPANTS.— The

"provided however, capital requirements shall not be imposed for swaps that are bona fide hedges or other effective hedges under generally accepted accounting principles."

"shall not"

Prudential Regulators shall impose both initial and variation margin requirements under this subsection on all swaps that are not cleared by a registered derivatives clearing organization, except that the Prudential Regulators ~~may, but are not required to,~~ impose margin requirements with respect to swaps in which one of the counterparties is—

"(i) neither a swap dealer, major swap participant, security-based swap dealer nor a major security-based swap participant;

"(ii) using the swap as part of an effective hedge under generally accepted accounting principles; and "a bona fide hedge or"

"(iii) predominantly engaged in activities that are not financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)).

"(B) NON-BANK SWAP DEALERS AND MAJOR SWAP PARTICIPANTS.—Margin requirements for swaps set by the Commission and the Securities and Exchange Commission under this subsection shall be as strict as or stricter than margin requirements for swaps set by the Prudential Regulators.

"(f) REPORTING AND RECORDKEEPING.—

"(1) IN GENERAL.—Each registered swap dealer and major swap participant—

"(A) shall make such reports as are prescribed by the Commission by rule or regulation regarding the transactions and positions and financial condition of such person;

"(B) for which

"(i) there is a Prudential Regulator shall keep books and records of

See proposed addition to page 40 line 16 to be inserted here on the following page.

Proposed addition to page 40 line 16:

"; provided however, margin shall not be required with respect to swaps in which one of the counterparties is —

"(i) neither a swap dealer, major swap participant, security-based swap dealer nor a major security-based swap participant;

"(ii) using the swap as part of a bona fide hedge or an effective hedge under generally accepted accounting principles; and

"(iii) predominantly engaged in activities that are not financial innature, as defined in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k))."

APPENDIX D

Testimony of Raymond Plank, Chairman and Chief Executive Officer, Apache Corporation Before the Subcommittee on Energy and Air Quality, of the Committee on Energy and Commerce, U.S. House of Representatives, February 13, 2002

Mr. Chairman and Members:

Thank you for the opportunity to speak to the Committee today.

My name is Raymond Plank, and I am founder and chief executive officer of Apache Corporation. Over 5 decades in the oil and gas business, Apache has grown from one of the smallest to one of the larger independent producers.

Natural gas is the single most important domestic energy source—an abundant resource that warms millions of homes, fuels much of America's industrial base and plays a large and growing role in the nation's electricity industry. However, while many believe natural gas is the fuel of the future, I believe that future is in jeopardy because of the flawed structure of the natural gas market in this country.

The fact is, the nation's energy markets skated by and escaped a disaster in the wake of Enron's collapse. Why? Certainly not because this market—in its current dysfunctional state—serves the nation's needs. No, we avoided a supply crunch because the recession and one of the warmest winters in recent history combined to keep demand in check. If the economy had been more robust, or if weather conditions had been different, the story could have been far different.

This is an issue that should be important to the other members of this panel because they have developed business plans, raised billions of dollars from investors and erected power plants based on the availability of reliable supplies of natural gas. The current market, roiled by excessive price volatility, has undermined the ability of Apache and other North American producers to meet their requirements.

Mr. Chairman, I know you have worked hard to introduce competition into the nation's energy markets. But deregulation has been hijacked by traders, hedge funds and others who profit from volatility and who scorn the hard-working men and women who produce this important resource. If you don't fix the natural gas market, then all your efforts to bring competition to the electricity market will be for naught because natural gas is the fuel of choice for new generating capacity.

The uncertainty in the gas market caused by excessive price volatility endangers the infrastructure required to explore for and produce natural gas. Every time the price goes down and Apache and other companies cut back, skilled workers—from roustabouts to engineers to scientists—leave the industry. Drilling rigs are taken out of service and cannibalized for spare parts and marginal wells are shut in, never to return to production.

Right now, the industry is not drilling enough wells to maintain production at current levels.

Yes, Mr. Chairman, Enron is gone, but the damage has been done to a vital element of the nation's economic security. In some ways, this is a homeland security issue: There is a ticking time bomb set to wreak havoc when the economy comes back and energy demand increases.

I'd like to give you some background on how we came to our position.

For the last 10 years, our ability to find and produce the natural gas this country needs has been crippled by increasing price volatility. North America is a mature producing province, which means that while there is still a great deal of natural gas to be found, producing it requires better technology, better science, more time and more money. Most of these projects take from 12 months to 2 years to complete. It is harder and harder to commit capital to these kinds of projects when we can't forecast what the price of our product is going to be tomorrow, much less a year from now.

Natural gas prices, like all commodity prices, run in cycles. That's been true as long as I can remember. Recently, however, as hedge funds and traders have come to dominate the market, the cycles have become shorter in duration and more pronounced. In press reports and presentations to analysts, these traders acknowledge that they derive their profits from price volatility.

The casino mentality that has taken over the energy markets has a real impact on consumers as well as producers.

Let me give you a real example that we all remember.

In December 1999, we were paid less than $2 for a thousand cubic feet of gas. In January 2001, the price climbed to nearly $10, only to fall back below $2 by October. To put that in perspective, think about the impact on the stock market—and the American economy—if the Dow Jones Industrial Average took a trip from 10,000 to 47,000 and back to 10,000 in a year and a half. What would your constituents be telling you if the price of gasoline jumped from $1.20 per gallon to $6 and then back down to $1.20?

Last winter's price spike dealt a damaging blow to the industrial economy, which in total accounts for 40 percent of U.S. natural gas consumption. Natural gas-intensive industries like steel, plastics and petrochemicals significantly curtailed or shut in production in response to extremely high gas costs. Some of this demand has been permanently displaced. In addition, natural gas volatility played a key role in California's energy problems. The consequences for the economy due to overheated gas prices are painfully clear.

But when the price falls back to $2 per thousand cubic feet, the capacity of the industry to supply natural gas is diminished—permanently. One consequence is a brain drain in the industry. The average age of U.S. geologists and petroleum engineers is 48 years old. As young engineers and scientists seek opportunities elsewhere, the nation will lose its technological edge in this industry.

When prices fall, companies like Apache reduce their drilling expenditures and seek more profitable avenues for investment, usually overseas. This year, Apache's North American exploration and development budget has been cut by 70 percent. Other oil and gas companies are taking similar measures.

As a consequence, I can assure you that the next price spike is just around the corner. It may not come until this fall or next winter, but it is inevitable and it could be severe.

As much as we know about getting natural gas out of the ground, there are many things about this market that have been hidden from view by powerful insiders who profit from its opacity. We can't find the answers because we don't have subpoena power. It's up to you to break through some of these Chinese walls and get to the bottom of this structurally flawed market.

Now, I'd like to discuss some of the most glaring problems with this market and our suggestions for fixing it.

Every month, the price we get for our natural gas production is based on indices published in one or more trade publications. The reporters who compile these price indices are generally hard-working, honest journalists, but their sources—the pipelines, utilities and marketers—are under no obligation to provide complete or even accurate information. Similarly, the American Gas Association's weekly storage report became a major market event because it was a proxy for supply and demand data but it was based on voluntary, self-serving data.

In a market as important as the natural gas market, the government should collect and disseminate real-time information on natural gas supply and demand from market participants, with penalties imposed on companies that fail to file accurate reports.

Even some energy marketers acknowledge that the current rules give unfair advantages to integrated energy companies with their regulated pipelines, unregulated marketing affiliates and electric generating units. While allegedly separate, these people go to work in the same office buildings, share coffee—and benefit from the same corporate incentive systems.

The current rules governing the conduct of regulated and unregulated affiliates are weak and subject to abuse. To prevent the trading of insider information, these functions should be legally and geographically separated and their dealings limited to real transactions with real money changing hands. If companies abuse these rules, they should be required to divest their unregulated affiliates.

Online trading platforms, which operate outside the longstanding framework that regulates commodities exchanges, provide their owners with vast information about the trading positions of other market players which can be used to manipulate the market.

These online platforms are exchanges; they should be subject to similar regulation to ensure fair treatment of all parties. In the equities market, there is a basic rule that agents cannot put their trades ahead of their clients' transactions; similar rules should guide the conduct of the energy markets.

The bright light of Wall Street cast on energy marketers in the aftermath of the Enron collapse revealed them to be over-leveraged. They rely on mark-to-market accounting of energy contracts that allows them to book the revenues and profits of long-term contracts up front, long before the revenues are collected and the profits realized. Though they appear profitable on the surface, a closer examination reveals that the profits may prove to be illusory. The current system incentivizes traders to book deal after deal, seeking profits from every move in the market and distorting legitimate supply and demand signals.

End mark-to-market accounting and require traders to book their revenues and profits when they are realized. Impose capital requirements to assure customers that the traders will be there to deliver the gas and electricity.

Some would have you believe that the fact that a company as large as Enron could fail without causing any disruption in the energy markets is a signal that these markets are deep and liquid. I disagree. I think it demonstrates that Enron and others like it add no value.

I also believe that failure to reform this market will cause lasting damage to the nation's energy infrastructure and economic health.

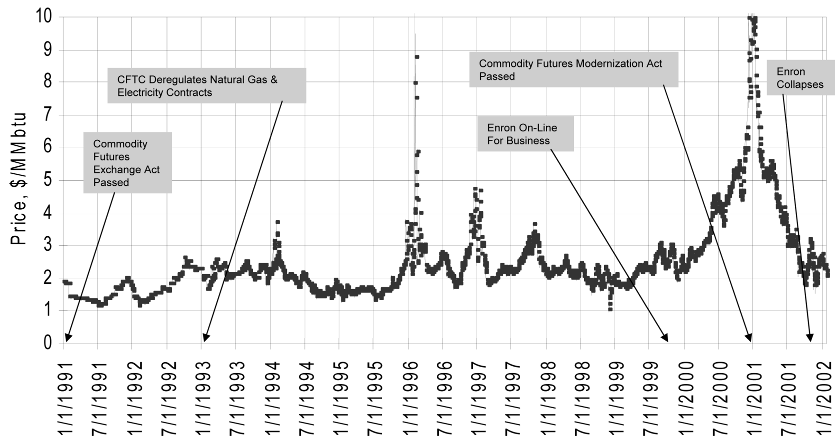
Mr. Chairman, you have before you the record of the fall of Enron—the self-dealing, the subterfuge and the apparent fraud. I think it's fair to ask whether the same behavior permeated Enron's biggest business—its natural gas and electricity trading operations. Once your Committee answers that question, I hope you will conduct a thorough examination of the structure of the energy market and make the changes necessary to ensure that there are not other Enrons out there waiting to happen.

The task before you is clear: To introduce effective oversight and transparency in this market, eliminate the casino mentality that places price volatility above physical supplies and restore an environment that will encourage producers to make the investments to meet the nation's vital energy needs.

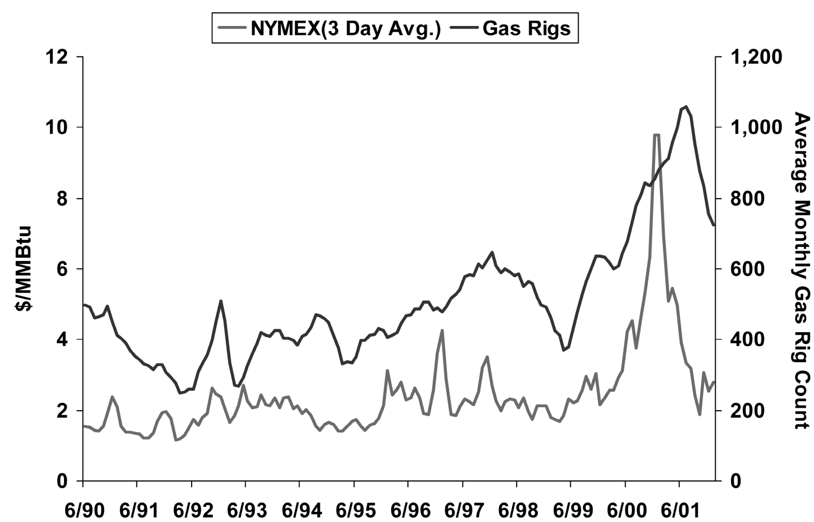
Thank you very much for the opportunity to be here today.

ATTACHMENT

Historical Henry Hub natural gas prices

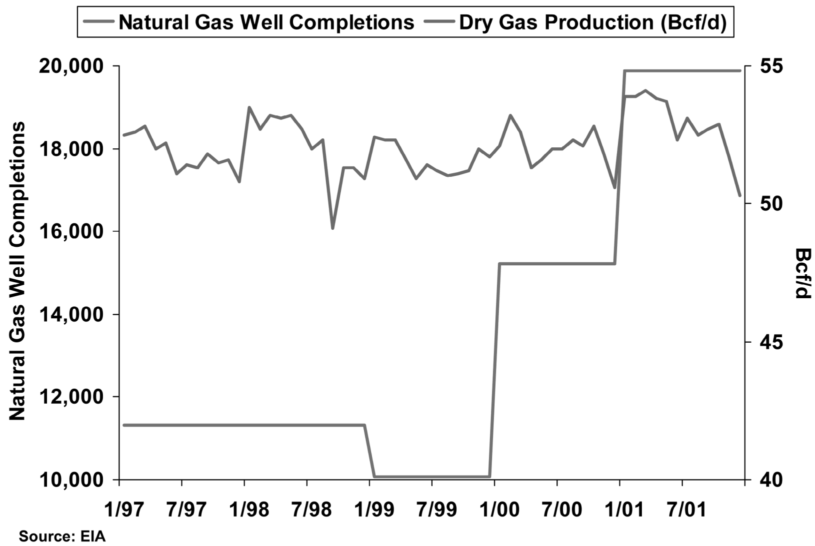


Drilling activity increases as natural gas prices climb …



Note: As of 11/1/01.

… but supply response has been limited



Volatility vs. the public interest

"Volatility is what a trader like Enron thrives on," said Analyst Donato Eassey of Merrill Lynch & Co. "They made a lot of money because there was a lot of volatility in both power and gas (markets)."

- Los Angeles Times, Jan. 23, 2001

The increase primarily was due to substantially higher profits from the energy marketing & trading business, reflecting successful proprietary natural gas and electric power trading during a year of nationwide volatility across these energy portfolios.

- Williams Companies, Year-end 2000 Earnings Release, Feb. 5, 2001

The hyper-confident Skilling is unrepentant about his company's long role as a deregulation crusader. Enron benefits from volatility, not high prices, he says.

- Business Week, Feb. 12, 2001

Volatility vs. Public Interest

"Our earnings aren't as much dependent on the absolute price of the commodity as they are on volatility," says Dynegy CEO Chuck Watson.

- Business Week, April 7, 2001

Although physical volumes increased for each commodity in the segment, the low level of volatility in the (European) gas and power markets caused profitability to remain flat.

- Enron 3Q01 Earnings Release, Oct. 16, 2001

Volatility vs. Public Interest

"We have more generation this year than last, and we had a strong quarter in trading and marketing electricity and gas," said Robert Brace, Duke's CFO. "The markets have been volatile, and we've made money on the volatility."

- Charlotte Observer, Oct. 17 2001

Dynegy Chairman Chuck Watson said he sees continued price volatility as a good profit opportunity for the company.

- Charlotte Observer, Oct. 17 2001

Submitted Statement by Terry W. Rathert, Founder, Executive Vice President, and Chief Financial Officer, Newfield Exploration Company

Chairman Peterson, Ranking Member Lucas and members of the Committee, thank you for the opportunity to provide testimony to the House Agriculture Committee regarding over-the-counter ("OTC") derivatives. My name is Terry W. Rathert. I am a founder of Newfield Exploration Company ("Newfield" or "Company"), and serve as its Executive Vice President and Chief Financial Officer. Newfield is an independent crude oil and natural gas exploration and production company traded on the New York Stock Exchange under the symbol "NFX" with a current market capitalization of approximately $6 billion and 2008 revenues of in excess of $2 billion.

Newfield appreciates the initiative and leadership taken by the Administration, House, Senate and Treasury Department in the area of Financial Regulatory Reform. Over the last few months, I have made two trips to Capitol Hill to help educate our policy makers on just how important derivates are to our Company and our ability to plan for the future. In short, we use derivative instruments as a risk management tool to *reduce* volatility.

Newfield supports your efforts and agrees with these stated objectives: (1) to prevent activities within the OTC derivatives markets from posing systemic risks to the financial system, (2) to increase transparency and (3) to prevent market abuse and manipulation. I believe that each of the various proposals seeks to reign in speculation where it is adverse to the interests of the common good. Further, regulation should provide sufficient protection for market participants and adequate assurances for the broader financial system to ensure that we do not experience an adverse future event like the near-collapse of AIG.

However, the proposals for financial regulatory reform cast a much broader "net" than needed to accomplish these objectives. I do not believe it was the intention of these proposals to increase the costs for those who use these financial instruments to manage risk and uncertainty in their business. My belief stems from wording in the proposals that carve out or exempt certain transactions or participants when there is "an effective hedge under generally accepted accounting principles". However, exempting the use of effective hedges as defined by GAAP is not sufficient. Under GAAP, we have the option to elect hedge accounting or mark-to-market accounting for derivative financial instruments – although in both cases, it is possible to have an effective hedge from a 'business' purpose perspective.

Newfield has been using OTC energy commodity derivatives for nearly 20 years to hedge our naturally long position in the market. We chose the OTC market because we could customize those hedge transactions to the manner in which we sell our physical product. But more importantly, by utilizing the OTC market, we avoid the potentially significant demand on liquidity associated with posting cash margin on the exchange traded contracts.

Effects on Liquidity

The proposed regulations would, to the extent possible, move the types of contracts we utilize for price risk management onto exchanges or cause them to be cleared; the net result, we believe, would be the same – a requirement for margin or collateral – a demand on our liquidity. To the extent "customized contracts" could not be moved onto exchanges for trading or cleared, the regulatory reform asks for 'significantly higher' capital charges or margin. Simply stated, Newfield could be required to post a significant amount of cash to hedge our production over a 1-2 year period. A reduction in our liquidity could impair our ability to drill wells, manage our day to day operations, maintain employees and find needed domestic supplies of oil and gas.

Our industry consistently invests in excess of its cash flow from operations. In fact, Newfield has invested more than its cash flow from operations in 18 of the last 20 years. The ability to hedge our future production has provided us with price assurance and more stable cash flows, and has allowed us to grow U.S. reserves, production and an employee base that has gone from just 23 in 1989 to more than 1,000 today. From a planning perspective, hedging is important to our Company.

Overly broad regulation of OTC derivatives could result in increased volatility - the opposite of its intended effect. Volatility would increase if we were required to preserve liquidity to allow us to be in a position to post margin during turbulent and uncertain times. We would have to significantly limit the capital we invest in our drilling programs. As a result, there would be more volatility in our activity levels, our oil and gas production and U.S. supply.

We are hedgers, not speculators. The counterparties in Newfield's OTC derivative contracts generally are financial institutions, including banks both within and outside of our commercial lending arrangements. None of our derivative contracts contain collateral posting requirements, although one contract could, in certain circumstances, require us to provide adequate assurance of our performance under the contract.

We have already invested in the barrels of oil or mcf of gas that will be produced in the future. Effectively, capital is already on the line. Regulatory reform that requires additional collateral for a "bona fide" hedge put in place by a "bona fide hedger" to manage risk and volatility is excessive. In this context, a "bona fide hedge" is a swap that (i) arises from the potential change in value of the physical assets that a person owns, produces, distributes, consumes, manufactures, processes, or merchandises, as its primary business or anticipates owning, producing, distributing, consuming, manufacturing, processing, or merchandising, as its primary business; and (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and further, that a "bona fide hedger" means a person that (i) owns, produces, distributes, consumes, manufactures, processes, or merchandises physical assets as its primary business; and (ii) enters into bona fide hedges or other effective hedges under generally accepted accounting principles. We propose that such transactions would be exempt from capital or margin requirements.

