Testimony of
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Before the House Committee on Agriculture

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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 counter-party 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.

<u>Overview</u>

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 Treasury's bill in many of those areas. The one exception would be the proposal to

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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.

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. 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.

<u>Jurisdiction and Regulatory Duplication</u>

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 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 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 counter-party 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 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.

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

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 counter-parties 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 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.

<u>Foreign Boards of Trade</u>

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.

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FIA

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

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

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

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

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2006.

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