Statement for the Record

by

The Honorable Kenneth E. Bentsen, Jr.

on behalf of the Securities Industry and Financial Markets Association

before the House Committee on Agriculture

United States House of Representatives

Re: Examining Legislative Improvements to Title VII of the Dodd-Frank Act

Thursday, March 14, 2013

Chairman Lucas and Ranking Member Peterson. My name is Ken Bentsen and I am Acting President and CEO of the Securities Industry and Financial Markets Association (SIFMA).[1] SIFMA appreciates the opportunity to testify on several important legislative improvements to Title VII of the Dodd-Frank Act relating to derivatives being considered by the House of Representatives.

As you know, the Dodd-Frank Act created a new regulatory regime for derivative products commonly referred to as swaps. Dodd-Frank seeks to reduce systemic risk by mandating central clearing for standardized swaps through clearinghouses. capital requirements and collection of margin for uncleared swaps; to protect customers through business conduct requirements; and to promote transparency through reporting requirements and required trading of swaps on exchanges or swap execution facilities. SIFMA supports these goals. There have been significant and constructive reforms put in place that market participants have implemented. Late last year, firms engaged in significant swap dealing activities were required to register with the CFTC as swap dealers and became subject to reporting, recordkeeping and other requirements, many more of which will be phased in over time. This week, the first swap transactions were required to be cleared at central clearinghouses to decrease systemic risk in the swap markets. These accomplishments will make our system safer, and it is important that market participants realize that these changes represent real progress.

However, as with all regulation, if Title VII is implemented incorrectly it may cause more harm than good. Specifically, incorrect implementation of Title VII has the potential to

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

detrimentally limit the availability and increase the cost of derivatives, which are a valuable risk management tool for American businesses, including manufacturers and the agricultural industry.

We recognize the tremendous undertaking required by regulators in their efforts to implement derivatives reform. Throughout this process, SIFMA has sought to constructively engage with regulators through the comment process.

As an overarching matter, I want to emphasize our belief that appropriate sequencing of Title VII rules and coordination between the various regulators responsible for them is critical to successful implementation of the Dodd-Frank Act. In order to adapt to the new swap regulatory regime, our member firms are making dramatic changes to their business, operational, legal and compliance systems. We continue to work closely with the relevant regulators on developing an appropriate implementation timeline to avoid a rushed process that would raise unnecessary complications and risk. In addition, we encourage the regulators to harmonize their rules so that similar products will be subject to similar rules. [2]

In the remainder of my testimony, I would like to focus on a few specific issues that are the topic of legislation currently pending before this Committee, which could have a profound impact on the success of Title VII and its impact on the marketplace.

The Swap Push-Out Rule:

The first important initiative I would like to highlight is legislation to amend Section 716 of the Dodd-Frank Act, often referred to as the "Swap Push-Out Rule." The Swap Push-Out Rule was added to the Dodd-Frank Act at a late stage in the Senate and was not debated or considered in the House of Representatives. It would force banks to "push out" certain swap activities into separately capitalized affiliates or subsidiaries by providing that a bank that engages in such swap activity would forfeit its right the Federal Reserve discount window or FDIC insurance.

The Swap Push-Out Rule has been opposed by senior prudential regulators from the time it was first considered. Ben Bernanke, Chairman of the Federal Reserve, stated in a letter to Congress that "forcing these activities out of insured depository institutions would weaken both

[2] SIFMA/ISDA Comments to CFTC on Proposed Schedule for Title VII Rulemaking (June 29, 2012), http://www.sifma.org/issues/item.aspx?id=8589939400; SIFMA Comments to SEC on the Sequencing of Compliance Dates for Security-Based Swap Final Rules (Aug. 13, 2012), http://www.sifma.org/issues/item.aspx?id=8589939893.