Regulatory Reporting

Newfield presently reports its aggregate positions on a very regular basis. These positions can be found in our quarterly reports on Form 10-Q and annual reports on Form 10-K filed with the Securities and Exchange Commission. Additionally, we update our positions even more promptly through our "@NFX" publication on our website and our current reports on Form 8-K filed with the Securities and Exchange Commission.

Newfield is not opposed to reporting its detailed individual positions, including counterparties, to regulators, provided that such information will not be available in the public domain or to such counterparties. A counterparty's knowledge of other counterparty positions could result in higher transaction costs to the Company.

Thank you for your attention. I would be happy to answer any questions you may have.

Terry W. Rathert
Executive Vice President & Chief Financial Officer
Newfield Exploration Company
363 N. Sam Houston Parkway East, Suite 100
Houston, Texas 77060

Attachment: Letter dated June 25, 2009 on this topic prepared by Newfield Exploration Company and sent to numerous elected officials.

NEWFIELD

June 25, 2009

Dear Elected Official;

I am writing to you on behalf of Newfield Exploration Company to express our serious concerns with the Commodity Exchange Act provisions of H.R. 2454, the "American Clean Energy and Security Act of 2009" as recently reported by the House Committee on Energy and Commerce. Stand alone bills have also been introduced in both the House and Senate – H.R. 977 by House Agriculture Committee Chairman Peterson and S. 272 by Senate Agriculture Chairman Tom Harkin.

Newfield is a large independent exploration and production company. We expect to produce more than 250 Bcfe in 2009, of which about 70% is American natural gas. Our largest producing areas are the Mid-Continent and Rocky Mountains. We have grown dramatically from about 100 employees in 1999 to more than 1,000 employees today, and are continuing to drill wells to help meet America's future energy needs. We take pride in operating with both financial and environmental integrity.

We applaud efforts to prevent activities in markets that could pose risks to the financial system. It is critical to promote efficiency and transparency in our markets and to prevent market abuses. However, the provisions of the referenced legislation as they apply to energy producers – as opposed to speculators - will severely hamper our ability to fund our drilling projects, resulting in less production, fewer jobs and ultimately higher commodity prices.

The availability of the over-the-counter market ("OTC") permits us to make commitments of capital to develop energy resources with an acceptable range of outcomes in today's volatile environment. We use these contracts as **price risk management tools.** To regulate or force energy commodity contracts onto or through an exchange would preclude our ability to use them. We cannot predict, nor preserve, the liquidity required to continue to do so in that event. The basic reason we use the OTC market instead of exchange traded contracts is to preserve liquidity – not having to post cash collateral – so we can plan our business and execute our business plan with a high degree of certainty . Since these positions settle against our future physical sales, they are not speculative. Here's an example:

> *At the end of 2008, our "mark to market" position was nearly a $1 billion asset. Six months earlier, that asset had been a liability of approximately $550 million. Had we been required to post collateral against that liability, it would have significantly, and negatively, impacted our liquidity and our ability to fund our capital budgets. It is important to emphasize that these positions settle against physical sales in the near term – they are not speculative.*

Hedges using the OTC market are vital to independent E&P companies like Newfield. Combined, independents drill more than 60% of all wells in the U.S. each year.

We believe this is a classic case of "unintended consequences," resulting in the punishment of legitimate transactions that reduce volatility and risk for the producer, rather than the punishment of speculators that are attempting to take advantage of price volatility. We believe this legislation should be amended to make a clear distinction between producers and speculators.

Thank you for your leadership and the consideration of our views. If I can be of assistance, please do not hesitate to call me.

Sincerely yours,

Terry Rathert

Terry Rathert
Executive Vice President and CFO
Newfield Exploration Company

SUBMITTED STATEMENT BY 3M COMPANY

3M Company ("3M") appreciates the opportunity to submit this statement for the record regarding the importance of the over-the-counter (OTC) derivatives market to the conduct of business at 3M. As you may know, 3M is a large U.S.-based employer and manufacturer established more than a century ago in Minnesota. Today, 3M is one of the largest and most diversified technology and manufacturing companies in the world.

3M thanks the Committee for studying the critical details related to reforms to the U.S. financial system and for considering our perspective in this important debate. In examining the concepts outlined in the recent U.S. Treasury proposal on financial system reforms, 3M respectfully urges the Committee to carefully consider the distinct differences among various derivative products and how they are used, and strongly encourages the Committee to preserve commercial users' access to OTC derivative products to manage various aspects of corporate risk.

Background on 3M

In 1902, five northern Minnesota entrepreneurs created the Minnesota Mining & Manufacturing Company, now known today as 3M. 3M is one of the largest and most diversified technology companies in the world. 3M is home to such well-known brands as Scotch, Scotch-Brite, Post-it, Nexcare, Filtrete, Command, and Thinsulate. 3M designs, manufactures and sell products based on 45 technology platforms and serves its customers through six large businesses: Consumer and Office; Display and Graphics; Electro and Communications; Health Care; Industrial and Transportation; and Safety, Security and Protection Services. 3M achieved $25.3 billion of worldwide sales in 2008.

Headquartered in St. Paul, Minnesota, 3M has operations in 29 U.S. states, including over 60% of 3M's worldwide manufacturing operations, employing 34,000 people. 3M's U.S. sales totaled approximately $9.2 billion in 2008. While its U.S. presence is strong, being able to compete successfully in the global marketplace is critical to 3M. 3M operates in more than 60 countries and sells products into more than 200 countries. In 2008, 64% of 3M's sales were outside the U.S., a percentage that is projected to rise to more than 70% by 2010.

Ahead of their peers, 3M's founders insisted on a robust investment in R&D. Looking back, it is this early and consistent commitment to R&D that has been the main component of 3M's success. Our diverse technology platforms allow 3M scientists to share and combine technologies from one business to another, creating unique, innovative solutions for our customers. 3M conducts over 60% of its worldwide R&D activities within the U.S.

Our commitment to R&D resulted in a $1.4 billion investment of 3M's capital in 2008 and a total of $6.7 billion during the past 5 years while producing high quality jobs for 3,700 researchers in the U.S. The success of these efforts is evidenced not only by 3M's revenue but also by the 561 U.S. patents awarded in 2008 alone, and over 40,000 global patents and patent applications in force.

Our success is also attributable to the people of 3M. Generations of imaginative and industrious employees in all of its business sectors throughout the world have built 3M into a successful global company. Our interest in speaking with you today is to preserve our ability to continue to invest and grow, creating substantive jobs and providing high quality products to a growing base of customers.

Treasury Proposal.

On August 11, 2009, the Administration submitted legislative language focusing on the regulatory reform of OTC derivatives. The Administration proposed the establishment of a comprehensive regulatory framework for OTC derivatives that is designed to:

1. Guard against activities in those markets posing excessive risk to the financial system.

2. Promote the transparency and efficiency of those markets.

3. Prevent market manipulation, fraud, insider trading, and other market abuses.

4. Block OTC derivatives from being marketed inappropriately to unsophisticated parties.

OTC Derivatives: Helping U.S. Companies Manage Risk in a Competitive Marketplace.

While 3M unequivocally supports these objectives, we have strong concerns about the potential impact of legislation on OTC derivatives and our ability to continue to use them to protect our operations from the risk of undue currency, commodity, and interest rate volatility.

Derivative products are essential risk management tools used by American companies in managing foreign exchange, commodity, interest rate and credit risks. The ability of commercial users to continue to use OTC derivatives consistent with the requirements of hedge accounting rules is critical for mitigating risk and limiting damage to American businesses' financial results in volatile market conditions.

We urge policy makers to preserve commercial users' access to existing derivative products as you design new regulations. We share the following comments with you in the spirit of working together to address the concerns about the stability of the financial system:

1. Guarding Against Activities Within OTC Markets From Posing Excessive Risk To The Financial System:

- We agree that the recent economic crisis has exposed some areas in our financial regulatory system that should be addressed. However, the vast majority of OTC derivatives have not exposed the financial system to excessive risk, and therefore regulation should be tailored. The OTC foreign exchange, commodity, and interest rate markets have operated uninterrupted throughout the economy's financial difficulties, permitting corporate end-users to prudently manage business risks through a difficult economic environment. In the Administration's proposal, the term "Major Swap Participant" should not include end-users that are using OTC derivatives for legitimate hedging activity only. We urge policy makers to focus on the areas of highest concern, such as credit default swaps.
- We would like to work with policy makers to address oversight where warranted, *but recommend that it be targeted and not applied to all derivatives and market participants.*

2. Promoting Transparency and Efficiency within the OTC Markets:

- We understand the need for reporting and record keeping. Publicly held companies are currently required by the SEC and FASB to make significant disclosures about their use of derivative instruments and hedging activities, including disclosures in their 10Ks and 10Qs.
- *We would like to work with policy makers on ways to efficiently collect information into a trade repository to further enhance transparency.* Guidelines which improve documentation, transparency and ensure compliance with hedge accounting rules should be considered as appropriate criteria for exempting end-users from margin requirements.
- **We oppose a mandate to move all OTC derivatives into a clearing or exchange environment.** The ability to customize the derivative to meet a company's specific risk management needs is crucial. Provisions that would require clearing of OTC derivatives would lead to standardization, thus impeding a company's ability to comply with the requirements of Financial Accounting Standard 133 (FAS 133). The inability to precisely hedge specific risks, whether currency, interest rates or commodities within the context of FAS 133, would expose corporate financial statements to unwanted volatility and uncertainty. Results could include lower capital expenditures and job growth as companies undertake fewer growth investments due to the need to maintain reserves for adverse impacts from unhedged financial risks.
- While we are mindful of the reduction in credit risk inherent in a clearing or exchange environment, robust margin requirements would create substantial incremental liquidity and administrative burdens for commercial users, resulting in higher financing and operational costs. Capital currently deployed in growth opportunities would be diverted into clearinghouse accounts. This could result in slower job creation, lower capital expenditures and R&D, and/or higher costs to consumers. Any exemption from clearing should *not* be linked to any eligibility requirements set by the clearing agencies.

  Hedging in the OTC market is customized to fit the underlying business risks being hedged. The clearinghouse concept relies upon high volumes of standardized products, a characteristic that does not exist in the customized hedging environment of the OTC market.

  By imposing initial and variation margin requirements, clearinghouses will add significant capital requirements for end-users, adding significant costs, discouraging hedging, and diverting scarce capital that could otherwise be used in further growing American businesses.

3. Preventing Market Manipulation, Fraud, Insider Trading, And Other Market Abuses.

- ◦ We support the appropriate regulatory agencies having the authority to police fraud, market manipulation and other market abuses. The CFTC is utilizing its existing statutory and regulatory authority to add significant transparency in the OTC market, receive a more complete picture of market information, and enforce position limits in related exchange-traded markets. *The comment period remains open on the CFTC proposal and this work should be allowed to continue.*

4. Blocking OTC Derivatives From Being Marketed Inappropriately To Unsophisticated Parties.

- ◦ We support modifications to current law that would improve efforts to protect unsophisticated parties from entering into inappropriate derivatives transactions.

We thank the Committee for the opportunity to share our perspective as an employer interested in preserving and enhancing the global competitiveness of American businesses and workers. 3M looks forward to working with you as the Committee crafts legislation to reform the U.S. financial system.

Submitted Statement by National Association of Manufacturers

Mr. Chairmen and Committee Members:

The National Association of Manufacturers (NAM)—the nation's largest industrial trade association—represents large, mid-size and small manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards.

The NAM appreciates and supports the Administration's efforts to improve transparency, accountability and stability in the derivatives market. At the same time, NAM members have some concerns about the regulatory framework for over-the-counter (OTC) derivatives proposed by the Treasury Department.

Manufacturers of all sizes use customized OTC derivatives to manage the risks of operating their businesses, including fluctuating currency exchange, interest rates and commodity prices. For example,

- **Currency Exchange Rates:** Companies that import or export may not want to bear the risk that the price of the dollar will fluctuate against the currencies they are using to buy or sell goods. In these cases, businesses can enter into a customized currency derivative that allows them to lock in the exchange rate.
- **Interest Rates:** Companies frequently borrow money at variable rates tied to an interest rate index. Businesses can manage the risk that the interest rate on their loan might increase by entering into a customized interest rate derivative and locking in a fixed rate for the entire maturity of the loan.
- **Commodity Prices:** Some manufacturers use large amounts of commodities in the production process, *e.g.,* natural gas, corn, aluminum. In order to manage their operating risk and preserve their margins, these companies can lock in the price of these commodities by entering into a customized commodity price swap linked to the price of the commodity causing the exposure.

The ability of end-users of all sizes to continue to use customized OTC derivatives is critical for mitigating risk and limiting damage to the health of American businesses, particularly during these unprecedented economic conditions. Consequently, NAM members are concerned about proposals that would require OTC derivatives used by business end-users to be centrally cleared or executed on exchanges as well as proposals that would impose capital requirements or prevent end-users from using underlying assets as collateral. The proposals would significantly increase costs for companies seeking to hedge risks through OTC products and limit, or eliminate altogether, needed customized products used for risk management.

A key benefit of OTC derivatives to end-users is the ability to customize derivatives to the specific risk management needs of the business. Provisions that require exchange trading of OTC derivatives would lead to the standardization of these tools, impeding the ability of companies to accurately hedge risks and comply with the requirements of Financial Accounting Standard 133 (FAS 133). Without the ability to hedge specific risks, companies would be forced to shoulder greater risks in an environment already marked by high volatility.

NAM members are also concerned about the onerous liquid collateral needs associated with OTC derivatives being exchange-traded or centrally cleared. Exchanges and clearinghouses insulate commercial participants from credit exposure by requiring the value of the derivative contract (mark-to-market) to be posted in cash or Treasury securities and for market moves twice a day. In general, a clearing requirement for customized OTC derivatives would result in an extraordinary drain on working capital for American companies by requiring significant amounts of liquid collateral to be posted. These margin requirements would create an additional administrative and liquidity burden for commercial users, resulting in additional financing and administrative costs.

On a broader note, the NAM agrees with the Administration that the current financial crisis has exposed some areas in our financial regulatory system that should be addressed. Not all OTC derivatives, however, pose a risk to the financial system. NAM members welcome the opportunity to work with policy makers to identify where increased, targeted oversight is warranted.

Similarly, the NAM understands the need for adequate reporting and record keeping. While corporations already provide reports to the Securities and Exchange Commission (SEC) and other government agencies, they would like to work with policy makers on ways to set up a trade repository to enhance further transparency by pulling together information already required under existing reporting requirements.

In addition, NAM members believe that any reform plan should clearly delineate regulatory authorities and functions among the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and other agencies in order to provide certainty to the market and to ensure similar products are governed by similar standards.

In sum, any reform effort should ensure companies' continued access to OTC derivatives, providing them with greater financial certainty and allowing them to allocate resources to core business activities. Thank you in advance for considering our concerns. As this proposal moves through the legislative process, the NAM looks forward to working with you on legislation that encourages transparency and stability in the derivatives markets without sacrificing the ability of corporations to use these critical risk management tools.

APPENDIX

How a Small Manufacturer Uses an OTC Customized Derivative

Manufacturers of all sizes use OTC derivatives to manage risk in their day to day operations. According to the International Swaps and Derivatives Association, more than 90 percent of Fortune 500 companies use customized derivatives, as do half of mid-sized companies and thousands of small U.S. companies. Here is an example of how a small manufacturer uses OTC customized derivatives to manage currency exchange fluctuations:

> **Example: Company** A, a U.S. exporter, sells heavy construction equipment to a buyer in Korea. The exporter will be paid upon delivery in South Korean Won.
>
> In order to protect against the risk that the Won might decline in value, the exporter enters into an OTC derivative to hedge that risk. The OTC contract would sell Won, tailored to the exact value that the exporter is being paid, on the specific day that the exporter is scheduled to receive payment.
>
> Under this example, the exporter knows the U.S. dollar value they will receive for the export, and the currency risk is effectively hedged. If the Won were to decline or increase in value after the time of the sale, but before payment is received, the exporter will be made whole through the settlement of the OTC derivative. In summary, the loss in the value of the goods sold would be offset by an increase in the value of the derivative.

SUBMITTED JOINT STATEMENT BY NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS; THE REAL ESTATE ROUNDTABLE; AND INTERNATIONAL COUNCIL OF SHOPPING CENTERS

The National Association of Real Estate Investment Trusts (NAREIT), The Real Estate Roundtable (RER) and the International Council of Shopping Centers (ICSC) (the "Associations") thank the Chairman, the Ranking Member and the Committee for the opportunity to submit these comments for the record of the hearing held by the Committee on Agriculture on September 17, 2009, regarding the proposed legislation by the Department of the Treasury to regulate over-the-counter (OTC) derivative markets.

The Associations support efforts by the Administration and the Congress to enact financial regulations that enhance transparency and accountability while restoring stability to capital markets. The Associations believe it is possible to enact this reform and minimize systemic risk while still maintaining access to reasonably priced and customized OTC derivative products for business end-users that seek to control cost and manage the risk inherent to their day-to-day business operations.

Commercial real estate companies rely upon low-cost, customized over-the-counter derivative products—such as interest rate swaps, forward starting swaps, and foreign exchange forward contracts—to mitigate risk and to manage the costs of their development and operational activities. By utilizing these products to minimize volatility and reduce risk, these companies can better manage their balance sheets and better serve their customers and shareholders.

We support efforts to contain any systemic risk posed by derivative arrangements between two major market participants through reasonable capital requirements and through mandatory central clearing or exchange trading of standardized derivatives.

However, proposals that would require OTC derivatives used by business end-users to be standardized, centrally cleared, executed on exchanges, or cash collateralized—or that would increase the cost of hedging through unreasonable capital charges—would create a significant drain on working capital and could prevent our member companies from accessing these important risk management tools.

The Associations appreciate the collaboration between Agriculture Committee Chairman Peterson and Financial Services Committee Chairman Frank, and the work of the Treasury Department in the effort to craft proposals that attempt to reduce systemic risk, while also recognizing the particular concerns of business end-users that utilize derivatives to manage business risk in a responsible way.

The Associations support these dual objectives, though we believe more must be done to ensure that the proposed legislation truly targets systemic risk and speculation without undermining legitimate risk management techniques for business end-users. We look forward to working with policymakers to achieve these goals.

National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

The Real Estate Roundtable

International Council of Shopping Centers

HEARING TO REVIEW PROPOSED LEGISLATION BY THE U.S. DEPARTMENT OF THE TREASURY REGARDING THE REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS

TUESDAY, SEPTEMBER 22, 2009

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

The Committee met, pursuant to call, at 11:04 a.m., in Room 1300, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee] presiding.

Members present: Representatives Peterson, Boswell, Scott, Marshall, Herseth Sandlin, Ellsworth, Walz, Kagen, Schrader, Halvorson, Dahlkemper, Markey, Kratovil, Schauer, Murphy, Pomeroy, Childers, Minnick, Lucas, King, Fortenberry, Smith, Latta, Thompson, Cassidy, and Lummis.

Staff present: Adam Durand, Tyler Jameson, John Konya, Scott Kuschmider, Clark Ogilvie, James Ryder, Rebekah Solem, Tamara Hinton, Kevin Kramp, Josh Mathis, Nicole Scott, Jamie Mitchell, and Sangina Wright.

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

The CHAIRMAN. The Committee will come to order.

Good morning, everybody, and welcome to the hearing.

