Testimony of

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The Committee on Agriculture of the United States House of Representatives

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Hearing - "Examining Legislative Improvements to Title VII of the Dodd-Frank Act"

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Chairman Lucas, Ranking Member Peterson and Members of the Committee, good morning and thank you for the opportunity to testify before the Committee today.

My name is Wallace Turbeville. I am a Senior Fellow at Demos, a national public policy organization working to reduce political and economic inequality, advancing a vision of a country where we all have an equal say in our democracy and an equal chance in our economy. I am testifying today on behalf of Americans for Financial Reform, a coalition of more than 250 organizations who have come together to advocate for the reform of the financial sector. I would also like to thank Marcus Stanley, AFR's Policy Director, for assistance in preparing this testimony.

I come to this testimony with extensive professional experience in both the derivatives markets and the commodity markets. For seven years, I practiced law specializing in public and private securities offerings, primarily municipal bond offerings for States, local governments and governmental utilities. I was then an investment banker at Goldman Sachs in its Municipal Bond Department for more than twelve years, specializing in governmental utilities in the United States and in Europe. After leaving Goldman, I managed a small advisory firm specializing in infrastructure finance around the world. I also served as CEO of a firm providing counterparty credit management services in the derivatives markets. For the last two years, I have focused my efforts on financial system reforms, participating in dozens of formal comments and various roundtable discussions at the request of regulatory agencies, the vast majority of them related to Title VII of the Dodd-Frank Act. This experience has prepared me well to discuss the amendments of Title VII of the Dodd-Frank Act that are the subject of this hearing.

Today the Committee is considering seven pieces of legislation. Six of these would amend Title VII of the Dodd-Frank Act, and one would impose new requirements for cost-benefit analysis on the Commodity Futures Trading Commission (the "CFTC"). Americans for Financial Reform oppose six of these legislative proposals. The specific reasons for our opposition to each bill are

outlined in detail in my written testimony and will also be outlined in opposition letters that we are submitting today or will be submitting in the future. A guiding principle for AFR is that the trillions of dollars in economic costs created by the 2008 financial crisis, as well as the numerous related problems revealed in Wall Street scandals, mean that we need increased oversight of our financial system and full implementation of the Dodd-Frank Act. This should not be a controversial position. Over 70 percent of the public supports tougher rules and enforcement for Wall Street, and similar proportions support the Dodd-Frank Act.[1] But the legislation offered here moves in the wrong direction. Bills such as HR 992 would enable additional bailouts of Wall Street banks. Legislation such as HR 677 on inter-affiliate swaps or the discussion draft on extraterritorial derivatives regulation would effectively limit the ability of regulators to provide proper oversight of complex derivatives markets.

The title of this hearing suggests that the Committee is considering "improvements" of the derivatives provisions of the Dodd-Frank Act. Despite the fact that the great majority of the Dodd-Frank Act has not yet been implemented or tested in the market, it has been suggested that there is a need for "clarifications" and "technical amendments."

This has caused me to think carefully about the concepts of improvements, clarifications and technical amendments. Derivatives bristle with devilishly complex risks and valuation issues. Even a sophisticated bank might value the same derivative differently in separate organizational units of the bank.[2] It has been reported that the infamous "London Whale" episode involved the obscuring of massive risk positions at JP Morgan Chase, a firm that claims industry leadership in risk management, by alteration to the quantitative formulas measuring risk.[3] In this technical area, these concepts are likely to be viewed differently by those who evaluate the regulation of the derivatives markets differently.

In truth, there is no urgency for "technical amendments" to Title VII at this time. This may seem surprising given the length and scope of the legislation, but there are two good reasons that it is true. First, in almost every area Title VII grants regulators extensive discretion to tailor and fine tune the broad directives in the Dodd Frank Act, and to introduce exemptions if need be. Indeed, regulators have been generous in doing just that, perhaps to a fault. Second, almost none of the significant elements of Title VII have yet been fully implemented. Without implementation, claims about their supposed harms are unfounded – especially since the key elements of Title

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1 Lake Research Partners, "Polling Memo: Two Year Anniversary Of The Wall Street Reform Law", July 18, 2012, available at http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/07/AFR-AARP-CRL-NCLR-Lake-Research-Dodd-Frank-Anniversary-Poll-MEMO-7-18-121.pdf .