financial stability and strong prudential regulation of derivative activities."[3] Sheila Bair, former FDIC Chairwoman, said that "by concentrating the activity in an affiliate of the insured bank, we could end up with less and lower quality capital, less information and oversight for the FDIC, and potentially less support for the insured bank in a time of crisis" and added that "one unintended outcome of this provision would be weakened, not strengthened, protection of the insured bank and the Deposit Insurance Fund."[4]

In addition to the increase in risk that would be caused by the Swaps Push-Out Rule, the limitations will significantly increase the cost to banks of providing customers with swap products as a result of the need to fragment related activities across different legal entities. As a result, U.S. corporate end users and farmers will face higher prices for the instruments they need to hedge the risks of the items they produce.[5] Mark Zandi, Chief Economist at Moody's Analytics, stated in a letter to Congressman Garrett that "Section 716 would create significant complications and counter the efforts to resolve [large financial] firms in an orderly manner."[6]

Last Congress, Congresswoman Nan Hayworth introduced H.R. 1838, legislation that would strike Section 716 from the Dodd Frank Act. The House Financial Services Committee considered and made significant changes to this bill. The first change was to modify this bill so that additional types of products could remain within the bank. This bill also included an important provision for foreign institutions. SIFMA supported both of these changes and submitted a letter of support for this bill.[7]

Last week, Congressman Hultgren introduced bipartisan legislation (H.R. 992) that would, in his words, "modify the 'push-out' provision in the Dodd-Frank Act to ensure that federally insured financial institutions can continue to conduct risk-mitigation efforts for clients

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[3] Letter from Ben Bernanke, Federal Reserve Chairman, to Senator Christopher Dodd (May 13, 2010), *available at* http://blogs.wsj.com/economics/2010/05/13/bernanke-letter-to-lawmakers-on-swaps-spin-off/.

[4] Letter from Sheila Bair, FDIC Chairman, to Senators Christopher Dodd and Blanche Lincoln (Apr. 30, 2010), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2010-05-04/pdf/CREC-2010-05-04-pt1-PgS3065-2.pdf#page=5.

[5] An example of negative impacts of the "Swap Push-Out Rule" can be seen when a mid-size agriculture producer ("Ag Producer") receives a revolver loan with a floating rate of interest from a bank. In order to hedge the interest rate exposure, the Ag Producer executes a master swap agreement with the Bank and executes a fixed-for-floating interest rate swap as a hedge ("Interest Rate Hedge"). The Ag Producer's risk management guidelines require it to hedge the price exposure related to its production of wheat by executing a wheat swap ("Wheat Hedge"). Under the Push-Out Rule, the bank would not be able to execute the wheat swap with the Ag Producer. With this restriction, the Ag Producer would be required to negotiate another master swap agreement with an affiliate of the bank or a third party and then execute the wheat swap with such entity. With separate entities as hedging counterparties, there is no netting of the Wheat Hedge and the Interest Rate Hedge. Without the efficiency of netting, the Ag Producer's gross exposure to both entities would be used to calculate its exposure and margin requirements.

[6] Letter from Mark Zandi, Chief Economist, Moody's Corporation, to Congressman Scott Garrett (Nov. 14, 2011).

[7] http://www.sifma.org/workarea/downloadasset.aspx?id=8589937400

like farmers and manufacturers that use swaps to insure against price fluctuations."[8] SIFMA applauds Congressman Hultgren for this critical legislation and urges the House Committee on Agriculture to favorably report this bill.

Cross-Border Impact of Dodd-Frank:

Though Title VII was signed into law two-and-a-half years ago, we still do not know which swaps activities will be subject to U.S. regulation and which will be subject to foreign regulation. Section 722 of the Dodd-Frank Act limits the CFTC's jurisdiction over swap transactions outside of the United States to those that "have a direct and significant connection with activities in, or effect on, commerce of the U.S." or are meant to evade Dodd-Frank. Section 772 limits the SEC's jurisdiction over security-based swap transactions outside of the United States to those meant to evade Dodd-Frank. However, the CFTC and SEC have not yet finalized (or, in the SEC's case, proposed) rules clarifying their interpretation of these statutory provisions. The result has been significant uncertainty in the international marketplace and, due to the aggressive position being taken by the CFTC as described below, a reluctance of foreign market participants to trade with U.S. financial institutions until that uncertainty is resolved.