Today marks the second of two hearings to review the Treasury Department's legislative proposals on over-the-counter derivatives, and I want to thank the Members for making it back to Washington early so you could attend this important hearing today.

I want to welcome Chairman Gensler and Chairman Schapiro, each of whom is making their first appearance before this Committee since they were confirmed by the Senate earlier this year.

Chairman Gensler has been extremely busy in his new role, and I want to commend him for the steps that he has taken, thus far, to promote market transparencies, specifically with respect to data reporting on index funds and swap dealers in the commodities market. This Committee held month-long hearings on this very topic and included similar data, disaggregation provisions in legislation that has passed earlier this year.

We intend to bring Chairman Gensler back very soon to discuss other issues relating to the futures markets. I look forward to working with him, as well as Chairman Schapiro, as we finish the job in passing long overdue legislation to bring order to the unregulated over-the-counter derivatives market.

Last Thursday, this Committee heard from industry stakeholders about Treasury's language as well their broader views on the practical effects of the major financial reform proposals that have been introduced. As I noted last Thursday, some of what has been proposed is similar to our line of thinking, which has been using the clearing model to mitigate the systemic risk of these over-the-counter products, which have grown exponentially in size and complexity.

While I think there are concerns from this Committee on both sides of the aisle about some of Treasury's language, the Administration, overall, has put forth some useful ideas that we can work with.

In particular, one point of contention we heard from several witnesses last week was a potential negative impact on end-users. This is proving to be a difficult problem to deal with, as I said last Thursday, but it is imperative that commercial users are not treated unfairly by any statutory or regulatory changes. These entities, for the most part, already have effective risk-management methods in place and, by virtue of their size, do not pose a systemic risk on the economy, like some of the market-making large banks or other financial institutions. We shouldn't throw the baby out with the bath water by hampering the ability of end-users to effectively hedge their price risk when it comes to regulatory reform.

In addition, I hope Chairman Gensler and Chairman Schapiro can offer their thoughts on financial reform as a whole, particularly the idea of the systemic risk regulator and how such a position could affect or take away from the missions of their respective agencies. I have made my position clear that I do not favor a systemic risk regulator, particularly if it is placed in the hands of the Federal Reserve, which is accountable to no one and has enjoyed a cozy relationship for many decades with the institutions that are largely responsible for this mess that we are in, in the first place.

I think that it is an important point to consider as we move into a crucial time in this debate, and I look forward to working with both Chairmen here today, as well as Ranking Member Lucas and other committees of jurisdiction to make sure that we don't lose sight of what is at stake.

There are a lot of big financial players who have a great deal of interest in maintaining the *status quo,* which is simply unacceptable to me and a lot of Members of this Committee.

Once again, I welcome Chairman Gensler and Chairman Schapiro. I look forward to their testimony.

And at this time, I would like to yield to the Ranking Member, Mr. Lucas from Oklahoma, for an opening statement.

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

Mr. LUCAS. Thank you, Mr. Chairman, and thank you for holding this hearing.

I also would like to extend a warm welcome to both our witnesses today. You two are in high demand, and I have watched with interest your appearance in front of other committees. Though this is your first time in front of the House Agriculture Committee, I trust and suspect it will not be your last.

On August 11, 2009, the Treasury Department released the Over-the-Counter Derivatives Market Act of 2009. Since the release, we have met with the exchange community, the dealer community, the end-user community and our staffs trying to gauge the impact of this legislative proposal. Reactions from those in the proposed regulatory community we have met with range from general concern to downright opposition.

Most believe, as I do, that the language is rather ambiguous and confusing. Some sections produce more questions than answers. For instance, the plan focuses on increasing transparency and standardization in the OTC derivatives market for all types of products, and recommends that all standardized OTC derivatives be cleared by a clearing organization or traded on an exchange. But the plan does not specify what would constitute standardized as opposed to customized derivatives. Also it does not mandate that all OTC derivatives be either traded on regulated exchanges or cleared through clearing organizations, only that as yet undefined standardized OTC derivative contracts be cleared.

In addition, incentivizing people to use standardized swaps will increase capital margin requirements on customized swaps. Here again, the Administration's proposal doesn't provide much clarity. The Administration's proposal is silent on how these increased costs will be calculated, who will be charged, who will charge the increased requirement, and who will hold the margin payment.

By no means are these the only examples of ambiguity or concerns created by the Administration's proposal, but they are the issues most frequently raised. I am anxious to learn from the regulators today, so that we might be able to get some clarity as the process moves forward.

I congratulate the Chairman for not only all of his efforts on this subject, but for having the two most important people responsible for implementing this language in front of the Committee so early in the process, so that we can get a common understanding of the proposals and the intentions.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman and other Members' statements will be made part of the record.

So, again, welcome to the Committee Chairman Gensler, Chairman Schapiro. We very much appreciate you being with us.

And with that, Mr. Gensler, I will turn the floor over to you for your statement, and then I think we have a lot of questions for you.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. GENSLER. Good morning, Chairman Peterson, Ranking Member Lucas, Members of the Committee. Thank you for inviting for me here to testify on behalf of the Commodity Futures Trading Commission regarding regulation of the over-the-counter derivatives, and my full statement will hopefully, if I can ask that be in the record, but it represents the Commission's statement on which I am testifying.

One year ago at this time, the financial system failed the American public, and the financial regulatory system as well failed the American public. And I believe we must now do all we can to ensure that this does not happen again. As a critical component of reform, not the only component but a critical component, we must bring comprehensive regulation to the over-the-counter derivatives marketplace. We must lower risk, promote market integrity, improve market transparency, while still allowing for this market, this risk-management market to exist.

Comprehensive regulation of the over-the-counter derivatives market, I believe, will require two complementary regimes: One, the regulation of the derivatives dealers themselves; these are the actors upon the stage. But also regulation of the key market functions or the stages themselves. This Committee took leadership on this important topic, derivatives regulation, when you passed H.R. 977 in February.

The joint framework for OTC derivatives legislation announced in the summer by the Chairman and Chairman Frank also includes essential provisions to protect the American public, and the legislation proposed and submitted to Congress by the Treasury on behalf of the Administration, where both the SEC and the CFTC were able to contribute, I believe are important steps towards comprehensive regulation of the derivatives market.

Regulating derivatives dealers is important because this financial crisis has taught us that the derivatives trading activities of even one firm can threaten the entire financial system and all Americans. Every taxpayer in this room, the Members of this Committee, your constituents, the audience, these gentlemen in front of me with their cameras clicking, all put money into this company that most Americans had never heard of, AIG; $180 billion of all of our money is right now in this institution, and it didn't have effective Federal regulation.

I believe we cannot afford any more multi-billion dollar bailouts of ineffectively regulated derivatives dealers. By comprehensively regulating the dealers, such as AIG, we can regulate the entire derivatives market, both standardized and customized products. The dealers should be required to meet capital standards and margin requirements to lower risk. I believe the dealers should also be required to meet business conduct standards to protect against fraud and manipulation and other abuses. And to promote transparency, the dealers should meet comprehensive reporting requirements so that the regulators can see all the trades and report those aggregates to the public.

But I believe we need to do more than just watch the dealers themselves and bring them under regulation. Congress, I believe, should also mandate that the standard product in these markets be brought on to centralized clearing and on to exchanges. One of the lessons we learned through the crisis is that financial institutions were not only too big to fail, but also too interconnected to be allowed to fail. In that regard, moving bilateral trades into regulated clearinghouses will reduce the risk that a failure of one firm will cause other firms to fail.

To meet the requirements that all the standardized products be brought on to centralized clearing, end-users have raised some concerns, as the Chairman and the Ranking Member noted. But end-users, I believe, should be permitted to access this clearing, bringing all standardized products on to the clearinghouses, through a clearing member. An end-user could use a financial institution, and that financial institution could then bring it to the standard exchanges and clearinghouses. Thus, we would be able to achieve a goal of bringing standardized swaps into clearing, while at the same time allowing end-users to enter into appropriate individualized credit terms with those financial institutions who are clearing members.

Transparency and efficiency would also improve for all end-users if we bring them onto regulated exchanges or trading venues. This would give both large and small end-users pricing, better pricing, both in standard and customized products.

I would like to also mention that we have been working very closely with the SEC, and comprehensive regulation of these markets will require ongoing cooperation. I believe that we are very fortunate to have a great partner in SEC Chairman Mary Schapiro. Since our designations were jointly announced by President-elect Obama in December, we have had a strong working relationship, and I look forward to working together to implement the regulatory reforms of the derivatives marketplace, as well as bringing forth to you and the rest of Congress recommendations as the President has asked us to do on how we best can tailor our regulations in the interest of protecting the American public.

Before I close, I would just like to mention, if Congress were to move forward, as I think we must, to regulate over-the-counter derivatives, the CFTC, and no doubt the SEC, will need additional resources for new staff and technology.

In our case, since the late 1990s, the markets have grown five-fold; the number of contracts we oversee and regulate six-fold, but our agency staff was cut by over 20 percent. With Congress's help, just this year, we are back to the staffing levels we were at in 1999. Taking on this additional oversight responsibility, I believe we will need to work with this Committee and the rest of Congress for additional resources.

So I look forward to working with Congress and other Federal regulators to bring this regulation forward for the American public, and with that, I look forward to questions.

[The prepared statement of Mr. Gensler follows:]

PREPARED STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Peterson, Ranking Member Lucas and Members of the Committee. Thank you for inviting me to testify today regarding the regulation of over-the-counter derivatives.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. We must now do all we can to ensure that it does not happen again. While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in our regulatory structure. As a critical component of reform, I believe that we have to bring comprehensive regulation to the over-the-counter (OTC) derivatives markets. We must lower risk, promote greater market integrity and improve market transparency.

The need for reform of our financial system parallels what we faced as a nation in the 1930s. In 1934, President Roosevelt boldly proposed to the Congress "the enactment of legislation providing for the regulation by the Federal Government of the operation of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation." The Congress responded to the then clear need for reform by enacting the Securities Act of 1933, the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936.

We need the same type of comprehensive regulatory reform today. Just as we then brought regulation to the commodities and securities markets, we now need to bring regulation to markets for risk management contracts called over-the-counter derivatives.

Comprehensive Regulatory Framework

Comprehensive regulation of the OTC derivatives markets will require two complementary regimes—one for regulation of the derivatives dealers, or the actors, and one for regulation of the derivatives markets, or the stages.

This regulatory framework must cover both standardized and customized swaps. This should include all of the different products, such as interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps, as well as all of the derivative products that may be developed in the future. We should eliminate exclusions and exemptions from regulation for OTC derivatives. Congress should extend the regulatory regimes of the Commodity Exchange Act ("CEA") and the Federal securities laws to fully cover OTC swaps in all commodities. I believe that the law must cover the entire marketplace, without exception.

Only with two complementary regimes that regulate both the derivatives dealers and the derivatives markets can we ensure that Federal regulators have full authority to lower risks, promote transparency and prevent fraud, manipulation and other abuses.

This Committee took leadership on OTC derivatives regulation by passing H.R. 977 in February. The joint framework for OTC derivatives legislation announced by Chairmen Peterson and Frank also includes essential provisions to protect the American public.

The legislative proposal submitted to Congress by the Treasury Department on behalf of the Obama Administration is a very important step toward comprehensive regulation of the OTC derivatives markets. The CFTC and the Securities and Exchange Commission worked with the Treasury Department on many of the most important provisions of the Administration bill.

Regulating Derivatives Dealers

Only by comprehensively regulating the institutions that deal in derivatives can we oversee and regulate the entire derivatives market. Through regulating the dealers, we can ensure that regulations apply to both standardized and customized products.

Derivatives dealers should be required to meet capital standards and margin requirements to help lower risk. Imposing prudent and conservative capital and margin requirements on all derivatives dealers will help prevent derivatives dealers or counterparties from amassing large or highly leveraged risks outside the oversight and prudential safeguards of regulators. Many of these dealers, being financial institutions, are currently regulated for capital. I believe, however, that we need to explicitly have in statute and by rule capital requirements for their derivatives exposure. This is even more important for those dealers who are not currently regulated or subject to capital requirements.

Customized derivatives are by their nature less standard, less liquid and less transparent. Therefore, I believe that higher capital and margin requirements for customized products are justified. This Committee addressed the issue of standardized *versus* customized swaps in H.R. 977.

Congress also should explicitly authorize regulators to require derivatives dealers and counterparties to segregate, or set aside, from their own funds the margin collected from counterparties. This would help ensure that counterparties are protected if either counterparty to the customized OTC transaction experiences financial difficulties.

Dealers should have to comply with business conduct standards to protect market integrity and lower risk. The CFTC and the SEC should be authorized to apply the same enforcement authority that we currently have over the futures and securities markets to OTC derivatives and those who trade them. Both the markets and the public benefit when there is a cop on the beat.

Business conduct standards also should ensure the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions. These standards for "back office" functions will help reduce risks by ensuring derivatives dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks.

To promote transparency and market integrity, a comprehensive reporting and record-keeping regime should be established for swaps, including swap repositories—for both standardized and customized products. This should include mandatory public disclosure of aggregate data on swap trading volumes and positions. A complete audit trail of all transactions should be available to the regulators.

The financial crisis has taught us that the derivatives trading activities of a single firm can threaten the entire financial system. Every single taxpayer in this room—both the Members of this Committee and the audience—put money into a company that most Americans had never even heard of. Approximately $180 billion of the tax dollars that you and I paid went into AIG to keep its collapse from further harming the economy. The AIG subsidiary that dealt in derivatives—AIG Financial Products—was not subject to any effective Federal regulation of its trading. Nor were the derivatives dealers affiliated with Lehman Brothers, Bear Stearns, and other investment banks. We must ensure that this never happens again. We cannot afford any more multi-billion-dollar bailouts.

Regulating Derivatives Markets

To effectively regulate OTC derivatives and protect the American public, Congress also should establish a comprehensive regulatory regime for the markets in which OTC derivatives trade.

Centralized Clearing: All derivatives that are accepted by central counterparty clearing should be considered "standardized" and thus required to be cleared. This is important to lower risk. The CFTC and SEC should be granted rule writing authority to ensure that dealers and traders cannot change just a few minor terms of a standardized swap to avoid clearing and the added transparency of exchanges and trading platforms. This is a key component of the bill this Committee passed in February, the Treasury proposal and the regulatory framework announced by Chairmen Peterson and Frank.

Requiring clearing of standardized products will protect the American public by lowering risk. One of the lessons learned from the crisis was that financial institutions were not only too big to fail, but too interconnected to fail. In that regard, moving bilateral trades into regulated clearinghouses will reduce the risk that a failure of one firm will cause other firms to fail.

When a contract is submitted for clearing, the clearinghouse is substituted as the counterparty for both the buyer and the seller. The clearinghouse guarantees the performance for each counterparty, reducing risk for both the buyer and the seller.

Clearinghouses should be required by statute and regulatory action to establish and maintain robust margin standards and other necessary risk controls and measures. It is important that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards. Thus, the Treasury bill includes provisions strengthening the statutory core principles for derivatives clearing organizations.

To promote transparency and competition, central counterparties should be required to have fair and open access criteria. First, to promote competition among exchanges and trading platforms, clearinghouses should be required to take on OTC derivatives trades from any regulated exchange or trading platform on a non-discriminatory basis. Second, clearinghouses should accept as clearing members any firm that meets objective, prudent standards to participate, regardless of whether it is a dealer or another type of trading entity. Clearinghouses also should have open governance that incorporates a broad range of viewpoints from members and other market participants.

To meet the requirement that all standardized products be brought into centralized clearing, end-users should be permitted to access clearing through a clearing member. This would establish a client relationship between end-users and clearing members whereby the clearing member would clear the transaction in a client account on behalf of the end-user. This is very similar to what currently exists in the futures marketplaces. I believe it would be appropriate for clearing members, most of whom would be financial institutions, to have the ability to enter into individualized credit arrangements with end-users that are not major market participants to satisfy the margin obligations of such end-users. Thus, we would be able to achieve the goal of bringing all standardized swaps to clearinghouses while concurrently allowing end-users to enter into appropriate, individualized credit terms with a clearing member.

Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction. This well-established practice of having the agency which regulates an exchange or trade execution facility also regulate the clearinghouses for that market should continue as we extend regulations to cover the OTC derivatives market.

Exchanges: I believe market transparency and efficiency would be further improved by moving the standardized part of the OTC markets onto regulated exchanges and regulated trade execution facilities. Exchanges greatly improve the functioning of the existing securities and futures markets. We should bring the same transparency and efficiency to the OTC swaps markets.

Transparency in pricing is critical to economic activity. Increasing transparency—including a consolidated reporting tape—for standardized derivatives would give both large and small end-users better pricing on standard and customized products. A corn or wheat farmer, for example, could better decide whether or not to hedge a risk based upon the reported pricing from the exchanges. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will enhance the ability of all end-users to effectively manage their risk, whether hedging or trading with standardized or customized swaps.

Position Limits: The CFTC should be granted statutory authority to set aggregate position limits across all markets and trading platforms on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets that the CFTC oversees. This will ensure that traders cannot evade position limits by moving to a related exchange or market. Exemptions to position limits should be limited and well defined.

Enforcement and Rulemaking Authority: The Congress should strengthen the CFTC's rulemaking, oversight and enforcement authorities with respect to registered exchanges and clearinghouses. Further, the Congress should extend the "*Zelener* fraud fix," which was included in last year's farm bill with respect to CFTC enforcement authority over off-exchange retail foreign currency transactions, to similar contracts in other commodities. I am pleased that these provisions are included in the Administration's proposal.

Foreign Boards of Trade: As part of regulatory reform legislation, the Congress should provide the CFTC with clear statutory authority to regulate U.S. traders on foreign boards of trade. Parties using terminals in the U.S. to trade a contract that settles against the price of a contract traded on a U.S. exchange should be subject to position limits and reporting requirements. Those limits would be consistent with limits that apply to the U.S. exchange. Such requirements were passed by this Committee in February and are included in the Administration bill.

Working With the SEC

Comprehensive regulation of OTC derivatives will require ongoing cooperation between the CFTC and the SEC. The President asked that our agencies provide recommendations to Congress and the Administration on how to best tailor our regulations in the interest of protecting the American public. We recently held two unprecedented joint meetings to look into the gaps that exist between the two agencies' financial regulatory authorities, overlap of regulatory authority and inconsistencies when the two agencies' regulate similar products, practices and markets. The President asked the CFTC and the SEC to propose legislative initiatives, where appropriate, to best harmonize our regulations. It is my hope that some of these proposals will be available to this Committee while you consider legislation regulating the OTC derivatives markets.

We are fortunate to have a great partner in SEC Chairman Mary Schapiro. Since our designations were jointly announced by then President-elect Obama, we have had a strong working relationship. As Chairman of the SEC, former Chairman of the CFTC and CEO of FINRA, Chairman Schapiro brings invaluable expertise in both the securities and commodity futures areas. Our mutual understanding, dedicated staffs and respective Commission support gives me great confidence that we will be able to get the job done.

Resources

The CFTC will need additional resources for new staff and technology to effectively regulate the OTC markets. The Commission is just this year getting back to the staffing levels that it had in the late 1990s. Since then, the markets grew five-fold and the number of contracts grew six-fold, but the agency's staff was cut by more than 20 percent. To take on additional oversight responsibilities, we will continue to work with this Committee, the Appropriations Committees, Congress and the Office of Management and Budget to secure additional resources.

Conclusion

I look forward to working with the Congress and other Federal regulators to apply comprehensive regulation to both derivatives dealers and the markets in which they trade. The United States thrives in a regulated market economy. This requires innovation, competition and regulation to ensure that our markets are fair and orderly. We have a tough job ahead of us, but it is essential that we get it done to protect the American public.