2 Arora, S., Barak, B., Brunnermeier, M., Ge, R., "Computational Complexity and Information Asymmetry in Financial Products," October 19, 2009, available at http://scholar.princeton.edu/markus/publications/term/39

3 Brinded, L., "JP Morgan's $2 Billion 'London Whale' Loss Challenges Industry's Risk Measures," International Business Times, June 13, 2012, available at http://www.ibtimes.co.uk/articles/351700/20120613/jp-morgan-cio-bruno-iksil-london-whale.htm

VII, such as clearing, exchange trading, and improved risk management, are hardly radical. They are based on tried and true solutions with which we have long experience in real markets.

Given the complexity of the swaps space, and the approach of the Dodd-Frank Act in relying on regulatory expertise to craft specific rules, Congress should not be advancing broad and sweeping statutory exemptions that overturn the judgment of expert regulators and effectively deregulate portions of the swaps market only a few years after the decision to regulate them for the first time. Given the delays in implementation of the Title VII provisions and the importance of gaining experience with how these provisions work once they are actually implemented, Congress should not be acting to delay their implementation even further. Yet several of the bills before you today do exactly that. For example, H.R. 677, the "Interaffiliate Swap Clarification Act", would create an overbroad and sweeping exemption for all interaffiliate swaps that completely ignores the nuanced and thoughtful work done by the CFTC in crafting its own rule proposal for interaffiliate swaps. And H.R. 1003 would add burdensome additional cost benefit analysis requirements to the Commodity Exchange Act, the effect of which would not be to improve the quality of rulemaking but instead to create indefinite additional delays in the implementation of financial reforms.

Instead, the Congressional emphasis now should be on supporting the drastically underfunded CFTC with adequate resources to complete Dodd-Frank rulemaking and to actually implement those rules through enforcement and market monitoring. Only then will Congress have the necessary information to examine how well these rules are actually working based on real data rather than the usual industry calls for deregulation and exemptions.

The proposed bill on extraterritorial jurisdiction creates a different kind of impediment for the CFTC. The derivatives markets are truly international with trading taking place in cyberspace. Events in other jurisdictions can easily spread to the US through intricate interrelationships across markets. The nature of the regulations in other jurisdictions, as well as their timing and even existence, remains an unknown. The ideal approach to jurisdiction in these circumstances is for the law to provide broad jurisdiction to the CFTC and to enhance the prospect that the rules in other jurisdictions will be comparable to the US approach. Broad jurisdiction means that there will be no gaps in terms of scope and timing. The exercise of jurisdiction can be managed through substituted compliance, if justified. Broad jurisdiction together with point-by-point examination of the rules of other jurisdictions will allow the CFTC to work with agencies of other jurisdictions to achieve regulatory harmony which reflects the US approach to rules, an approach that will most certainly be the most prudent and efficient. Yet as I outline further in my testimony, the proposed bill on extraterritorial jurisdiction would interfere with this process and undermine the CFTC's ability to regulate swaps that directly affect the U.S. economy.

Americans for Financial Reform does not object to actual technical amendments, by which I mean amendments that make non-substantive and necessary changes to facilitate the achievement of the goals of the original statute. One of the bills before the committee today,

H.R. 742, the "Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013," fits this description well. AFR does not oppose it.

However, the other bills here are far from being " clarifications or technical amendments" and AFR does not see them as improvements. Instead, they significantly alter the Dodd-Frank Act in ways that effectively deregulate the financial sector and work against the goals of improving the safety, stability, fairness, and efficiency of our financial system.

I use the term "financial system" intentionally. Far too often, discourse on financial reform conflates the profitability of individual financial institutions with a safe, sound and efficient financial system. Financial institutions seek short term profits and massive earnings from derivatives, and all too often they are able to sustain the long term risks involved in this pursuit due to the public safety net that supports too-big-to-fail banks. Combined with the fact that executive pay is frequently determined by short-term profits, this means that short-term incentives dominate their behaviors, often at the expense of the public at large and the safety of the broader financial system. The Dodd-Frank Act puts sensible risk limits on activities in the derivatives markets. This is good for the financial system, even if it reduces the profitability potential of some financial institutions.

