SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

ONE YEAR LATER — THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

STATEMENT OF JOHN M. DAMGARD, PRESIDENT
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Chairwoman Stabenow, Ranking Member Roberts, members of the Committee, I am John Damgard, president of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today as we approach the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms, as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearing organizations (DCOs), our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearing organizations and commit a substantial amount of their own capital to guarantee customer transactions. Our member firms, along with the DCOs of which they are members, take seriously their responsibility to manage carefully the significant financial risks that they assume on a daily basis.

We take justifiable pride that throughout the financial crisis, the futures markets operated well; no FCM failed and no customer lost money as a result of a failure of the futures regulatory system.

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

When Congress was considering the Dodd-Frank Act, many in the financial services industry — and in Congress — cautioned that the extraterritorial reach of the regulatory structure being established in the U.S. would unnecessarily interfere with the regulatory programs being established in the European Union and Asia and would inhibit the ability of U.S. market participants to compete internationally. As we approach the effective date of the Dodd-Frank Act, there is increasing evidence that last year's fears will be this year's reality.

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[1] This statement is written prior to the Commission's scheduled meeting on June 14, at which it is expected to consider effective dates of the several provisions of the Dodd-Frank Act. The Commission's actions at that meeting may help resolve some or all of the questions that have arisen regarding the interpretation of the effective date provisions, and the legal uncertainty arising therefrom, discussed herein.

We were pleased, therefore, to learn that Ms. Stabenow and Mr. Roberts recently wrote to their colleagues in the European Parliament, in which they acknowledged "that there are significant questions about the legal and jurisdictional reach of U.S. regulation" and pledged to work with the European Parliament and U.S. regulatory authorities to resolve these questions. As the Senators emphasized, "a key objective of the [Dodd-Frank] Act was to 'consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards' for the regulation of derivatives transactions."

Although we understand that consultation among the Commission and international regulators has been considerable, coordination appears to have been lacking. To the contrary, the message that has been received — publicly, at least — is that "consistent international standards" can only be assured by adopting the same rules that the Commission has proposed. We respectfully submit that "coordination" requires a willingness to compromise for the sake of achieving a common goal. These are qualities that any successful Senator understands and for which this Committee, with its long tradition of bipartisanship, is known and respected. FIA, therefore, welcomes the Senators' pledge to work closely with their European colleagues "to harmonize rules on trade reporting, execution and other issues that affect the global markets." Having just returned from London, where FIA co-sponsored the International Derivatives Expo, I am confident that your involvement will be welcomed in Europe as well. The potential extraterritorial reach of the Dodd-Frank Act, and the legal uncertainty such reach would engender, was a constant theme among participants.

The failure of the Commission to provide clear guidance on the extraterritorial scope of the Dodd-Frank Act prior to its effective date, and the resultant legal and regulatory uncertainty to which market facilities and participants both here and abroad will be exposed, will require such participants to incur significant costs to comply with the Dodd-Frank Act or assume the regulatory risk that they will be found to be in violation of one or more provisions of the Dodd-Frank Act and, perhaps, ordered to cease business activities until they are in compliance. No market facility or participant can afford to take this risk.

For example, the Dodd-Frank Act makes it unlawful for a clearing organization "directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a derivatives clearing organization with respect to . . . a swap," unless that clearing organization is registered with the Commission as a clearing organization. Under this provision, it appears that a foreign clearing organization would be required to be registered as a DCO, if it clears just one swap for a U.S. participant. This is the case even if the Commission has not determined that the swap is required to be cleared.

Concurrently, however, Congress has provided that the Dodd-Frank Act should not apply to activities that do not have "a direct and significant connection with activities in, or effect on, commerce of" the U.S. The Commission, therefore, has authority to exempt a clearing organization with limited U.S. participation from registration. An exemption would permit such clearing organizations to offer clearing services to U.S. participants without having to incur the costs of applying for registration and, thereafter, meet duplicative and potentially conflicting, regulatory requirements of the Commission and its home country regulator.

The Dodd-Frank Act also makes it unlawful for a clearing member to accept money or securities from a swaps customer without being registered as an FCM. This provision caused FIA to file a petition for a temporary exemption from registration as an FCM on behalf of our members' non-U.S. affiliates that are clearing members of ICE Clear Europe, and similarly situated clearing members. (A copy of the petition is attached to this statement, and we respectfully request that it be made a part of the record.) ICE Clear Europe is the clearing organization for over-the-counter energy derivatives executed through the IntercontinentalExchange. We filed this petition for temporary exemption as a precautionary measure in order to assure that U.S. customers would be able to continue to clear trades without disruption after the July 16 effective date of the Dodd-Frank Act.

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

Two of the more active swaps clearing organizations registered with the Commission, ICE Clear Europe and LCH.Clearnet Ltd., are located outside of the U.S., and we fully expect that other foreign clearing organizations may elect or be required to be registered with the Commission as DCOs. Certainly, any foreign clearing organization that elects to apply for registration as a DCO should be permitted to apply. However, we do not believe every foreign clearing organization that clears swaps, where U.S. participants are involved, should be required to be registered simply because it clears for U.S. participants.

An exemption from registration would relieve the Commission of the substantial costs of overseeing such foreign clearing organizations and free staff to focus on transactions that more directly affect U.S. market participants. In his testimony before the Senate Appropriations Subcommittee on Financial Services and General Government in May, Chairman Gensler stated that the Commission currently oversees 14 registered DCOs and anticipates that the Dodd-Frank Act will result in an additional six or seven clearing organizations applying for registration as a DCO. The Commission is requesting a 30 additional staff "to address the significant increase in the number of DCOs."