Thank you for inviting me to testify today. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much, Chairman Gensler.

Chairman Schapiro, welcome to the Committee and look forward to your testimony as well.

STATEMENT OF HON. MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C.

Ms. SCHAPIRO. Thank you very much, Chairman Peterson, Ranking Member Lucas, and Members of the Committee.

It has actually been 15 years since I last testified before the House Agriculture Committee when I was Chairman of the CFTC. So I really do appreciate this opportunity to come back and testify on behalf of the Securities and Exchange Commission concerning the Over-the-Counter Derivatives Markets Act of 2009 proposed, in August, by the Treasury Department.

I am especially pleased to appear with CFTC Chairman Gary Gensler, with whom I have worked closely over the last several months on a variety of issues. Indeed, our two agencies already have begun an ambitious program to better harmonize our roles and procedures, and we recently held joint hearings highlighting key differences in our approaches. Both of our Commissions are eager to address these issues and ensure that remaining differences are justified by meaningful distinctions between markets and products.

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

One significant gap is the lack of regulation of OTC derivatives, which were largely excluded from the regulatory framework by the Commodity Futures Modernization Act of 2000. OTC derivatives present a number of risks that can facilitate leverage, enable concentrations of risk, and behave unexpectedly in times of crisis. And while some derivatives can also reduce certain types of risks, they can also cause others.

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

Last, the largely unregulated derivatives market can also undermine the regulated securities and futures market by serving as a less regulated alternative, facilitating a flow of funds out of regulated markets into shadow markets.

The Treasury proposal is an important step forward in improving transparency and establishing the necessary regulatory framework. While it would go a long way towards improving the regulation of

OTC derivatives, I believe it should be strengthened in several ways.

First, to minimize regulatory arbitrage, regulate swaps like their underlying references. Market participants often use derivatives and the underlying assets they reference as substitutes. Whether to participate in the fortunes of a public company directly, as through the purchase of its common stock, or indirectly, as through the purchase of an equity swap or a credit default swap, this has become a matter of choice. Whether the participation is direct or indirect, the same or similar economic effects can often be achieved. As a result, even subtle differences in the regulation of economic substitutes can lead to gaming and advantages for any one participant. But that participant's regulatory arbitrage activities, and a general migration to the less regulated derivatives market, can undermine the interests of other participants as well as everyone's interest in minimizing fraud and systemic risk.

Second, provide the tools needed to appropriately enforce the anti-fraud authority retained by the bill. Treasury's proposal would retain the SEC's existing anti-fraud authority over all securities-related swaps but, unfortunately, does not currently provide the tools needed to adequately police all of these swaps. To be effective, enforcement also requires examination authority over entities dealing in securities-related swaps, direct access to real-time data, and comprehensive anti-fraud and anti-manipulation rulemaking authority.

Third, clarify that the definition of *securities-based swap* includes not only single- and narrow-based CDS but broad-based CDS where payment is triggered by a single security or small group of securities. For example, payment is triggered under many so-called index CDS by the event of default of a single security referenced in the index. These CDS raise the same policy concerns under the securities laws as single-named CDS.

Fourth, clarify that a swap is not considered a mixed swap simply as a result of a swap having a floating interest rate component.

Fifth, close the unregulated foreign bank loophole by identifying banking products. Treasury's proposal inadvertently would exclude from the new swap regulatory framework OTC derivatives offered to U.S. persons by unregulated foreign banks and their subsidiaries if the products are characterized as bank products.

Sixth, provide the CFTC and the SEC with clear authority to require that swaps intermediaries segregate counterparty funds and securities. Recent events have focused attention on bankruptcy protections with respect to resolution regimes for OTC derivatives dealers and other major participants in the market. Chairman Gensler suggests that legislation should provide for an insolvency framework that protects first and foremost customers, and I completely agree.

And finally, direct regulators to adopt stronger business conduct rules to protect less sophisticated investors and end-users.

In closing, the Treasury proposal makes significant strides towards addressing current problems in the OTC derivatives marketplace. I look forward to continuing to work with this Committee, the Congress, the Treasury, and the CFTC to enact strong legislation in this area. Again, I appreciate the opportunity to be here, and I look forward to answering your questions.

[The prepared statement of Ms. Schapiro follows:]

PREPARED STATEMENT OF HON. MARY L. SCHAPIRO, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C.

I. Introduction

Chairman Peterson, Ranking Member Lucas, Members of the Committee:

Thank you for the opportunity to testify on behalf of the Securities and Exchange Commission[1] concerning the regulation of over-the-counter ("OTC") derivatives and, in particular, the Over-the-Counter Derivatives Markets Act of 2009, which was proposed in August by the Department of the Treasury. I am pleased to appear with CFTC Chairman Gary Gensler with whom I have worked closely over the last several months on a variety of issues. As you know, our two agencies have already begun an ambitious program of joint work to better harmonize our rules and procedures. Earlier this month, we held 2 days of joint hearings that highlighted some of the key differences in our regulatory approaches. We are eager to address these issues. Although some differences may remain over time, I believe this process will help ensure that any differences are justified by meaningful distinctions between markets and products and the others will be harmonized and improved. I also look forward to continuing our joint efforts to push for real regulatory reform.

The recent financial crisis has revealed serious weaknesses in U.S. financial regulation. Among them were gaps in the existing regulatory structure; failures to enforce existing standards; and failures to adapt the existing regulatory framework and provide effective regulation over traditionally siloed markets that had grown interconnected through globalization, deregulation and technological advances. Fixing these weaknesses is vital, particularly in the current market environment, and it is a goal to which the SEC is absolutely committed.

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

It is critical that we work together to enact legislation that will bring greater transparency and oversight to the OTC derivatives market. The derivatives market has grown enormously since the late 1990s to approximately $450 trillion of outstanding notional amount in June 2009.

This market presents a number of risks. Chief among these is systemic risk. OTC derivatives can facilitate significant leverage, result in concentrations of risk, and behave unexpectedly in times of crisis. Some derivatives, like credit default swaps (CDS), can reduce certain types of risk, while causing others. For example, CDS permit individual firms to obtain or reduce credit risk exposure to a single company or a sector, thereby reducing or increasing that risk. In addition to obtaining or reducing exposure to credit risk, a CDS contract participant will take on counterparty and liquidity risk from the other side of the CDS. Through CDS, financial institutions and other market participants can shift credit risk from one party to another, and thus the CDS market may be relevant to a particular firm's willingness to participate in an issuer's securities offering or to lend to a firm. However, CDS can also lead to greater systemic risk by, among other things, concentrating risk in a small number of large institutions and facilitating lax lending standards more generally.

These risks are heightened by the lack of regulatory oversight of dealers and other participants in this market. This combination can lead to inadequate capital and risk management standards. Associated failures can cascade through the global financial system.

Moreover, OTC derivatives markets directly affect the regulated securities and futures markets by serving as a less regulated alternative for engaging in economically equivalent activity. The regulatory arbitrage possibilities can facilitate a flow of funds out of the regulated markets and into the unregulated shadow markets. The lack of transparency and oversight also enables bad actors to hide trading activities that would be more easily detected if done in the regulated markets. These issues must be addressed, and I am committed to working closely with this Committee, the Congress, the Administration, and the CFTC to close this gap and restore a sound structure for U.S. financial regulation.

The Treasury proposal would establish a comprehensive framework for regulating OTC derivatives. The framework is designed to achieve four broad objectives: (1)

[1] Commissioner Paredes does not endorse this testimony.

preventing activities in the OTC derivatives markets from posing risk to the financial system; (2) promoting efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. Importantly, it emphasizes that the securities and commodities laws should be amended to ensure that the SEC and CFTC, consistent with their respective missions, have the authority to achieve—together with the efforts of other regulators—the four policy objectives for OTC derivatives regulation.

The proposed legislation is an important step forward. It would bring currently unregulated swaps, swaps dealers, and swaps markets under a comprehensive regulatory framework, thereby improving transparency and regulatory oversight. It also would facilitate the standardization and central clearing of swaps, thereby fostering a "better" market and reducing counterparty risk.

II. Strengthening Treasury's Proposal

While Treasury's proposal would go a long way towards bringing OTC derivatives under a comprehensive regulatory framework, I believe it should be strengthened in several ways to further avoid regulatory gaps and eliminate regulatory arbitrage opportunities. I agree with Chairman Gensler that Treasury's proposal can be enhanced to prevent the exclusions for foreign currency swaps and forwards from being used by market participants to avoid regulation and from undermining the CFTC's enforcement authority over retail foreign currency fraud. I also agree that the proposal can be enhanced to bolster protections against insolvency risk, and on other matters.

In addition, I offer the following suggestions:

A. Minimize Regulatory Arbitrage and Gaming Opportunities by Regulating Swaps Like Their Underlying "References"

Market participants often view derivatives and the "underlying" assets they reference almost interchangeably. Thus, a participant may well decide to take a position in the fortunes of a company by entering into transactions in OTC derivatives like equity swaps rather than through the purchase of common stock. When carefully structured, the economic payoffs could be similar, if not virtually identical. Yet the legal consequences attached to these alternatives may be different.

Gaming—regulatory arbitrage—possibilities abound when economically equivalent alternatives are subject to different regulatory regimes. An individual market participant can have incentives to migrate to products that are subject to lighter regulatory oversight.

Treasury's proposal would for the first time bring the OTC derivatives market under a regulatory umbrella by establishing a new regulatory framework for OTC derivatives. Treasury's proposal would divide regulatory responsibility for securities-related OTC derivatives between the SEC and the CFTC, and provide regulatory responsibility for other OTC derivatives to the CFTC. Although we believe this approach would do much to eliminate differences within the broad and varied world of "swaps," it could result in significant regulatory differences between "swaps" products and the currently "regulated" securities and futures products. For example, energy swaps would not be regulated in the same way as energy futures, and securities swaps would not be regulated in the same way as securities. This is significant because, in evaluating whether to engage in a swap transaction, market participants are far more likely to focus on the choice between a swap and regulated alternatives (*e.g.,* between a Microsoft swap on the one hand and a Microsoft option or Microsoft stock on the other, or between an oil swap and an oil future), than between swaps involving different "underlying" assets (*e.g.,* a Microsoft swap and an oil swap). Thus, these regulatory differences could perpetuate existing regulatory arbitrage opportunities that encourage the migration of activities from the traditional regulated markets into the differently regulated swaps market.

In addition, Treasury's proposal would create regulatory arbitrage between narrow-based security index swaps and broad-based security index swaps. For example, market participants could engage in the synthetic transactions in the swaps market, or craft swaps specifically to fall within the broad-based category instead of the narrow-based category. These risks are particularly high in customized over-the-counter transactions where individual market participants can self-select the particular securities in one or more swaps.

Accordingly, Congress should consider modifying the proposal so that all securities-related OTC derivatives are regulated more like securities; and commodity and other non-securities-related OTC derivatives are regulated more like futures. At the core of this approach is the principle that similar products should be regulated similarly, or equivalently, if possible. This straightforward approach would result in securities-related OTC derivatives—which can be used to establish either synthetic "long" exposures to an underlying security or group of securities, or synthetic "short" exposures to an underlying security or group of securities—and the underlying securities being regulated consistently. Similarly, commodity-related OTC derivatives, such as swap contracts for oil and natural gas, would be regulated in a similar manner as the underlying oil or natural gas futures.

This approach also would be simpler to implement. Congress should extend the Federal securities laws to all securities-related OTC derivatives and extend the Commodity Exchange Act to all commodity-related and non-securities related OTC derivatives. This would significantly reduce the arbitrage opportunities between the regulated markets (securities or futures) and the differently regulated swaps market, as well as between narrow-based security index swaps and broad-based security index swaps, while building off the existing regulatory framework. Although some differences would likely remain (as they currently do between the SEC and CFTC regimes), these differences could be addressed through the harmonization process that we already have underway.

B. Strengthen Existing Anti-Fraud and Anti-Manipulation Authority

Treasury's proposal also attempts to retain the SEC's existing anti-fraud authority over all securities-related OTC derivatives, even those securities-related OTC derivatives over which the SEC would not have regulatory authority. This authority is essential to policing fraud in the securities markets; to be effective, though, enforcement also requires: (1) examination authority over entities dealing in securities-related swaps; (2) direct access to real-time data on these swaps; and (3) comprehensive anti-fraud and anti-manipulation rulemaking authority for these swaps.

For example, in investigating possible market manipulation during the financial crisis, the SEC sought to use its anti-fraud authority to gather information about transactions both in securities-related OTC derivatives and in the underlying securities. Investigations of securities-related OTC derivative transactions, however, were far more difficult and time-consuming than those involving cash equities and options. In contrast to the audit trail data available in the equity markets, data on securities-related OTC derivative transactions were not readily available and needed to be reconstructed manually. The SEC's enforcement efforts were seriously complicated by the lack of a mechanism for promptly obtaining critical information—who traded, how much, and when—that is complete and accurate.

If Congress determines to split regulatory responsibility over securities-related OTC derivatives, Congress should provide these tools to help ensure effective anti-fraud enforcement over all securities-related OTC derivatives.

C. Credit Default Swaps and Regulatory Arbitrage

As we saw first hand during the financial crisis, trading practices in the CDS market have a direct effect on the underlying securities markets. Both narrow- and broad-based index CDS can be used as synthetic alternatives to debt—and even equity—securities of one or more companies. In addition, market participants may use CDS to establish a short position with respect to the fortunes of a specific company. In particular, a market participant may be able even to use a *broad-based index* CDS that includes the company as a way to short that company's debt or equity. In brief, debt and equity securities and single-name and narrow- and broad-based index CDS are all economic substitutes, and therefore ripe for regulatory arbitrage.

Under current law, the Commission has stated that *exchange-traded* CDS on securities, whether on one security or a basket of securities, are securities. To avoid gaming by financial engineers under the new regulatory regime, Congress should consider clarifying that the definition of "security-based swap" includes not only single-name and narrow-based index CDS, but also broad-based index CDS, and other similar products, when payment is triggered by a single security or issuer or narrow-based index of securities or issuers. This also would be consistent with the approach advocated above to extend the Federal securities laws to all securities-related OTC derivatives.

D. Business Conduct Standards and Eligible Contract Participants

One of the lessons learned from the most recent financial crisis is that certain smaller and less sophisticated institutions need protections from abusive practices by their swaps intermediaries. There is a need for more stringent business conduct standards. This is an area in which I believe we and the CFTC are largely in agreement. Treasury's proposal would require the SEC, the CFTC, and other regulators to adopt business conduct rules for dealers and major participants in the OTC derivatives markets. This is an important component of regulatory reform, and we fully support it. But these provisions should be stronger. We believe that Congress should strengthen this authority so that the SEC and CFTC may adopt stronger and more protective rules in certain situations—for example, where a swaps dealer is selling OTC derivatives to smaller or less sophisticated participants, including certain municipalities, in the OTC derivatives market.

In addition, Congress should consider revising the qualification standards for participation in the OTC derivatives markets. The standards for being an "eligible contract participant" ("ECP") are important under Treasury's proposal because only ECPs may trade derivatives over-the-counter. All other market participants must trade on exchanges, which provide better protections for less sophisticated participants. More specifically, Congress should consider raising the qualification standards for a governmental entity or political subdivision—such as a municipal government—to qualify as an ECP. Higher standards may also be appropriate for individuals, corporations and other entities.

E. Protecting Customer and Counterparty Assets

One key issue is how best to protect customer and counterparty assets in the event of insolvency. I agree with Chairman Gensler that it would be prudent for legislation to address this issue. Recent events have focused attention on bankruptcy protections with respect to resolution regimes for OTC derivatives dealers and other major participants in the OTC derivatives market. Chairman Gensler suggests that legislation should provide for an insolvency framework that protects, first and foremost, customers. I absolutely agree. I believe that a resolution regime should provide legal restrictions on how counterparty assets held by OTC derivatives dealers and other major market participants would be treated in the event of an insolvency, as well indicate the extent to which counterparties would have a prior claim on the other assets of the estate. Without legal certainty, the insolvency of an OTC derivatives dealer or other major OTC derivatives participant could result in further market disruptions and systemic risk.

F. Ensuring That the "Identified Banking Products" Exception Is Not Abused

Treasury's proposal contains an exclusion from the regulatory scheme for OTC derivatives for products that are "identified banking products." Although this exclusion may make sense for banks that are regulated in the U.S., we believe that this exclusion could allow foreign banks (and their subsidiaries) that are not subject to oversight by any Federal banking regulator, to offer OTC derivatives to U.S. persons in the guise of "bank products." I believe this exclusion should be revised to make clear that it is not available to foreign banks or their subsidiaries that are not subject to Federal banking oversight.

III. Conclusion

The Treasury proposal is a significant step toward addressing current problems in the OTC derivatives marketplace. It provides a comprehensive regulatory framework that addresses risks to the financial system and promotes efficiency and transparency in the markets. I strongly encourage Congress to build off this proposal and enact legislation that will bring even more vital transparency and oversight to this market.

Thank you for the opportunity to address issues of such importance for the strength and stability of the U.S. financial system, and the integrity of the U.S. capital markets. I look forward to answering your questions.

The CHAIRMAN. Thank you very much, Chairman Schapiro, and again, I thank both of you for being here.

The Treasury proposal presumes a swap is standardized and, therefore, must be cleared if the clearinghouse will accept it. And then it layers on top of that presumption a joint rulemaking to come up with a definition of *standardized*, which is only effective if the clearinghouse is willing to clear the so-deemed standardized swap.

So why shouldn't the only standard be whether a clearinghouse will accept the swap products and can clear it in a safe and sound manner in the context of the agency's role as safety and soundness regulator at the clearinghouses? Both of you.

Mr. GENSLER. The benefit of bringing the marketplace into transparent exchanges and on to clearinghouses is very important, but it can be done only if we also make sure that the clearinghouses have strong risk management. And so if a clearinghouse were able to accept a contract for central clearing, the Treasury proposal, and one that I support in this regard, would say that that should be on central clearing. But we would still allow end-users to tailor products that sometimes are not so standardized that they can be brought into this risk management of a central clearinghouse, and in that regard, that should be still allowed.

But the Treasury proposal also adds one other thing which is rulemaking authority. So the presumption is, if a clearinghouse, not a mom-and-pop clearinghouse but a real clearinghouse, could accept a contract for clearing and they deem it to be a prudent under their risk management, it should be deemed to be standard. But also, then have a rulemaking, so if they were high-volume contracts or look-alike contracts that at least the regulators could look at it. I think it is similar to what you had in your bill, H.R. 977, in February, to still take a second look.

Ms. SCHAPIRO. I would only add that we have to have an overriding concern that the integrity of a clearinghouse not be compromised by the acceptance of a particular contract for clearance and settlement if, in fact, they don't have, as Chairman Gensler points out, the risk-management procedures to appropriately manage that contract, and be prepared if there is a default with respect to that contract. So, I think, it is more than just the acceptance of a contract that makes it susceptible to clearing. There is a layer of risk management and other protections that we, as regulators, need to be concerned about because the failure of a clearinghouse would really, potentially, be a catastrophic event.

The CHAIRMAN. For a customized swap or a standardized swap that can't be cleared, what does the Treasury proposal say will happen with regard to those swaps?

Mr. GENSLER. They would still be fully regulated but regulated through the dealer regulation. They would be reported to central repositories and to the market regulators, so that the cop on the beat can protect against fraud and manipulation; and also to the bank regulator if it was by a bank. The bank or dealer would also have to have appropriate capital to mitigate against the risk at that financial institution. Finally, there would still be anti-fraud, anti-manipulation, other business conduct standards to protect against abuses. So fully regulated but allowed because it is really important that end-users be able to hedge even customized risk.