While the CFTC has proposed guidance on the cross-border impact of their swaps rules, that guidance inappropriately recasts the restriction that Congress placed on CFTC jurisdiction over swap transactions outside the United States into a grant of authority to regulate cross-border trades. The CFTC primarily does so with a very broad definition of "U.S. Person," which it applies to persons with even a minimal jurisdictional nexus to the United States. In addition, the CFTC has released several differing interim and proposed definitions of "U.S. Person" for varying purposes, resulting in a great deal of ambiguity and confusion for market participants. SIFMA supports a final definition of U.S. Person that focuses on real, rather than nominal, connections to the United States and that is simple, objective and determinable so a person can determine its status and the status of its counterparties.[9] Equally significant, the CFTC has issued its proposed cross-border release as "guidance" rather than as formal rulemaking process subject to the Administrative Procedure Act. By doing so, the CFTC avoids the need to conduct a cost-benefit analysis, which is critical for ensuring that the CFTC appropriately weighs any costs imposed on market participants as a result of implementing an overly broad and complex U.S. person definition against perceived benefits.

[8] In addition, the bill would fix a drafting error acknowledged by the Swap Push-Out Rule's authors, under which the limited exceptions to the rule that apply to insured depositing institutions appear not to include U.S. uninsured branches or agencies of foreign banks.

[9] SIFMA Comments to CFTC Proposed Interpretive Guidance (August 27, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589940053; SIFMA/TCH/FSR Comments to CFTC on Further Proposed Guidance (Feb. 6. 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589941955.

The SEC has not yet proposed cross-border rules. The Commission and its staff have publicly suggested, however, that they will consider a holistic cross-border rule proposal later this year. It is rumored that this document will be nearly 1,000 pages long and will include many questions for public comment.

Last Congress, Congressmen Himes and Garrett introduced bipartisan legislation (H.R. 3283) that would provide clarity on this issue. The Himes-Garrett bill would permit non-U.S. swap dealers to comply with capital rules in their home jurisdiction that are comparable to U.S. capital rules and adhere to Basel standards. The legislation also prevents the requirement that registered swap dealers post separate margins for each jurisdiction under which they are regulated. During the 112th Congress, the House Financial Services Committee acted to support this legislation by a vote of 41 to 18. SIFMA strongly supports this effort to clarify the jurisdiction of U.S. regulators and urges the House Agriculture Committee to vote for this critical legislation.

Swap Execution Facilities:

As I noted above, the Dodd-Frank Act requires a subset of the most standardized swaps to be traded on an exchange or a new platform known as a "swap execution facility," commonly called a "SEF." Congress generally defined what constitutes a SEF but left further definition to the CFTC and SEC. To date, both the CFTC and SEC have proposed SEF definitions for the products under their respective jurisdiction, but neither Commission has adopted a final definition.

An appropriately flexible definition of "SEF" is critical for ensuring that SEF trading requirement does not negatively impact liquidity in the swap markets. In truth, it remains unclear what will happen to liquidity of instruments that have been traditionally transacted bilaterally when they are subjected to a SEF environment. Understanding this reality, the SEC has proposed a rule that would permit SEFs to naturally evolve their execution mechanisms for those swaps that are widely traded. These SEFs could be structured in many different ways, similar to how electronic trading platforms have evolved in the securities markets.