A Successful Model for the Oversight of Foreign DCOs

This does not need to be the result. As noted above, Congress determined to limit the application of the Dodd-Frank Act on activities outside of the U.S. The statute should not apply to a foreign clearing organization, unless such activities have "a direct and significant connection with activities in, or effect on, commerce of" the U.S. We believe the Commission has authority to interpret this provision to exclude from its jurisdiction certain entities and transactions that do not have a significant impact on U.S. commerce. Elsewhere in the Dodd-Frank Act, the Commission has specific authority to exempt a foreign clearing organization from registration,

subject to conditions, if the Commission determines that the foreign clearing organization is subject to comparable, comprehensive supervision and regulation by government authorities in its home country.

The Commission's Part 30 rules, which govern the offer and sale of foreign futures and options transactions to U.S. participants, is a tested, successful model for the regulation of international transactions that could serve as a starting point for exempting foreign clearing organizations and other market participants from the Commission's registration requirements. The Commission's Part 30 rules were first promulgated nearly 24 years ago in 1987. Under these rules, foreign clearing organizations are not required to be registered with the Commission to clear futures contracts executed on foreign exchanges on behalf of U.S. participants. In addition, a foreign clearing member is not required to be registered with the Commission as an FCM, if the foreign clearing member carries only a customer omnibus account on behalf of a U.S. FCM and does not carry an account directly for a U.S. customer.

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

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

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

Exemptive Relief Will Facilitate Coordination Among International Regulators

By granting appropriate exemptive relief, we believe the Commission will facilitate greater coordination among international regulators and the establishment of consistent standards with respect to the regulation of swaps among regulatory authorities in the U.S., Asia and the European Union. An example of the need for such coordination has been brought into sharp relief with recent reports that the European Parliament is considering amendments to the EU's European Market Infrastructure Regulation ("EMIR"), which would effectively prohibit a third-country clearing organization from providing clearing services to EU entities, unless the clearing organization is authorized by each EU member state. A third country clearing organization could be authorized only if the European Commission recognized that the legal and supervisory arrangements of its home jurisdiction were "equivalent" to those contained within EMIR. We have been advised that European Securities and Markets Authority (ESMA) anticipates that it will be able to recognize US DCOs, but would expect that such recognition would be reciprocal.

If the European Parliament adopts these amendments, we believe it would be extremely difficult for U.S. DCOs to offer their clearing services to entities within the EU, unless U.S. regulation is determined to be "equivalent" to the standards contained in EMIR. The potential "balkanization" of derivatives clearing in this way benefits no one, denying market participants access to clearing, reducing competition and increasing global systemic risk. Yet, the Commission's ability to work with ESMA will be severely constrained if the Dodd-Frank Act is interpreted to require EU clearing organizations to be registered here to offer clearing services to U.S. participants.

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

Legal and Regulatory Uncertainty Creates Substantial Financial Risk

Legal uncertainty is a domestic as well as an international concern. When Congress determined that the provisions of the Dodd-Frank Act would generally become effective on July 16, it no doubt assumed that the bulk of the regulations necessary to implement its provisions would have been adopted. Despite the best efforts of the Commission and its staff, however, that is not the case.

Importantly, the Commission only recently proposed rules to establish a segregation scheme for cleared swaps customer collateral. The proposed rules would create a regulatory regime for the segregation of cleared swaps customer collateral that differs substantially from the regulations governing the segregation of customer funds held in connection with futures and options on futures transactions executed on U.S. designated contract markets. The Commission has also requested comment on alternative segregation schemes and has made clear that the final rules may look significantly different from the rules the Commission has proposed. The rules governing cleared swaps customer collateral are a linchpin of the Commission's customer protection regime. Until such rules become final, the extent to which other customer protections can be implemented will be limited.

Whichever segregation scheme is ultimately selected, FCMs and end-users alike would need to make substantial changes to their back office systems. At a June 3, 2011 Commission roundtable on the proposed rules, several representatives of investment managers also anticipated that, once the segregation rules are adopted, they would need two years before they would be ready to engage in cleared swaps transactions. In addition to implementing changes to their back office systems, they would have to undertake a significant educational process with their clients to explain their respective rights and obligations under the rules. They would then need to obtain written authorization from each client to engage in cleared swaps transactions on their behalf. This process cannot begin until the rules have been adopted.

Moreover, the Commission has not yet made decisions on other critical issues that will determine the Commission's view of the full scope of its jurisdiction. The basic definitions of a "swap dealer", "major swap participant" and "swap" have not been adopted. Similarly, rules relating to capital and margin requirements have not been finalized. As a result, many swap market

participants may not be aware, or may be uncertain, whether they will be required to be registered with the Commission in some capacity or otherwise be affected by the proposed rules. Until these issues and the extraterritorial scope of the Commission's jurisdiction are resolved, holding companies with multiple affiliates will be unable to determine the appropriate entity (or entities) that should be registered as swap dealers.

Consequently, there is substantial uncertainty concerning the ability of market participants to conduct a broad range of activities after July 16 as well as the continued legality of transactions entered into prior to that date. Such legal uncertainty benefits no one and exposes all market participants to substantial financial risk.

On Friday, June 10, FIA joined with other financial services trade associations to request the Commission to adopt appropriate interpretative and exemptive relief necessary to assure an orderly implementation of the amendments to the Commodity Exchange Act made by the Dodd-Frank Act and avert severe market disruption. FIA respectfully requests the Committee to encourage the Commission to exercise its interpretative and exemptive authority to this end.

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