Ms. SCHAPIRO. I think that is a very complete answer. The legislation actually lays out an entire list of actions that would need to comprise the dealer regulation component, and that is how we would approach the customized products, through dealer regulation.

The CHAIRMAN. Who, if anyone, will check the financial integrity of the swap participants and ensure the proper risk management practices, margin capital, are applied?

Mr. GENSLER. I think that the oversight of the financial institutions who are swap dealers would still be the traditional prudential regulators, whether that is a bank regulator, or the SEC, has prudential regulation. We, at the CFTC have a smaller role in that regard over futures commission merchants, but I think that most of these swap dealers would end up likely either under the bank regulator or the SEC with regard to what the Chairman asked about their risk management at that swap dealer.

Ms. SCHAPIRO. The dealer obviously would have responsibility for ensuring the capability of their counterparty, who may well be a major swap participant, to ensure they can meet the terms and conditions of the contract into which they have entered.

The CHAIRMAN. All right. Thank you. My time is up. Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Along that general line, I am concerned about the Administration's OTC derivatives proposal which would, seemingly, force non-financial dealers to meet certain capital requirements in order to provide legitimate risk services on the OTC commodity derivatives markets. Given that these non-financial dealers do not have deposits, unlike the large financial institutions, and in many cases no systematic risk profile, has the Administration considered what the consequences of that would be?

And let me ask one more question and let the panel address both of them along that line. Are you concerned that such a requirement could unintentionally create a bank monopoly in the OTC commodity derivatives market and thereby, of course, reduce competition, reduce liquidity, raise prices, increase systematic risk?

Mr. GENSLER. Congressman Lucas, one of the lessons out of this crisis is that there were significant gaps of institutions not covered like nondeposit institutions. AIG, as I referenced earlier, was not a deposit-taking institution. So the Administration approach, and I support this and believe we must cover anyone who holds themselves out to the public as a derivatives dealer, whether they are a traditional deposit-taking institution, whether they are another type of financial institution, or for that matter, even if it was a large oil company who actively holds themselves out to the public as a derivatives dealer. There is a difference between that and somebody who is just participating in the markets, to hedge their own risk, of course.

So, it would consistently apply, and in fact, I believe there would not be a monopoly in the banks because you would have consistent regimes that others would participate, and be allowed to participate, in a nondiscriminatory way.

Ms. SCHAPIRO. I would really agree with that. I think if we don't cover all dealers regardless of whether they are deposit-taking institutions and, therefore, invoke the Federal Deposit Insurance Fund, we will see business migrate from well-regulated institutions to less well-regulated institutions. We won't have solved the problem that we are all attempting to solve through this bill or through some similar approach to bringing all the players and the products under the regulatory umbrella.

Mr. LUCAS. Don't you think it is a fair statement, depending on what kind of capital requirements we put together, unintentionally, I will say, that we won't ultimately drive this market into this one set of hands that have the deepest pockets to be able to manage the requirements, and consequently really dramatically shrink the competition out there? Isn't that——

Mr. GENSLER. I actually—I understand that question, but I don't see it that way, with all due respect. I think that if it is a bank, currently a financial institution, they have capital charges already.

If it is a non-bank and they are not setting aside any capital, yes, you are absolutely correct. But, I believe that we want to protect the American public, that non-bank derivative dealers do have some capital behind what they are doing.

Mr. LUCAS. Considering the number and volume of non-bank dealers who participate in the OTC commodity derivative markets, should capital requirements at least be limited to firms whose failure would create systematic risk in the U.S. economy? And that is teeing off just a moment ago, I think, of where you have been headed, but let me ask one more in addition to that.

What result does the Administration hope to achieve by imposing these capital requirements on these non-financial companies that use the markets to legitimately hedge their commodity risk and offer risk-management services to others? Doesn't this still help reduce the overall risk to the economy?

Mr. GENSLER. It most certainly does, in that there is a broad array of derivative dealers, but if a company holds themselves out to the public as a dealer, as actively trading these and risk management for others, they right now are unregulated. Their chief financial officers, their risk management, they put capital aside and may even be capital that is also committed to other things in that business. And so it is just important that they do have that buffer, that cushion, so we don't find ourselves, again, if I can come back to AIG, where this market migrates to an unregulated participant, and there is then an advantage that the unregulated participant has to the regulated participant.

Ms. SCHAPIRO. I would just add that even the failure of a non-systemically-important institution creates a lot of havoc and harm in the marketplace for its counterparties and for other institutions. So I would be uncomfortable with limiting capital requirements to just those that are systemically important, because capital provides an important cushion against losses for all institutions. This is why we require, obviously, banks and broker dealers and futures commission merchants to have capital regardless of how large they are; although capital is geared towards the size and the risk of the institution.

Mr. LUCAS. Thank you, Mr. Chairman.

Mr. GENSLER. If I might add also, I know it is outside our remit, but the Administration has talked about those institutions that are so systemically relevant that they are called tier-one institutions. There may be other provisions that this Committee and Congress considers, that those might have additional capital. But what we are working with here is, if you hold yourself out as a derivatives dealer, there is some concept that there is capital or cushion there that is not necessarily as high as what might be there for these tier-one institutions.

Mr. LUCAS. Mr. Chairman, indulge me for just one more moment.

My concern is that we don't, in the effort to be so protective and to avoid the tier-one, the tremendous institutions, that we strangle out the whole industry, the whole series of products that fall at that lower tier where a failure would be borne out by the company, not by the whole economy.

Thank you, Mr. Chairman.

The CHAIRMAN. Well, if the Committee would indulge, I think this might be the right—it is just my understanding that these people are paying for this. Maybe they don't put the margin up or the capital up, but somehow or another, they are paying for this. A counterparty isn't going to give them that protection without extracting something for it, right? So, I mean, they are already doing it. If they don't put the money up, then they are maybe getting a bigger spread or something to cover it. Isn't that what is actually going on here?

Mr. GENSLER. The Chairman is correct. The dealer currently charges counterparties for extending credit through these contracts. Whether it is 5¢ a million cubic foot or a few basis points on an interest swap, they certainly do.

The CHAIRMAN. As you guys put this together, I mean, you are going to probably allow that to continue as long as you think that whatever they are doing is adequate to cover the risk, right? You are not going to be so prescriptive that you are going to force them to change?

Mr. GENSLER. That is what we are recommending as relates to margin, that the end-users, not the dealers, but the end-users would be allowed to enter into arrangements with dealers, and the dealers could have individualized credit arrangements, but the dealer would still have to post margin at the central clearinghouse.

Mr. LUCAS. Thank you, Mr. Chairman.

The CHAIRMAN. All right, thank you.

The gentleman from Iowa, the Chairman of the Subcommittee, Mr. Boswell.

Mr. BOSWELL. Well, thank you, Mr. Chairman. I just say to other Members of our Committee that we all ought to appreciate the personal interest that our Chairman and Ranking Member put into this subject. You can tell that from what has already gone on.

So not to repeat some of that, but I would like to add my appreciation to you both being here. You have an awesome responsibility, and the whole country is looking right over your shoulder. And I guess we are going to all get acquainted better as time goes on. So I appreciate your accepting the responsibility and what you bring to the table, and we look forward to that.

I think I will digress a little bit because there are a number of Members here that will get into a lot of detail that I could as well, and I may yet. But last week, it was called to my attention by a constituent, which was most unexpected, some of the things that are going on in the life insurance side. And there was quite an article written on September 6 in *The New York Times* entitled, *Wall Street Pursues Profit in Bundles of Life Insurance.*

I trust you are familiar with that. I see you nodding your head. So, with that, I won't read from it, but I could. I am concerned about it, and I would like to know if you are.

The article says many things, but would you elaborate for me—does this securitization of life settlements not only add another element of possible risk to an investor that was already in need of more transparency and consumer safeguard, but it is something that we should even allow? What are your thoughts?

Ms. SCHAPIRO. It is a wonderful question. It is an area I am actually profoundly worried about. And about a month and a half ago, I asked the SEC staff to form a task force to explore all of the issues that surround the process of securitizing life insurance policies. It is becoming a very large business. It is a multi billion dollar business to sell life insurance policies for more than the surrender value but less than the cash value, and then bundle those up together and then cut them into pieces of securities and sell them.

They raise all sorts of issues with respect to the Privacy Act because underlying information about the health of individuals whose policies are part of the securitized product may be made available to investors. They raise issues about the ability of the people who sold their life insurance policies, to ever get policies again. They raise tax implications for them. So there are multiple sales practice issues, and there are multiple issues around the whole securitization process.

None of these securitized products have yet been registered with the SEC. They have been done with private placements, but we are aggressively exploring the issues. We are working with other interested parties, like the National Association of Insurance Commissioners, and we will proceed to take this process apart very carefully.

Mr. BOSWELL. Maybe you could comment about why aren't they regulated? What have you got in mind?

Ms. SCHAPIRO. Well, we need to understand the full range of issues because, as I say, there are sales practice issues when people are convinced to give up their life insurance policies, and what is the price they are getting for that, and is it fair?

Mr. BOSWELL. If I could, my time is going fast. I like what you are saying, and I want follow up on this.

Ms. SCHAPIRO. Okay. I don't know where we will land in terms of policy yet.

Mr. BOSWELL. I am sure you don't, but I want you to keep us very closely in touch of what is going on, and let's keep this dialogue going.

Ms. SCHAPIRO. I would be happy to.

Mr. BOSWELL. Okay. And we put it into the record last week about this issue and made several points, but you know, some of these—this bittersweet side of it, kind of and others, maybe there is some opportunity for people who don't need the insurance anymore, but they lapse in all these details. However, if it is put on the market and sold in a sense, then they are going to keep paying out the premiums. And maybe the criteria that the insurance company used to figure out what it is going to cost no longer is valid. So there are all kinds of possibilities here that needs attention, as I can say the least of.

Mr. Chairman, with your concurrence, thus——

Mr. POMEROY. Would the gentleman yield just for a moment on that?

Mr. BOSWELL. I will.

Mr. POMEROY. There are tax incentives underwriting the fundamental life products, and I believe that when it is a securitized issue spread around with no remote concept of insurable interest, you raise profound questions about whether or not this tax incentive ought to apply anymore. I believe that they are placing the fundamental industry at risk with this whole track they have gone down, and it does deserve the kind of examination by regulatory authorities and Members of Congress alike.

I thank the gentleman for raising it.

Mr. BOSWELL. You are welcome, and I will just finish with this statement, which you already know. There are trillions of dollars invested out there. Possibly, some say $26 trillion, I don't know what it is. It is humongous, and so it is very huge. So, it deserves your attention, and I appreciate what you have said, and so let's keep in touch.

I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from Iowa, Mr. King.

Mr. KING. Thank you, Mr. Chairman.

And I thank the witnesses.

As I listened to this discussion, I would like to return a little bit to the AIG, which was brought up a number of times. And I want to say the words out loud that you were talking about using different definitions, but improperly defined, too big to be allowed to fail. And so I think that the specter of that hangs over our discussion here.

And I haven't heard very much discussion about what you view the consequences might have been if we had not invested that huge sum of money into holding up AIG. How that might have broken out, and what would be the results today, short from the prediction of the global financial collapse, what would it look like in the United States today if we had just simply let them fail and let the markets do the adjustment? And I would ask first Chairman Gensler.

Mr. GENSLER. Well, you ask a very difficult question because it is running history parallel in two regimes. I do think that what we were facing last fall was quite uncertain, that AIG had a book of business that was over $450 billion of just credit default swaps. They had other books of business, but it was with significant European banks, as well as about a third of that book was here in the states backing up mortgage securitization products, all very lightly regulated. If it had triggered, there was tens of billions of dollars that would have cascaded around the system and other institutions.

Recall, also, that was the same week that Lehman Brothers failed. That was the same week that, for the first time in decades, a money fund was worth something less than a dollar; it broke the buck. So there was a run on money markets. There was a run on investment banks. There was a classic run on the whole financial system. I don't know exactly what would have happened, but that run would have accelerated, in my opinion, over those next several days.

Mr. KING. Mr. Chairman, would we have recovered, you believe, and would it have rearranged our financial markets in a fashion that would have sent a message out through the investment community to, let's say, restrain their investments unless there was better capital behind the traders, rendered unnecessary by regulators?

Mr. GENSLER. I was a private citizen and not a government official at the time, but I would certainly say it would have rearranged things. I am not sure if it would have rearranged things calamitously or not, but it would certainly have rearranged things. But these were very difficult decisions that the regulators at the time faced.

Mr. KING. Thank you.

Mr. GENSLER. And if I might say, we shouldn't have to face those decisions again. That is why we are both here to say, let's bring regulation to the over-the-counter derivatives.

Mr. KING. I do hear that, and I thank you.

And I direct a similar question to Chairman Schapiro.

Ms. SCHAPIRO. Thank you, Congressman.

I also was a private citizen last fall, so I have no particular insights other than those that I have gained at the SEC in the meantime. But I do think that given the number of counterparties that AIG had, there likely would have been multiple other failures in the system if they had collapsed. And the process that we have been going through painfully for the past year likely would have been prolonged and more difficult. It is hard to, obviously, say exactly.

Mr. KING. Thank you.

And the question I posed here really sets up the follow-up question, and I will come back to you, ma'am, and that is, is there any discussion about requiring reinsurance on the part of the traders? You know, I describe it as being bonded to do a certain dollars worth volume of business. If that discussion had a viable path that could be part of this dialogue, then how do we avoid the reinsurance companies from becoming too big to be allowed to fail?

Mr. GENSLER. Well, I am intrigued by your suggestion. I think that is why we have proposed that there be capital, and capital by the dealers, as well as margin which is sometimes similar to capital by the counterparties, and so the concept of reinsurance is another concept one might add to this. But capital is a big cushion and important cushion to this and margin.

Mr. KING. And Chairman Schapiro?

Ms. SCHAPIRO. I agree with that. I think margin essentially collateralizing the positions in many ways, and can have the same impact without worrying about the further integrity of other financial institutions that have now become intertwined in the process.

Mr. KING. Have either of you considered an alternative that might be more of a free market alternative that would not require the Federal Government to be the regulator of first resort and setting the standards of capital at the over-the-counter level, or——

Mr. GENSLER. Well, the American public benefits by a regulated market economy——

Mr. KING.—another alternative?

Mr. GENSLER. Well, this is both—I think we need the regulation. The other alternative to me is more costly to the American public.

Now, it is true that, just as we do in the securities and futures market, we do rely on some self-regulation of the exchanges, but if the regulators set the overall rules, exchanges can then help and clearinghouses, obviously, can help in implementing those rules.

Mr. KING. Chairman Schapiro.

Ms. SCHAPIRO. The securities regulatory regime really relies very heavily on self-regulatory organizations, primarily the exchanges in this context. The key to which those are successful though is strong governmental oversight of the self-regulatory organizations so that they continue to act in the public interest. If they are publicly owned entities, as they are increasingly in both commodities and securities markets, they are not diverted from their public interest responsibilities by their desire for shareholder return. So, we can have reliance on clearing organizations to perform certain functions, but it has got to be under the oversight of the Federal Government.

Mr. KING. Thank you.

I thank the witnesses.

Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

I want to ask a question about the CFTC's authority over foreign boards of trade, but before we do, a couple of my colleagues raised some points that I would just like for you to respond to.

On the AIG situation, there is a question here that we need to examine and answer that has not been done, and that question is that for the Financial Products Division of AIG, there was no effective Federal regulation. That same situation was true for Bear Stearns, Lehman Brothers, all down the line. So the question is, why? Why was there not any Federal regulation? Who and how was the ball dropped there? Why didn't we see this? Why wasn't there effective Federal regulation?

Ms. SCHAPIRO. Let me take the first stab at that. I don't know the answer with respect to AIG and how it was structured.

With respect to Lehman Brothers and Bear Stearns, there was ineffective, honestly, Federal regulation through basically a voluntary regulatory program at the Securities and Exchange Commission called the Consolidated Supervised Entity Program. And it was essentially voluntary for those institutions through their holding companies to be regulated in this way.

The lessons learned coming out of that really suggest that the capital rules were not adequate to deal with the liquidity stresses that were created when these institutions began to fail. There was a lack of appreciation that secured funding; even that funding that was backed by high quality collateral such as Treasury bills, could become unavailable and really impair liquidity. Without liquidity, institutions couldn't continue to do business.

I think we learned that there is a much greater need at these financial institutions for supervisory focus on the quality of the assets they are holding and their liquidity.

We certainly learned that valuation models that were relied upon for capital purposes and other purposes were wholly inadequate, not up to the task, and were not sufficiently stress-tested so that we could understand in a really bad situation how these institutions would perform. And it was a neglect of looking at the low probability but really extreme events to understand their impact.

So, from my perspective, these are all lessons coming out of the failure of those institutions, and, hence, the need for regulators to have clear authority to require changes when necessary in the conduct of a business that is threatening systemic integrity.

Mr. SCOTT. Okay. Well, thank you for that answer. I just think we should know the why.

Let me go to another point. The Treasury proposal seemingly gives the CFTC authority over foreign boards of trade, which I am concerned may invite regulatory retaliation against U.S. markets and businesses by foreign regulators. Foreign boards of trade will need to register with the CFTC in order to provide electronic access to its U.S. participants. So, in order to register with the CFTC, the foreign boards of trade must adopt position limits for contracts that are linked to a contract traded on the U.S. DCM. But, the Treasury proposal goes further than limited contracts, however, and also gives the CFTC the authority to set position limits on any contract traded on a foreign board of trade that is offered to U.S. market participants, regardless of whether or not there is a linkage of a U.S. contract. So where does the Treasury derive their authority to regulate transactions on a foreign exchange?

Mr. GENSLER. Maybe this one is for the CFTC. What we are trying to address is something that you all also addressed in your bill in February, that we have some foreign futures exchanges now— but in the future, it may also be swaps markets—that access U.S. customers, also link those contracts, in what you may be familiar with which became known as the London Loophole.

So we want to address that in statute, just as you did in February, so that if terminals are placed here or if they are not physical terminals but there is access to investors here, contracts are linked, then we bring that regime under regulation.

We currently are somewhat limited in the statute, and we use something called No Action letters to do it. And that has been somewhat more effective. We have just revised such a letter with the largest foreign board of the trade, the ICE Europe, we did that, but we had to do it with a lot of diplomacy with foreign regulators, and I think it would be good to have it also in statute.

Mr. SCOTT. Are you all concerned that these foreign regulators may retaliate against U.S. markets?

Mr. GENSLER. That is always a legitimate concern. That is why we worked so closely with the FSA in London and have a very good relationship with the head of that, Adair Turner. We have just recently entered into two Memoranda of Understanding in those regards to oversee clearing and this ICE Europe in a more tight regulation because, as well, they also oversee some of our exchanges over there.

Mr. SCOTT. Thank you, sir.

I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Nebraska, Mr. Fortenberry.

Mr. FORTENBERRY. Thank you, Mr. Chairman.

And I am sorry, I regret I didn't have the benefit of your earlier testimony, but let's go back to some fundamentals here. Let's ask ourselves, what is the purpose of a commodities market? And then I want you to answer, what percent of people in the market now are hedgers, have commodity possession *versus* speculators?

Mr. GENSLER. The commodity markets, which go back over 150 years in regulated or in regular futures exchanges, help hedgers, whether they be farmers or ranchers or, later on, oil producers to hedge a risk, and then speculators take on that risk.

Mr. FORTENBERRY. I know the answer to this, this is just an exercise, as you understand.

Mr. GENSLER. I understand, but I am trying to give you the best answer, and so they are both very important pieces of the market.