The CFTC has proposed a different rule that would require customers to either trade swaps on SEFs as if they were traded on exchanges or to solicit prices by issuing requests for quotes, generally known as "RFQs," from a minimum of five market participants for each swap subject to the SEF trading requirement. This differs from current market practice and could have significant impact on the liquidity in the swap market. By signaling to the market the desire to purchase a swap, customers may be telegraphing important information that may impede best execution of their orders. While we appreciate the CFTC's goals of encouraging competition

among dealers to decrease the price of swaps, the reality is that this practice will do just the opposite and drive up the cost of transactions, ultimately harming the corporations and other swaps users this rule aims to protect.

Last Congress, the House Financial Services Committee supported, by voice vote, legislation that would require CFTC and the SEC to adopt SEF rules that allow the swaps markets to naturally evolve to the best form of execution (H.R. 2586). H.R. 2586 would explicitly not require a minimum number of participants to receive or respond to quote requests and would prevent regulators from requiring SEFs to display quotes for any period of time. Finally, this bill would prevent regulators from limiting the means by which these contracts should be executed and ensuring that the final regulation does not require trading systems to interact with each other. SIFMA urges Congress to support similar legislation in this Congress.

Inter-Affiliate Swaps:

The Dodd-Frank Act is effectively silent on the application of swap rules to swaps entered into between affiliates. Such inter-affiliate swaps provide important benefits to corporate groups by enabling centralized management of market, liquidity, capital and other risks inherent in their businesses and allowing these groups to realize hedging efficiencies. Since the swaps are between affiliates, rather than with external counterparties, they pose no systemic risk and therefore there are no significant gains to be achieved by requiring them to be cleared or subjecting them to margin posting requirements. In addition, these swaps are not market transactions and, as a result, requiring market participants to report them or trade them on an exchange or swap execution facility provides no transparency benefits to the market—if anything, it would introduce useless noise that would make Dodd-Frank's transparency rules less helpful.

During the 112th Congress, the House of Representatives voted 357 to 36 in support of legislation (H.R. 2779) that would exempt inter-affiliate trades from certain Title VII requirements due to the important role the transactions play in firms' risk management procedures and the negative impact the full scope of Title VII regulation would have if applied to them. In this Congress, Congressman Stivers has introduced H.R. 677, the Inter-Affiliate Swap Clarification Act, which would exempt certain inter-affiliate transactions from the margin, clearing, and reporting requirements under Title VII. SIFMA supports this initiative and urges the House Committee on Agriculture to vote in support of this important bill.

Cost-Benefit Analysis:

As noted above, it is critical that regulators carefully balance the benefits of swap-related regulation with the potential decreases in liquidity and increased costs to customers wishing to

hedge their activities. As a result, throughout the Title VII rulemaking process, SIFMA has encouraged regulators to conduct comprehensive cost-benefit analysis for all Dodd-Frank rules.

This is consistent with the Obama Administration's efforts to promote better cost-benefit analysis for federal agencies through Executive Order 13563,[10] which requires all agencies proposing or adopting regulations to include cost-benefit analyses in an attempt to minimize burdens, maximize net benefits and specify performance objectives. The President also stated that regulations should be subject to meaningful public comment, be harmonized across agencies, ensure objectivity and be subject to periodic review. In 2012, in testimony before the House Committee on Government Reform, SEC Chairman Schapiro stated "I continue to be committed to ensuring that the Commission engages in sound, robust economic analysis in its rulemaking, in furtherance of the Commission's statutory mission, and will continue to work to enhance both the process and substance of that analysis."[11]

Congressman Conaway has introduced legislation (H.R. 1003) that would require the CFTC's cost-benefit analysis to be both quantitative and qualitative and specifies in greater detail the costs and benefits that the CFTC must take into account as part of their cost-benefit analyses. The bill also requires that a regulation adopted by the CFTC must "measure, and seek to improve, the actual results of regulatory requirements." SIFMA strongly supports H.R. 1003 and urges the House Committee on Agriculture to support this vital initiative that would enhance cost-benefit analysis done by the CFTC.

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

[10] http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order

[11] http://www.sec.gov/news/testimony/2012/ts041712mls.htm