Depending upon the underlying commodity, some markets are—have significantly more hedgers; some more significantly speculators. We recently broke out more of our data between producers and merchants, what you might consider a traditional hedger and swap dealers, money-managed funds and the like. And generally speaking, less than half—but it depends on the market—less than half is usually the traditional hedger or producer merchant category.

Mr. FORTENBERRY. Less than half since when?

Mr. GENSLER. I am just—I am just referring to the most recent data. We can certainly follow up.

Mr. FORTENBERRY. Well, the reason I ask is, the purpose of the commodities market clearly is to hedge risk, to decrease market volatility so that we have—the vagaries of the economy are smoothed out. That we have less potential disruptions because of the risky nature of growing crops or producing oil and the other production capabilities that we have in our country. If that system is broken and the market itself actually increases risk for the overall economy, do we have a fundamental problem here?

Now, last year, when we were dealing with this issue and were going over and over it trying to figure out, where is the smoking gun? Why are oil prices shooting through the roof when the underlying fundamentals seem to indicate that supply-and-demand variables were not consistent with such a run-up in the price? And of course, that leads to an increase in price of the other commodities that are trailing behind, particularly agriculture commodities, which ends up turning hog markets and ethanol markets and all types of production capabilities upside down. Now we are back home dealing with farmers who are in very dire straits because of something that they had no control over.

We have a fundamental crack or a problem in our foundation here in that the system designed to hedge risk, to ameliorate risk, actually has caused risk in the economy; what is the underlying solution to that? And I know you are talking about increasing capital, transparency in all swaps, all types of derivative markets that are out there, will that solve this problem? That is my point.

I am sorry to be a little bit testy with you here. That wasn't my intention, but just try to get to the fundamental point.

Mr. GENSLER. I think you are right. All derivatives markets, whether futures or these things we call derivatives, OTC derivatives are risk-management contracts and price-discovery markets so people can discover the price of bearing that risk, the price of hogs or corn or wheat.

We are recommending that we bring regulation and transparency to the big part of the market that doesn't have it right now, the over-the-counter swaps marketplace, that we regulate the dealers and that we bring the standard part of the market onto transparent exchanges.

I think that goes a far way to the Congressman's question but also to have the ability to set aggregate position limits, not only in the futures market, but across these markets where it affects the markets, particularly for products that have finite supply.

Mr. FORTENBERRY. Do you think, applying a test backwards in time, that a regulatory framework that you just described with increased transparency and requirements on all trades, no matter how you define them, no matter how they are sliced up, no matter how they are derived, having them open and clear as to what is going on, would have actually prevented the type of run-up in oil prices and other commodities that went along with that? Because even though there are underlying supply-and-demand fundamentals, they didn't indicate the need for such or indicate a future possibility of prices reaching that level. In other words, the market that is designed to hedge risk, to take care of market vagaries, actually caused the run-up in markets and the severe disruption to the economy.

Mr. GENSLER. I think that given more tools, and this is true of both our agencies——

Mr. FORTENBERRY. Can you do that—I am sorry, I am out of time. Can you apply in real-time what you are projecting into the future back to the situation last year, would it have been prevented?

Mr. GENSLER. I am not able to do the hypothetical. It is a good hypothetical, but I am not able to do that. I think we bring good transparency and lower risk to the system, and we have the tools to police against manipulation and corners and squeezes and other abuses that might be at the center of what you are saying.

But we are also not price-setting agencies, neither of us. So there are going to be times that there are trends in investor psychology or in market psychology that also happens. We are there to make sure they are fair and——

Mr. FORTENBERRY.—you should try to get to that issue.

Mr. GENSLER. Yes.

Mr. FORTENBERRY. All right. Thank you, Mr. Chairman.

Mr. MARSHALL. Thank you, Mr. Chairman. I guess picking up on where Mr. Fortenberry left off, the position limits authority that you would like the CFTC to have which would run across all markets. Do you plan to give the CFTC sufficient discretion to make judgments concerning limits that would vary from participant to participant? Those participants that in your judgment are really truly assisting with price discovery and market liquidity and those sorts of things, it seems to me you might at some point want to permit them to have larger position limits than other participants. And it is simply a matter of math, it is simply a matter of numbers. We have had that discussion before. I would be, interested in maybe a written response in this instance.

My question actually today has more to do with this clearing process. You have referenced what others have already talked about, and that is this possibility that clearing members would provide financing that would assist end-users in using the new system. The pushback we have been getting, of course, is that end-users, folks who really need to hedge, just aren't going to be able to do it, they are not going to be able to afford it.

And it would be helpful if, perhaps, the CFTC could get together with those who are proposing to have clearing operations and sort of flesh out how this would work and what impact—assuming that it works well and that financing is available for margining, *et cetera*—what impact this would have on end-users? Would we lose a lot of end-users or wouldn't we lose a lot of end-users? And that will help us out a lot if basically there is a small additional cost but people are still able to hedge, and that additional cost is something that generally protects the system, that protects the public, then that is something we can live with.

If, on the other hand, people aren't going to be able to hedge, they are just going to not be able to have access to the market, then we are going to have problems. We are going to have to try to redefine who is going to be covered by clearing requirements.

Mr. GENSLER. Congressman, it is good to be back with you. I think that end-users will benefit and actually take some of the cost out of the system for them by the transparency, that they will see the price as somebody else trades it. And that is the truth in securities and futures markets today.

As it relates to the other question about central clearing, central clearing will lower risk, but many end-users have raised the question, well, does that apply to me? Does that mean that I, too, as a small company in Georgia or in Iowa or anywhere. I have to post margin. And what I believe we can do to satisfy both goals, to satisfy the goal that we bring everything into central clearing, is require the clearing member, the large financial institution, the dealer, to do so; but then they can enter into an individualized credit arrangement. And right now derivatives do have costs in them. All the end-users have a cost for credit extension. A credit extension is one of the two pieces of these risk management contracts.

Mr. MARSHALL. It would be very helpful to us if you, your agency, maybe teaming up with the proposed clearing agencies, could help us understand what the real impact will be. We understand the theory, and that these folks will have help that they are not really mentioning when they object to the clearing requirement.

It would be very helpful to us if you could sort of put some numbers down that might guide us. I don't know whether you can do that, but it would be very helpful. I will just make that statement.

Mr. GENSLER. I certainly would like to follow up with you on that.

Mr. MARSHALL. That would be wonderful.

Page 7, first full paragraph of your testimony, you talk about central counterparties being required to have fair and open access criteria, and that the clearinghouses should be required to take on OTC derivative trades from any regulated exchange or trading platform on a nondiscriminatory basis.

As I think how this clearing process is probably going to evolve, I thought that it was probably going to—you know, exchanges that—or that clearinghouses would become familiar with particular kinds of trades, particular products, as has happened where exchanges are concerned. I mean that one exchange winds up being the main exchange for doing X. And the product consequently—and the reason it is is because of liquidity, or because of comfort, or something like that, there is a better deal to be offered. And I am wondering whether or not that isn't the same with these clearinghouses. Clearinghouses that are more familiar with a particular product are going to be able to offer a better price, better margining rules, those sorts of things. And if they are required to accept products that they are not familiar with, then they are going to be less likely, it seems to me, to offer those, be able to offer those products the same way that somebody else familiar with the product would, and costs would go up.

Mr. GENSLER. It is actually the reverse we are trying to do. We are trying to promote competition amongst exchanges and trading venues. And so what we are saying is that a clearinghouse could not be vertically integrated in such a way with an exchange or trading platform so that the only product they accept is from that exchange or trading platform. And so thus we want to promote competition, somewhat like what is in the options market right now, where there is one clearinghouse but many exchanges.

Ms. SCHAPIRO. I was just going to add, if I could, that there is a competitive clearing model where there are multiple exchanges and multiple clearinghouses, and there is competition to keep price down. The securities model really is a utility model of a clearinghouse, very much along the lines you suggest; the Options Clearing Corporation clears the options transactions for all of the options exchanges; DTCC in New York clears for all the securities exchanges. And it is a very efficient model because they become highly expert in handling the products, just as you suggest.

Mr. MARSHALL. And I am not entirely sure that the models that you just offered will fit very well with these things that are essentially futures. And I worry that the organizations that are offering clearing are going to have to pay a lot more attention post the actual event, the actual purchase, the actual swap. And they know they are. They have to understand the market, and they are going to be worried about costs associated with that. And they are going to become familiar with particular products.

So that is what I was worried about, and that they be able to offer better price and better service for particular products, and consequently you get concentration.

Mr. GENSLER. And we would only recommend that a clearinghouse accept a contract that they can legitimately risk-manage and accept. But once they have accepted product A, from Congressman Minnick's exchange, if I might say, if somebody wants to take it to Representative Lummis' exchange, if you had a different one, they could take it off. But the clearinghouse would have to accept each of their exchanges once they have accepted a product for clearing.

Mr. MARSHALL. I thank the Chairman for his indulgence. I am over my time. Thank you.

The CHAIRMAN. I thank the gentleman. The gentleman from Pennsylvania, Mr. Thompson.

Mr. THOMPSON. Thank you, Mr. Chairman. I am going to switch gears just a little bit and move to the other end of this process. Let's assume the Treasury proposal becomes law. What will be the additional resource needs of your respective agencies in terms of personnel, equipment and other needs, and how much will that cost? Any estimates?

Ms. SCHAPIRO. We don't have estimates at this point, though we would be happy to provide them to the Committee. I would say the rule harmonization process and the joint rulemaking initiative will require significant amounts of time and staff to build the joint rule through the rulemaking time frame that is laid out in the statute.

Then, of course, there will also will be the process of approving clearinghouses, setting up the regulatory framework, overseeing them through an inspection program. And the same would be true with respect to oversight of the dealers either by the bank regulators, the SEC or the CFTC. So that is an examination program, although I don't expect that there will be huge numbers of dealers.

And then there will be the reporting capabilities that will have to be through a repository or other mechanisms, reporting systems that must be developed, that will collect transaction data and make it available to the public and to the regulators.

And then, of course, once we have all that data, we have to be in a position to analyze it and understand what kinds of activities are taking place that may need a further response.

So there is a lot to do here. We are creating an entirely new regulatory program around products that are valued at trillions and trillions of dollars. So I don't have specific numbers for you, but it will not be insignificant, I don't believe.

Mr. GENSLER. And I was just going to say, though we don't have a specific number because we don't know the scope of the legislation. This Committee included, I believe in your bill in February, authorization for 100 new staff, if it were to move forward in that regard. And so we have been using your wisdom and guidance a little bit internally to think about how to do this.

I don't know if the 100 on top of—we have approximately 570, 580 people now. We need to be much larger just to do our current mission. But it has given us some guideposts as we are thinking about this, your own guidance from February.

Mr. THOMPSON. Thank you. Just recently, the power producers weighed in on the derivatives debate and expressed a fear that the proposed changes, as defined currently, would make it harder to protect against swings in commodity prices. And obviously commodities they are looking at are specific to energy.

Do you in your view—I would offer this to both Chairmen—how will this legislation impact energy markets and overall prices? Do you share their concern or do you see the validity of their concerns?

Mr. GENSLER. Well, I think that it will bring greater transparency to energy markets. One of the great challenges market participants have is that the over-the-counter derivatives market is opaque. And that may have developed by history, but there are many people that actually want to keep it opaque. They are many of the people who we are looking to regulate. They have advantages in keeping it opaque. So I think they and all of their associations would benefit by that transparency.

They have also raised some concerns about would they have some costs with regard to posting margin. And then, as I tried to address in my written statement, there is a solution to that where clearing members would post margin and then enter into individual credit arrangements with these gas companies and utilities.

Ms. SCHAPIRO. While it is not a perfect analogy by any means, it has been my experience when we have made markets more transparent, spreads have tightened, volatility has been less of an issue, because there is generally available information about the price, for example, of corporate bonds. So, again, not a perfect analogy, but I would agree with what Chairman Gensler has said.

Mr. THOMPSON. Okay. Thank you. And my final question is just straightforward. Do you believe this legislation will cause additional drying up of liquidity in any way, or any threat of that?

Mr. GENSLER. I think actually it will enhance liquidity. That when you bring transparency to markets, as was done through the Securities and Exchange Act in the 1930s and the Commodity Exchange Act that enhances market liquidity, it might take some of the advantages away from certain big dealers.

Ms. SCHAPIRO. I would say that I think the facility of exchange trading has generally enhanced liquidity in markets.

Mr. THOMPSON. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from Wisconsin, Mr. Kagen.

Mr. KAGEN. Thank you, Mr. Chairman for holding this very important hearing. And I was very pleased to hear in your opening remarks that you were steadfastly against providing the Federal Reserve with the authority to be the systemic risk regulator. And I just want to confirm that our guests here would confirm that they would also agree with this. So I will give you an opportunity to say yes or no, that you would be in agreement in opposing the Federal Reserve's opportunity to be the systemic risk regulator.

Ms. Schapiro.

Ms. SCHAPIRO. Well, like most questions, I can't answer it yes or no. My perspective on this is slightly different than the Administration's or some of the other proposals that you have heard. I think we do have a need for a systemic risk regulator, and it could be the Fed. But what is almost more important is that we have a very empowered systemic risk council that is comprised of the CFTC, the SEC, the Fed, the FDIC, OCC, the full panoply of regulators who can take on the role of really the macroprudential view of risk in a system, can set capital standards if they need to be higher than what the primary regulators have done, and can direct the systemic risk regulator to act in an emergency.

I think the multiple perspectives that we can get from a council as opposed to a single all-powerful systemic risk regulator is going to be really important to the future of our system. Because we have very different products, as you have heard today; we have very different financial institutions under our different jurisdictions, depository institutions, broker-dealers, FCMs, and so we have regulators with very different expertise. And to bring all of that talent to the table to make some of the fundamental decisions about systemic risk regulation, I think is very important.

That said, I do think at the end of the day some single entity—it could be the Fed, it doesn't have to be—needs to be in a position to be a second set of eyes over the roles of the primary regulators.

Mr. KAGEN. Would you agree that if we eliminate those entities that are too big to fail, we may not require such a risk regulator?

Ms. SCHAPIRO. I think it would be good to have a risk regulator that is constantly viewing the landscape and understanding where risks are beginning to build, but it is critical we eliminate the too-big-to-fail doctrine.

Mr. KAGEN. Would you agree with me, if you are too big to fail you should not exist and you should be broken up into regional entities?

Ms. SCHAPIRO. Let me say this carefully. I do believe that we cannot suffer under the too-big-to-fail doctrine as an economy for very much longer, that we must have in place resolution mechanisms or ways to keep institutions from becoming too big to fail for the future.

Mr. KAGEN. Well, would you agree with the testimony offered here last week from Garry O'Connor that, "the OTC derivatives markets currently represent a greater risk to our underlying economy than they did before the financial crisis began."? Would you agree that we are in a position today, as you take a look at the Office of the Comptroller of the Currency's report at the end of the first quarter of this year, that we have such a concentration of this activity that we are at greater risk today than a year ago?

Ms. SCHAPIRO. I don't know if we are at greater risk than a year ago. I think we are still at risk. I think it is a critical reason that this legislation has to move forward. We have to bring these markets under regulation.

Mr. KAGEN. Mr. Gensler.

Mr. GENSLER. There were four or five questions there. If I might address myself to the last question you just raised about concentration, I do think that these markets have become more concentrated. We see this in other industries as well: in the drug industry, in the auto industry and other industries, the movie industry. But the financial industry is increasingly concentrated. I think it is something appropriate for Congress to take up. And it also influences how we look at setting and thinking about position limits as to whether markets are better served if at least there is a minimum number of participants in a market promoting both competition and liquidity. And if it is highly concentrated to three or four or even five large financial institutions, they internalize the deal flow, they still provide important risk management but they internalize it, probably provide less attractive pricing, ultimately margins are a little wider, and the system as a whole is more at risk.

Mr. KAGEN. Well, last week John Damgard from the Futures Industry Association expressed that their organization is against the idea of position limits in terms of trading swaps because it might push activity offshore and make things more opaque than they are today. Would you care to comment on that?

Mr. GENSLER. I think that it is important for all of us to work very closely on the international side. I know that we can only give a small part of it to the Commodity Futures Trading Commission, but that all of the regulators, and even Congress, reaching out internationally, so that we do this in coordination and concert.

I, though, believe as it relates to the authorities we are talking about for over-the-counter derivatives or even for position limits, we still have to foremost protect the American public, and that as we reach out to our colleagues in Europe and in Asia, that we still remind ourselves that we have to protect the investors and the markets here.

Mr. KAGEN. Well, let me just in closing express the very sincere and earnest concerns of the people of Wisconsin that I represent, that one of the reasons that they have a lack of confidence, not just in the economy but in their government, is our inability to catch all the crooks that caused this economic mess. We haven't cleaned it up yet, we are still at the systemic risk, and we haven't yet finished our job here in Congress about rewriting the legislation to help prevent it from happening ever again.

So I will end by asking you to respond in writing as to how successful the Administration has been thus far at catching the crooks, and the rest of it I will leave up to us here to rewrite the legislation. I yield back my time.

The CHAIRMAN. I thank the gentleman. The gentleman from Oregon, Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman. I guess I am not as optimistic as most people here that we are going to be curing the problem. All the certified smart people prior to 2007 felt it was wise not to regulate swaps and stuff on the market, and we got rid of Glass-Steagall a few years before that. I think we are destined to repeat, unfortunately, the errors of the past. And I am a little concerned when I hear that liquidity is going to actually increase as a result of this legislation, when I argue respectfully we have way too much liquidity. And people began to think that risk itself was going to be solving its own problem just by spreading the burden around.

So, we all should be thoughtful about where we are going to end up here. We can do a few things that make sense, trying to ensure the individual out there that doesn't understand this, much like me, that there is some increased scrutiny going on.

And the too-big-to-fail comments, I would associate myself with Representative Kagen. I guess I am mostly interested in how do we gauge whatever we come up with at the end of the day is actually performing correctly? What are our performance outcomes, short of failure or avoiding the failure; because we didn't have a failure in 5 years, therefore our regulations are perfect. How do we know, going forward? What are the outcomes you are envisioning?

And I am not talking about just auditing more companies and clearing more trades, that sort of thing. How is the CFTC and the SEC going to report back to Congress and the American citizens that we are meeting our benchmarks, do we have certain benchmarks that even people back home would understand? How are we going to monitor success here?

Mr. GENSLER. I think that is an excellent question. I think that for your constituents in Oregon that it is important that those who want to manage their risk or hedge their risk have transparent markets in which they can do that. And liquidity is part of that, but that they can actually, whether it is a small municipality or a company of some size, can see that and not—so spreads or the price they pay and the costs they pay would come down. That that is available risk management for them is key.

I think as a nation it is that these large financial institutions are really setting aside capital for the risks that they are taking on in these marketplaces, and that we are able as regulators to police against the fraud manipulation, which is inevitable given human nature, that we can police against that effectively.

Ms. SCHAPIRO. I would agree with all that and add just a couple of things. I think we will also be able to measure success if we can see that hedgers who have legitimate reasons to be in these markets have access to the markets on a free and competitive basis, that they are not being held to monopoly rents or put at a disadvantage by dealers. That the risk is well managed in dealers, which we should be able to determine through examination and oversight programs to understand exactly where the risks are; how they are managing them; and that the public has information about currently quite opaque markets and what the potential is in those markets for something to go wrong and to be able to see what the implications of a problem would be.

So, it is a great question and we should think more carefully about it and come back to Congress with a report if this legislation is passed that explains exactly why we think it is or is not a success.

Mr. SCHRADER. If I may, I just would urge that we have a set of performance measures included in whatever legislation goes forward so we can actually track what is going on and monitor the monitorees, if you will, or the regulators, to make sure we feel comfortable things are going on correctly.

I yield back my time.

The CHAIRMAN. I thank the gentleman. And I apologize, Mrs. Lummis. You were being locked out. Mr. Thompson has got wide shoulders and must have been a fullback or defensive tackle in his younger days.

Mr. THOMPSON. Lineman.

The CHAIRMAN. A lineman? So I apologize.

Mrs. LUMMIS. That is quite all right, Mr. Chairman.

Chairman Gensler, thanks for being here. I am from Wyoming so I come from an energy producing state. And like Mr. Schrader and Mr. Kagen, I have heard from my constituents. And both large and small energy producers in Wyoming are concerned about noncash collateral and the fact that it is an essential tool to them for legitimate hedging in the over-the-counter market.

So my question is, how will restrictions on noncash collateral affect the energy company's ability to manage financial risk?

Mr. GENSLER. I, like you, have met with a lot of energy companies in these last 5 weeks, and I think that we can achieve both goals. We can bring this market onto exchanges and clearing, while at the same time allowing these energy companies to continue to actively use these risk management contracts. And what they have asked is, would they have to post cash collateral? And I think that we can have them set up clearing arrangements with the dealers where they could enter into other arrangements, noncash collateral as you said, to assure that they could meet needs if they run into bankruptcy but, short of that, that they can use their cash to drill more oil wells and so forth.

Mrs. LUMMIS. That is exactly the concern they have, so thank you for that.

My next question is for both of you. I know you have talked optimistically about harmonizing rulemaking, and that is a tough thing to do. It is easier in dialogue than in practice. Then we throw in, according to the Administration's proposal, the Federal Reserve into the regulatory mix. Can you tell me how the Federal Reserve fits in this regulatory puzzle?

Ms. SCHAPIRO. I think with respect to rulemaking, the Treasury steps in as the tie-breaker to the extent that the SEC and the CFTC are not able to conduct joint rulemaking—tell me if I am wrong—within specified time periods. I have some concern about that approach as an independent agency.

Let me step back and say that I do think that while the harmonization and the joint rulemaking that is required under the statute by the SEC and the CFTC is not an insignificant task. There are at least a dozen areas where we have to engage in joint rulemaking from the definition of terms or business conduct standards, back office standards, dealer regulation, and so forth. And it will take an enormous amount of effort from the staffs of both agencies.

But then the statute does provide for this tie-breaker—which I find, as an independent agency, to be a little bit of a concern—and creates the opportunity for industry or others who don't like either the CFTC or the SEC's approach on dual rulemaking to just go up to the next level and have the not yet tie broken. So I am a little bit concerned about that.

We might offer as an alternative a provision that was actually in Gramm-Leach-Bliley that would allow either agency to petition the Court of Appeals for an expedited process where there was a breakdown between the two agencies, for example, in determining how particular rules should be made going forward.

Mr. GENSLER. I am going to focus on one other piece because it is at the core of your question as well, is with regard to clearing. I think that since President Roosevelt and Congress laid out these two agencies, and our predecessors, that market regulators have overseen exchanges, clearing, customer protection, investor protection and that has worked fairly well. It is not without—it is not perfect but it has worked fairly well over these decades. And that as we enter into this new area of over-the-counter derivatives, clearing and exchanges, we should borrow from that model, and the SEC and CFTC, working with Congress, should find a way that we oversee both clearing and exchanges for this new area.

And if we have joint rulemaking, which is going to be a challenge—Chairman Schapiro and I have a great relationship and it is working very well, but there will be other Chairmen after us, of course, that you have to consider. But it should be the SEC and CFTC that oversees market functions like clearing and exchanges.

Mrs. LUMMIS. And I have one more question, Mr. Chairman. There was testimony last week from Terrence Duffy of the CME Group. And he argued that the best approach to harmonizing is to have the CFTC regulate products that are primarily commodities and the SEC regulate products that are primarily securities.

In situations where neither securities nor commodities are primary, the firm could pick their regulator. His concern—and I share it—is that over-regulation on the commodity side will simply drive investors to more favorable regimes, and those were his words.

Do you share Mr. Duffy's concern and what do you think about his suggestions regarding harmonizing?

Mr. GENSLER. I think that our two agencies need to do a far better job where we have joint oversight. And certainly Mr. Duffy's exchange is sometimes seen where we have some jointness that we could do better.

I think with regard to the underlying theme, the Treasury has proposed joint rulemaking which will be a challenge, but an alternative would be where there is primarily an interest rate swap, or a currency swap, or commodity, or broad-based security swap, that you would have the CFTC take a lead, and where it was primarily the individual underlying security or narrow-based swap, the SEC.

What we have proposed with the Administration right now is more joint rulemaking than maybe you have quoted the witness from last week suggesting. So the two alternatives would be that we do a lot of joint rulemaking, as we have proposed, or we narrow that joint rulemaking, and then you have a way to say, well, this agency takes the lead on these and this agency takes the lead on that.

Mrs. LUMMIS. Okay. Thanks.

Ms. SCHAPIRO. I would just add, I think we have some concerns with how you would determine what the primary component is of a mixed swap. And so, if that is the direction the Congress takes, we would have a lot of work to do to try to figure out what that primary component is and whether or not it changes on a daily or weekly basis and are we flipping jurisdiction back and forth. I think there are some mechanical issues to that approach, which I believe is why the Administration went with the concurrent jurisdiction for the mixed products.

Mrs. LUMMIS. Thank you both.

The CHAIRMAN. I thank the gentlelady. The gentlelady from Pennsylvania, Mrs. Dahlkemper.

Mrs. DAHLKEMPER. Thank you, Mr. Chairman.

Chairman Gensler and Chairman Schapiro, as we look at regulating systemic risk, how do you define *systemic risk,* and how much of this risk can we reasonably regulate out of the financial system without providing disincentives for risk management?

Ms. SCHAPIRO. Well, that is a great question. I think it is a little of "you know it when you see it" kind of a calculation. But certainly the attributes of systemic risk regulation or systemic risk are obviously the ability of an institution to bring down other institutions, severely disrupt the financial markets, severely disrupt the economy, shut down the credit markets, or disrupt the orderly trading of securities and commodities.

So I think it is a necessarily elastic and flexible term when we talk about systemic risk. But we mean activities or institutions that have the potential to harm the broader financial services and broader financial markets, and not just that single institution. So not just that bank, not just that broker-dealer, but the activities that have the potential to span across the financial markets and impact more broadly on the economy.

Mrs. DAHLKEMPER. Mr. Gensler.

Mr. GENSLER. I was just going to add, when Congress amended the Commodity Exchange Act so that we would have explicit authority over clearing organizations and the like, this is now about 8 or 9 years ago, Congress also inserted in our statute part of our mission that the Commodity Futures Trading Commission, I believe is—I can't remember the exact words, that is why I asked my General Counsel—but to protect against systemic risk. I mean that was one of the features that I am glad to have the right staff here.

Mrs. DAHLKEMPER. Good staff is important.

Mr. GENSLER. It is really important. In fact I want to thank the Chairman and the whole Committee for allowing me to have John Riley, speaking of good staff. But that one of the missions of the CFTC and the subject of this Act is the avoidance of systemic risk. Now, I think that we take that to heart every day as our oversight of clearing organizations. The futures commission merchants that we oversee generally are also overseen by others, and there is a focus on that, in that regard, more broadly.

Mrs. DAHLKEMPER. I did want to, kind of switching back actually to Mr. Kagen, and this is to you, Chairman Schapiro. The recent SEC Inspector General report regarding the Madoff case did not really paint a very pretty picture of things at the SEC, and details how inexperienced lawyers with little or no industry experience were leading investigations into Madoff and missing red flags, that it could have been exposed as fraud decades earlier. Obviously many of our constituents have been angry watching this unfold through the media.

And I just want to know what is being done to correct this problem with your investigatory and enforcement teams and bringing in personnel with more industry knowledge. Where are things at so that we can feel more comfortable going forward with the SEC?

Ms. SCHAPIRO. Absolutely, I would be happy to answer that. And I also would point your staff to our website where we have put up a very detailed explanation of all the initiatives the agency has undertaken in the last 7 months since I arrived, that are very much focused on a response to the problems within the agency that were exposed by the failure to prevent the Madoff fraud and to detect it early on.

But you highlighted a couple that are really critical: skills and training. We have made an enormous effort in the last 6 months to try to recruit new skill sets to the agency, not lawyers, not accountants, but others with experience in trading, financial analysis, derivative products, forensic accounting, to have much more current knowledge about new products and new trading practices on Wall Street. And we are having tremendous success now in our ability to recruit those kind of skill sets to the agency.

We have also embarked on much more aggressive training programs. I was very surprised when I arrived at the agency to see the extent to which training was conducted that, in my view, is not nearly sufficient. So we are putting hundreds of people now through the Chartered Financial Analyst® program and the association of Certified Fraud Examiners program, as well as bringing in people to teach on, again, the latest products, product development and trading strategies.

We have also reorganized our enforcement department. We have brought in new leadership across the agency, including the new enforcement director and new deputy, and the head of our New York office, and they have taken a very different approach to enforcement. They have eliminated a layer of management, put more front-line investigators on the job and moved people into specialized groups that can develop great expertise in particular areas of securities law enforcement, and so move more quickly and more effectively, we hope, to find the problems and bring cases.

And I could talk about this forever. I won't do that to you and take all of your time. But again, on the technology front, we are making changes throughout the organization, and those are, as I said, all posted on *SEC.gov*.

Mrs. DAHLKEMPER. I appreciate that. And I will go on the Web site and read all of that. Thank you very much. I yield back my time.

The CHAIRMAN. I thank the gentlelady. The gentleman from North Dakota, Mr. Pomeroy.

Mr. POMEROY. I just want to begin, Mr. Chairman, by thanking you for this hearing and commend this panel in particular. This is more horsepower than I have seen in these respective vital regulatory positions in quite a while, and I believe you are going to play critical roles in getting us back on track. It has just been a pleasure to listen to you this morning.

The question I have is in terms of trying to get our—I am wrestling with how these clearinghouses are going to work with products that so many participants say are not standardized, they are uniquely tailored and therefore can't be measured adequately on an exchange.

Mr. Gensler, you have been collecting information on this since I believe June of 2008, your agency. Are you making headway in terms of determining the tradeable nature *versus* the unique characteristic of each swap, and do you have thoughts in that regard?

Mr. GENSLER. I have anecdotal thoughts, if I might, if I am allowed to share. But I think that each of the markets, from interest rates all the way to credit default swaps, have a different proportion that is able to be brought into centralized clearing. And interest rate swaps, actually, there is a group right now, a clearinghouse, that is able to bring almost the entire interest rate swap market out to 30 year swaps. They are now working to bring the options on those on.

Whereas in credit default swaps, if I can go to that, 40 percent of that market is on indices. That market is fairly standardized. The other 60 percent that is on individual credit names is more choppy, and some portion of that could be brought in.

And the energy space, again, I have reached out anecdotally, and people have talked about any ratio from, I will say broadly, 50 to 75 percent, which is probably standardized. Whether it is 50 percent or 80 percent that is standard enough to be brought into a clearinghouse, and whether these anecdotes will prove out to be correct, the markets benefit and the public benefits to bring that in. And even this customized product, somebody wants to hedge a risk in your fine state, North Dakota wants to hedge a risk in a customized way, they will benefit by being able to see the pricing on a real-time basis on something that is fairly similar because ½ or ⅔ of the market, maybe more, will be able to be standardized.

Mr. POMEROY. That makes sense to me, contrary to what we heard last week. I believe there is much more that can be done here.

I am interested in your thoughts, Chairman Schapiro, on a council of regulators. I worked as an insurance commissioner at an earlier time in my life, and across the states you would work on issues together, you would work with the Association of Insurance Commissioners, but we each had our state capital we were reporting to and where we derived our authority. You know, it wasn't easy, it wasn't pretty. But you can, regulators can work together across jurisdictional lines.

But on the other hand, I don't understand how what just happened in our economy happened. I can't believe the chinks between regulators was so large that all of this activity could go virtually unnoticed by people with their eye shades or their blinders on. And so council regulators, I like the idea, I believe it can work but, boy, that certainly is in contrast to what we have seen. Why will it work going forward?

Ms. SCHAPIRO. Well, I think it works in conjunction with a systemic risk regulator. I appreciate the Administration's view that they don't believe a committee can effectively make decisions in an emergency and effectively put aside their particular issues of jurisdiction. So we think that it does make sense to have a systemic risk regulator who can pull the trigger, so to speak, when it is necessary.

We think the council is really important as a counterbalance, because residing too much authority in any single regulator creates risks and hazards of its own, particularly if that regulator has multiple responsibilities and may in fact be conflicted in carrying out those different responsibilities. So what a council can bring to a systemic risk regulator and to each of the functional regulators is a broad perspective of the marketplace. Garry may see risks developing in his part of the market that we are not seeing, but that may in fact very profoundly affect the securities markets. So the mechanism of a council allows us to share that information. The same would be true with the bank regulators.

Mr. POMEROY. I also expect it might allow one regulatory authority to learn from another regulatory authority. An example here is brought to the floor this week by legislation introduced by Senator Cantwell relative to a standard for proving market manipulation. CFTC has a knowing standard, SEC has a knowing or reckless standard. Would that be one example of where you might learn from one another?

Ms. SCHAPIRO. That is exactly right. And I would say that even in just the 2 days of joint Commission meetings we held for the first time ever, I think we walked away knowing so much more about how each other approached issues like new product approval, position limits, manipulation, insider trading, and came away with a lot of ideas about how we could each go back and do things a little bit differently and a little bit better by adopting some of what the other had done.

I don't mean to sound overly optimistic, but I think there is enormous benefit in it.

Mr. GENSLER. And if I might just say, on that very important narrower point about our manipulation standard, I do look forward to working with this Committee and coming back to you to ask for some ways to enhance what we have right now in our statute. It might not be exactly what is over at the SEC, because we also police and look out for corners and squeezes and trade practices that are a little bit different in the commodities markets and the securities markets, but we do think that there is time now to enhance our manipulation standards so we can better police these markets.

Mr. POMEROY. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. The gentleman from New York, Mr. Murphy.

Mr. MURPHY. Thank you, Mr. Chairman.

In that same vein in terms of harmonization, Chairman Schapiro, I was very excited to see in your remarks, your comments about some kind of segregation of assets or protection in insolvency, because it was my sense that this was a huge part of what snowballed this financial crisis as all of our financial players, investors, and counterparties all ran away.

Chairman Gensler, do you also agree that we need to really address this issue in the way that Chairman Schapiro does?

Mr. GENSLER. There are many things that I would like to address here today around over-the-counter derivatives and the regulation of over-the-counter derivatives. I think our financial regulatory system failed, so I would look forward to working with however Congress addresses this issue of the broader regulatory oversight council, systemic regulator, and so forth. My main mission and goal here is to work with you and other committees to get the over-the-counter derivatives marketplace overseen and regulated under whatever structure, super-structure is addressed.

Mr. MURPHY. Sure. Maybe I wasn't clear or maybe you were just avoiding wanting to get into that. But the question—and I think it is very, very important for all the bilateral and potentially customized CFTC transactions out there—is: Is this issue of segregation of accounts or some protection of customer accounts—okay, you were talking to staff. I wasn't sure you knew.

So Chairman Schapiro commented that she thought that was something important. It is something that I don't think we are doing enough of.

Mr. GENSLER. I apologize. In terms of that I do believe that we need to do more on this regard, that customer accounts need, if they post margin, need to be properly segregated. It would also require some modest but important modifications to bankruptcy law as well. And I believe that we have actually shared with this Committee with the Chairman and Ranking Member, but we can make it available broadly to everyone, language to achieve that goal.

Mr. MURPHY. I just want to reiterate, I think it is incredibly important, from what I hear from all the customers, that that was really part of the snowballing. So you testified about it seemed to be a little bit different understanding of the margin requirements for customers than what we are hearing from the Treasury. And I tend to agree that we want to come up with something where the customers can work out with their derivatives dealers what their issues, with respect to credit need, to be.

What is your sense about—in terms of how we are going to work with the Treasury and some of the other agencies on that, because it feels like they are pushing a little bit more for harder margin requirements for customers, and you are hearing from us that we think there needs to be a little more flexibility for end-users.

Mr. GENSLER. Well, the natural process of Congressional oversight is a good and healthy process. I have evolved on this as well over the last few weeks. I think that we can achieve both goals. I think we can achieve the goal of bringing all the standard products in the clearing, but at the same time allow end-users to have these individual credit arrangements with the clearing member. I think it would be a loss if we just exempted all of these transactions from the requirement of clearing or exempted all of the end-user transactions from the benefits of transparent exchanges or trading platforms.

Mr. MURPHY. Okay. The last thing I will try to cover, I hear a lot, in the draft legislation, us talking about whatever the clearinghouses will take is the definition of *standard*. I am just curious practically how would that work, because if I am the customer I don't want to have to go shop around every clearinghouse and get a sign-off that they refused my transaction before I can enter into it bilaterally.

Have we thought through the mechanism for that, because it seems like that is a reasonable standard, but one that seems hard to implement.

Mr. GENSLER. Well, I think that it should be very clear and transparent what transactions a clearinghouse accepts. It should only be a perspective. If you have entered into a trade and nobody is accepting it on Tuesday, and then the following Tuesday people are, to try to retrospectively grab that transaction would be one approach that would be healthy.

Mr. MURPHY. That would still mean I have to go talk to all the clearinghouses on Tuesday to say that they turned me down.

Mr. GENSLER. Well, we could do this through rulemaking, but that it should be very transparent and obvious which ones they accept. And the dealers would be required to know that, too.

Ms. SCHAPIRO. I think the dealers are the key here. They have to take the responsibility, in my mind, of knowing what products have been accepted for clearing and in fact are being cleared, so that the end-user isn't ultimately responsible for trying to figure that information out, and, potentially, entering into a customized transaction when they could have entered into a standardized transaction. I think the burden needs to be on the dealers to do that.

I think the burden also needs to be, frankly, on the SEC and the CFTC to ensure that it is widely clear and transparent what is accepted for clearing and what isn't, and perhaps even deemed so by either of the agencies.

Mr. MURPHY. Okay. I appreciate that. Thank you.

The CHAIRMAN. I thank the gentleman. The gentleman from Louisiana, Dr. Cassidy.

Mr. CASSIDY. I am sorry, I had to leave, so it may be that Mr. Murphy and even Mr. Peterson's earlier questions addressed this, so I apologize at the outset if it is redundant. But as I think about this—and you mentioned the benefits of transparency—as I think of the smaller end-users, it seems as if those folks are most vulnerable to this process. The smaller end-user is going to need a clearing party to, if you will, loan them the money to "monitorize," if you will, their balance assets or their capital assets, their balance due to the capital assets. And I have to think that they are going to pay a higher cost for that than a major player, if you will.

It almost seems like we are erecting barriers for smaller end-users to participate in the market, or at least we are going to end up penalizing them financially just by the nature of this.

Mr. GENSLER. I actually think that an opaque system as we have now is the greatest barrier to the small end-user. The large sophisticated hedge fund, they get pretty good pricing out of the dealers right now. But the small commercial enterprise—it could be a parish in your state that has to hedge a risk, interest rate risk on a municipal bond deal—they generally, they don't know. They might have to go out of the parish, might go out and spend $50,000 or $100,000 for a financial consultant so that they can discern what that is that those folks up in New York do.

I think the greatest benefit is for the small user if we can bring the bulk of the market into transparent exchanges.

Mr. CASSIDY. Can I just take off on that? One, thank you for knowing they are parishes and not counties.

Mr. GENSLER. You are welcome.

Mr. CASSIDY. That said, almost though what you just described could be done by transparency and not by requiring them to have, if you will, a margin. So we are mixing the two.

Mr. GENSLER. But the two, you are right, I think the two come together, because that small end-user would also benefit, because today they already have the cost embedded in these risk management contracts. These derivatives are just a way to insure a risk, if I might, if Congressman Pomeroy will allow me to use the word "insure," if you insure a risk in these markets. But right now they are also an extension of credit. That parish or small company in Louisiana is also receiving an extension of credit; they are not sending in checks, but even the accountants make them put it on their balance sheet.

Mr. CASSIDY. So this will just make overt which is currently embedded with the——

Mr. GENSLER. That is right, and more transparent as well. Right now on natural gas, the largest traders tell me it is probably $0.05 a million cubic foot. A small utility might be more than that. The credit extension is right in that contract.

Mr. CASSIDY. So just because I am learning from this, if I can continue to pick your brain, if you will, I have a letter from a major natural gas producer that says that they will, if you will—their collateral is their untapped reserves. Clearly this is something that is customized. So walk me through how that would work for them in this process.

Mr. GENSLER. How it would work if it was a—they would enter into a derivative risk transfer contract with some financial, usually financial dealer. It might be a big multinational oil company as well. That dealer, if it was a standard contract, would have to bring it to a central clearing party. But that dealer would be allowed, if

Congress went forward with its recommendation, to enter into a credit arrangement with that natural gas company where the natural gas company might be posting their gas reserves in the ground as security against that transaction, which many of them do. The largest natural gas companies do enter into these secured arrangements already. Smaller ones tend to have unsecured lines.

Mr. CASSIDY. But still, inherently in that, there is going to be an increased cost for them, correct. Because if they are doing an over-the-counter now for this company, it is not necessarily embedded within their cost of doing business; rather, now what was formerly not there is explicitly there.

Mr. GENSLER. Well, actually, it is there if they are currently using their physical assets in the ground and they are posting that, then that would not change, that would be similar under this. If currently they are not posting any margin or taking it out, it is already priced into the contract. It might be opaque, but it is priced into the contract.

Mr. CASSIDY. Okay. Thank you very much. I yield back.

The CHAIRMAN. If I could editorialize a little bit. It is my impression that some of the big financial players have sent a bunch of these end-users around to talk to you about this. But from what I can tell out of this, somebody that doesn't understand it as much as Mr. Gensler does, that this is actually going to cost those big guys money and actually save the little guys money. I really think that is what is going on here.

Mr. CASSIDY. If I can respond. Actually, I have not talked to a single one. It is just as I read this, I keep on thinking of Frederick Hayek who said that bureaucracies set up to regulate corporations end up protecting corporations. And it seems what we are doing is institutionalizing the fundamental role of these clearing parties as central to our entire system.

The CHAIRMAN. But the thing is when you bring this out into the open and when you standardize this or clear it, you actually narrow the spreads. And that is why the big guys are fighting this, bottom line, because it is going to cost them money and it is going to help people that use it. I mean, that is where this is. I mean, that has been at the heart of this whole thing.

When we went to Europe, this old saw that everybody is going to go to Europe if we get too tough, well, what we heard over there was the reason they didn't regulate is they were told that if they got too tough, everybody is going to go to the U.S., and it was the same people that were telling both sides. So I mean this has been going on, and it is part of why we got into this trouble in the first place.

So I am just saying I am with you, I am where you are, and we are going to get an outcome that is going to benefit these little guys. So just bear with us and we are going to sort through this, and I think we will be able to come to an agreement in the end and see the big picture.

So anyway, I apologize for the editorializing. The gentleman from Idaho, Mr. Minnick.

Mr. MINNICK. Thank you, Mr. Chairman. I continue to find it highly questionable, and personally disturbing, that both we and the Administration are putting you in a position where, with respect to indistinguishably identical product we are asking—we are giving you joint authority and responsibility to establish regulatory oversight, not just of the product, but the dealers, the exchanges, and the clearing houses. And I am not particularly comforted by the thought that where a product originates originally should be a guide as to who should have primacy with respect to establishing the derivative regulation.

I am also not enamored of the thought that it would be for two independent agencies, if you can't agree, and it is absolutely foreseeable that you will not, and even if you can agree, your successors won't, that it should go, two independent agencies should send their disputes to the Treasury, part of the Administration, for resolution. I think that will increase, in the future, with the areas where you choose not to agree.

And I also question Chairman Schapiro's suggestion that it ought to be a judicial body, which is apparently going to lack much expertise and not be current as the resolving authority.

I am wondering if there might be a better solution in—could we ask you to, among yourselves, come up with a Memorandum of Understanding defining who has primacy, at least for some period of time, based upon some other criterion of your selection? I am thinking capital leverage, margin, collateral, those kinds of things that are more generic and unrelated to the character of the underlying security. Could you work out between yourself as to which agency would have primacy in establishing underlying resolution of these issues so that we could have, you and we, for the future could have a road map that would give some indication as to which agency was going to deal with which issues?

Ms. SCHAPIRO. Let me take a stab at that first. Let me say that the reason we suggested the potential process through the Court of Appeals is that one existed under prior legislation, under Graham-Leach-Bliley, but only because I think that is a better approach than having these elevated to the Treasury Department.

We would certainly be willing to try to work through, and we have MOUs ready under other circumstances, for example, with respect to the existing central counterparties that have been approved and so forth. But we would be more than willing to try to work through an MOU that might set out criteria to guide some of our decision-making as we go forward.

I think a joint rulemaking authority, as I have said, will be enormously time-consuming. It will be very difficult; there is no question about that. But where to draw lines, once the decision was made not to merge these two agencies, even though they do regulate in some cases nearly indistinguishable products as you said, there are a thousand places to draw those lines. And the Administration chose the ones it did, and we think we can work through those very effectively with the CFTC. But I don't want to underestimate for anyone the difficulty of our getting from here to the end in that process.

Mr. GENSLER. I would just add to that, I think that your suggestion is a good suggestion. Congress is the first place actually to draw the lines effectively, but by the way, where there is still overlap, the suggestion of having a more explicit Memorandum of Understanding is a good one. There will probably still be some; we will narrow the gaps.

Mr. MINNICK. Well, if we don't do it for you, I think we are not, at least that is not our current disposition, I would feel much more comfortable, while we do have two people of your talent and your mutual goodwill, if you could work that out among yourselves in a way that would provide a template for future regulators. I think that would be extremely helpful.

Mr. GENSLER. I think it is good suggestion.

Mr. MINNICK. I yield back.

The CHAIRMAN. I thank the gentleman.

And Chairman Frank and I have made a commitment to try to narrow this gap as much as we can legislatively as we go through this process. I think we should settle this here, frankly, but there is some question about whether we can do that. There are some technicalities. But, I agree with the gentleman, and we are going to do everything we can to try to sort this out and not put them into conflict because that is not serving anybody well.

The gentleman from Mississippi, Mr. Childers.

Mr. CHILDERS. Thank you, Mr. Chairman.

My questions have pretty much been answered, but I would like to say to both of the Chairmen that I certainly appreciate on behalf of all of our colleagues here this morning both of you being here. To use Congressman Pomeroy's words, this is a lot of horsepower here this morning. Thank you very much for being here. Thank you.

Mr. GENSLER. I thank you for that compliment and Congressman Pomeroy's compliment. I have never been compared to a horse, but it is good. Thank you.

The CHAIRMAN. I thank the gentleman.

I have a couple more questions here. Both of you question the Treasury's proposal to exclude foreign exchange swaps and forwards from this entire scope of regulation. Treasury argues that this exclusion is necessary to preserve the dollar's position as the world's leading currency. Can you explain Treasury's argument of why you believe this class of derivatives should be regulated?

Mr. GENSLER. I think as we move forward with Congress, we want to make sure that we cover the entire marketplace, and the Treasury proposal that was sent up, which we collaborated on, is very strong and covers interest rate and currency commodities, equity, credit default swaps.

What we would want to assure is that any exceptions from that are clearly targeted and can't be used somehow to avoid that oversight of interest rate swaps and currency swaps and the like. And this has been a challenge Congress has wrestled with, really, for 35 years since our agency was set up; how does one sort of exclude forwards but cover futures? How do you exclude some aspect of currencies for the reasons that you just mentioned?

Our concern is that we would not want to evade—be able to have market participants evade the oversight of these currency swaps and interest rate swaps, and also that retail foreign exchange transactions are fully covered.

Ms. SCHAPIRO. This is not particularly an SEC issue, but recalling my days at the CFTC 15 years ago, while there has been enormous change in the regulatory regime since then, the concern about retail forex transactions existed then. It exists today, and that was the reason we felt very strongly that Chairman Gensler has taken the right approach in trying to narrow this exception.

The CHAIRMAN. At last week's hearing, we heard testimony concerning the need for greater independence of clearinghouses from a single or a group of swap participants. In fact, the Justice Department is looking into whether dealers that have an equity stake in the market, which collects price information on credit default swaps, have an unfair advantage over other market participants relating to CDS price information. If Treasury's proposal goes forward, do either of you have similar concerns regarding clearinghouse independence?

Mr. GENSLER. I think it is a very important issue, the governance of clearinghouses, as current governance of clearinghouses, but that they have open governance and they hear from a wide range of membership, that they are not susceptible to control by one community, particularly the dealer community. I think we should have clear authority to be able to write rules and oversee those government features.

Ms. SCHAPIRO. I would agree with that. I think it is critical that the governance structure includes a broad range of market participants and users, not just dealers, in order to ensure that the clearinghouses operate in the broadest public interest. I think it is also critical, as was said, that there be active Federal oversight of the clearinghouses and the government mechanism so that they do provide free and open access.

The CHAIRMAN. Thank you.

The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

In my earlier questioning, Mr. Gensler, I asked if you would be willing to maybe get together with the clearing community and come up with some concrete models of cost savings or costs, one of the two, with regard to clearing end-users, their concerns. You have heard their testimony already. So maybe you could just use them as examples and then run through a number of different scenarios to give us actual concrete numbers. You have described hidden costs of financing capacity that doesn't really permit the end-user really to understand the costs that are associated with current hedging, and the advantages associated with certainty and price discovery and a lot of other things. If you could crank all that in, that would be enormously helpful to us, and so I guess my question, will you do that is my question right now, and could you tell us how quickly you can do it?

Mr. GENSLER. I am certainly committed to meeting with the clearing members and users. I don't know how susceptible it is to coming down to an analytic, or a specific pennies per million cubic foot or basis points for an interest rate swap. But I will certainly commit to meet with any community that you think would be appropriate for us to meet with.

Mr. MARSHALL. Well, I can't give you guidance on who to meet with. It is just this has come up in almost everybody's questioning. It is the thing where we are really getting a lot of pushback, and so it would really help us if you can narrow it a little bit because we get these dramatic statements that we won't be able to hedge.

The CHAIRMAN. Would the gentleman yield?

Mr. MARSHALL. Yes.

The CHAIRMAN. You know, I mean, we have contracts that were customized that ended up going to be standardized, and the margins narrowed when that happened. So the best way to do that would be to go back and just take some of these examples, because you can't really tell what the market is going to do. But I can tell you that a lot of this stuff that has been ginned up around here has been by those guys that are on the other side of this. When this goes on a clearinghouse or exchange or is made transparent, their margins are going to narrow.

Mr. MARSHALL. That is clear.

The CHAIRMAN. So, Mr. Gensler, am I right?

Mr. GENSLER. I couldn't agree more with the Chairman. We are talking about a paradigm shift here. We are saying that, yes, we want to lower the risk to the American public. See, we have mutualized this risk right now. The American public bears a lot of risk in that crisis that we have lived through. It feels stable right now, but we shouldn't forget, this was a very real crisis that we have lived through. And so the American public bears the risk. We are trying to take that and push that back into the dealer community through more capital, and yes, the end-users would be posting some margin on trades.

Now, what we have recommended here today is that those end-users be able to enter into specific credit arrangements that would be less opaque because that is already in these contracts. But I agree with the Chairman that there will be some in the financial community who would prefer not to have this paradigm shift.

Mr. MARSHALL. May I just, there is an obvious business opportunity here for folks to provide financing to facilitate this clearing process. It doesn't necessarily have to be the clearing member. It could be some other entity that actually is formed specifically for this objective.

But again, I say, these are not abstractions. I mean, fairly obvious things that you are talking about that are advantages to the process that is being proposed, and I think the Chairman is absolutely right. A lot of the pushback is because in an opaque world, a call-around market, *et cetera*, you make more fees.

And so if we can cut back on the transaction fees, obviously it is going to benefit the general population that is trying to hedge. But if you could just give us some concrete examples, it would be great. And I think you can do that. It may be you have to go plus or minus, but it would really help us a lot in better understanding the numbers here and being able to respond to those who are saying this is really going to put me out of business, the business of hedging anyway, to respond, no, it is not; here is probably what is going to happen. Tell us why these numbers are wrong.

Mr. GENSLER. We will do our best to do that, and I agree with you that this is at the core of some of this debate right now. So we would like to best respond to your question.

Mr. MARSHALL. Thank you, sir.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

Anybody else got anything good?

With that, we thank you very much, Chairman Gensler and Chairman Schapiro, for being with us today, for your patience in answering our questions, and we will continue to work on this jointly together so we can come up with the right solution for the American people at the end of the day, and hopefully sooner rather than later.

Thank you very much. The Committee stands adjourned.

[Whereupon, at 1:10 p.m., the Committee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED STATEMENT BY INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Independent producers drill about 90 percent of American natural gas and oil wells, accounting for more than 80 percent of American natural gas and more than 65 percent of American oil. The Independent Petroleum Association of America ("IPAA") represents these thousands of independent producers. Many of these producers hedge their production to lessen the volatility in prices to better plan their budgets for finding and producing oil and natural gas, and in turn keep employment levels stable or growing. As end-users in the derivatives market, independent producers strongly support increased transparency and encourage adequate funding and authority for the Commodity Futures Trading Commission to oversee commodity markets and prevent market manipulation.

However, increased transparency and stronger enforcement do not require that all trading be done through regulated exchanges. When producers hedge, they tend to rely on the over-the-counter ("OTC") market, which enables hedging transactions to be customized, primarily to rely on the producers' natural gas and oil reserves as collateral or the producer's credit standing with its bank. Banks with loans to producers often require producers to hedge their production. The banks often perform this service for the producer, using the producers' natural gas and oil reserves as collateral.

The Treasury Department's financial reform proposal recognizes the continued importance of the OTC market. Secretary Geithner has testified that "[d]estroying OTC derivates would leave U.S. companies with a terrible choice between either not protecting themselves at all against some of their financial risks or partially protecting themselves against financial risk with a standardized derivative and thereby damaging their financial statement." IPAA is in complete agreement with the Secretary's assessment and with the intent to distinguish between end-users and derivative dealers or major market participants.

Without access to the OTC market, producers would have two choices. Producers could attempt to monetize their assets and hedge through an exchange, which would consume cash previously reinvested in exploration and production. Or producers simply would be unable to afford the exchange hedging requirements and would not hedge. This choice would subject producers to pricing uncertainty and the ensuing uncertainty to producers' budgets for exploration, production, and employee salaries.

How and Why Producers Hedge

Many energy producers, who own the underlying physical commodities, use hedging as a primary risk-management tool to provide cash-flow certainty. These energy producers were not responsible for the recent swings in futures prices. In 2000, about 17 percent of independent producers used swaps to manage financial risk. That percentage increased dramatically to 41.5 percent in 2007, based on a recent IPAA survey, as detailed in its *Profile of Independent Producers 2009.*

Many independent producers hedge a significant portion of forecasted future natural gas and oil production volumes to reduce revenue risk related to ever-changing commodity prices. Wild swings in natural gas and oil prices impede the industry's ability to stabilize revenues and prudently manage cash flow, which is used to fund development activities that produce vital energy resources and maximize value for stakeholders. For many independent producers, hedging is the primary method of ensuring that adequate cash flow is available to meet their financial obligations. They also hedge production to provide security to lenders that base producers' credit on the value of their natural gas and oil reserves, reserves that are pledged as collateral on bank loans. Conscientious hedging programs provide significant protection for creditors. This protection, in turn, helps provide access to capital for the long-term survival of producers.

Impact of the Proposed Reforms on Producers

The Administration's proposal appears to try to address the concerns described above. However, the push for standardized contracts to trade exclusively through regulated exchanges creates enormous uncertainty as to what will constitute a standardized contract. Equally important is the definition of major swap participant. The Administration's proposed definition of "major swap participant" includes anyone who (1) is not a swap dealer, (2) maintains a "substantial" net position in outstanding derivative contracts, and (3) is not using the contracts to maintain an effective hedge under Generally Accepted Accounting Principles. Uncertainties associated with the second and third components of the definition are likely to undermine the deference the Administration appeared to give to end-users. A more clear-cut exemption approach is needed.

Failure to address this uncertainty could require producers to trade on a regulated exchange where the contrast is stark with current hedging methods. Currently, many independent producers hedge exclusively with the high-credit quality banks that are participants in their lending groups and hold the mortgages on their natural gas and oil properties. This arrangement eliminates the need for posting collateral between the producers and their banks. Producers enter into hedges and their banks hold those positions on their books through settlement, at which time either producers make a payment to the banks, or banks make a payment to producers, and the position is terminated. Under a broad interpretation of "standardized derivative contract" or "major swap participant," producers could be prohibited from hedging with their banks and forced to trade directly with the exchanges, which would require producers to post cash collateral twice daily, based on the mark-to-market value of their hedges.

The requirement to post collateral would effectively preclude the ability of many independent producers to hedge production and would imperil their business in many ways, leading to the destruction of relationships with stakeholders and harming the American consumers who depend on natural gas and oil products for food, shelter, transportation, medicine and other essentials of modern life. The inability to hedge would reduce the certainty in producers' ability to forecast cash flow to cover obligations to debt and equity holders, including debt service and dividend payments, respectively.

Furthermore, without the assurance of receiving a certain price for future production, creditors would lower their valuation of natural gas and oil reserves and reduce the amount of capital available to develop production and maintain, as well as increase, production volumes to meet consumer demand. Without development activities, natural gas and oil production volumes would decline, in some cases very rapidly—leading to a supply shortage in the market. The resulting spike in energy costs would have a decidedly negative impact on the American economy.

The Treasury Department's proposal is encouraging, in that the scope appears to address the importance of maintaining end-users' access to the OTC market. The details will determine whether this intent is actually accomplished. We thank the Administration and the Members of the Agriculture Committee for their thoughtful consideration of how to implement reform without serious unintended consequences. Natural gas and oil are both vital components of our nation's energy supply. In fact, as a resource that is clean burning, readily available and abundant in America, it would make sense for natural gas to be adopted as a major component of the Administration's energy policy. America's independent producers reinvest a majority of their free cash flow to supply the country with reliable energy that is vital to our nation's energy security. Hedging through the OTC market helps producers reduce risk and plan for long-term viability in a highly capital-intensive business that depends on predictable cash flow and access to capital.

Suggested Treatment of End-Users

At the September 17, 2009 hearing, Committee Members engaged panel members to provide suggested language to clarify the exemption from mandatory clearing in the Treasury Proposal. In response, the American Public Gas Association ("APGA") submitted a letter to the Committee on September 30, 2009. APGA suggested inclusion of an additional exception, in which mandatory clearing would not apply if "one of the counterparties to the swap is a producer, processor, merchandiser, distributor or a manufacturer of, or user of, a commodity and enters the swap to educe or manage risks in connection with the conduct or management of its commercial enterprise."

IPAA believes that this type of approach could address some of the end-users' concerns with efforts to encourage mandatory clearing, such as those contained in Treasury's proposal. IPAA will be giving consideration to this proposal within its membership, and encourages the Committee to take APGA's proposal under serious review.

○