In thinking about the benefits of sensible limitations on derivatives activities, I would also like to add a personal note on one of the bills under consideration. HR 1038 purports to benefit public utilities by exempting them from some of the protections in Title VII of the Dodd Frank Act. This is a subject near and dear to my heart since I devoted most of my professional career to assistance of governmental enterprises in their capital-raising activities. In those years, I had the uncomfortable opportunity to witness sales calls by derivatives specialists on governmental utilities. I have seen the technique of fostering a sense of trust, encouraging an advisory relationship that can be exploited to sell an immensely profitable derivative when other alternatives could be better. As pointed out earlier, even the most sophisticated financial institutions struggle with evaluating the risks associated with derivatives. It is completely unreasonable to expect that governmental utilities will have the ability to measure the risks of derivative transactions. This is especially so given the massive incentives of swap dealers to ingratiate themselves as functional advisors and obfuscate their costs and risks. This means that swap dealers must be constrained in their dealings with governmental utilities. Their business conduct standards should be enhanced, not undercut. Public entities are at a major disadvantage in negotiating with swap dealers and the public's interest is in rectifying this imbalance, not facilitating it.

Below, I discuss the bills before you today in more detail. I would also refer you to the opposition letters that Americans for Financial Reform is submitting on most of these pieces of legislation.

Extraterritoriality

CFTC Chairman Gensler has correctly observed that a faulty extraterritoriality rule could blow a hole in the bottom of the ship of derivatives regulation. Modern markets are interrelated and trading occurs in cyberspace. The very concept of national jurisdictions is challenged by the modern financial system, especially in the area of derivatives.

American financial institutions operate derivatives businesses in many nations through branches and guaranteed affiliates. Moreover, foreign banks similarly maintain large derivatives businesses in the US. There is no assurance that financial regulations in those countries will regulate their activities using comparable standards, either in the form of written rules or in their application. Indeed, in some jurisdictions, there is no assurance when or even if rules will be finalized.

The discussion draft on extraterritoriality before the committee today would greatly hamper the ability of the CFTC to effectively address the complex problem of extraterritoriality. It does this by undermining the jurisdiction granted to the agency in Section 722(d) of the Dodd-Frank Act and limiting the ability of the agency to work with foreign regulators to ensure the full comparability of U.S. and foreign derivatives rules. Given the centrality of proper cross-border regulation to effective oversight of the derivatives markets, as well as the potential exposure of the U.S. taxpayer and the U.S. financial system to failures in regulation abroad, it is of central importance to support the CFTC in implementing strong cross-border rules. Instead, this legislation would weaken it.

There is no doubt that the viability of the US financial system is tied inextricably to international markets. In 2008, foreign banks needed access to US dollars to avoid default on ongoing dollar denominated liabilities. They could not rely on borrowing dollars in the crippled US commercial paper market. The only remaining source was the foreign exchange market in which dollars are swapped between US and foreign banks as of a future date in exchange for other currencies, a $4 trillion ***per day*** market.[4] Banks in other countries came to doubt the reliability of US banks - no one knew whether US banks were solvent because they held huge quantities of toxic mortgage assets that could no longer be valued accurately. The market began to evaporate, as foreign banks feared that US banks would not deliver the required currency on the appointed date. A worldwide collapse might ensue if the foreign banks defaulted for want of dollars. The Fed offered unlimited access to foreign central banks to swap dollars for foreign currency so that the central banks could in turn loan dollars to local banks, avoiding their default. Most accurately measured, the daily peak of Fed swaps exceeded $850 billion.

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[4] Bank for International Settlements, "Triennial Central Bank Survey, Report on Global Foreign Exchange Market Activity in 2010," December 2010, available at http://www.bis.org/publ/rpfxf10t.pdf

Under these circumstances, a prudent approach to extraterritoriality is essential. Jurisdiction and the exercise of jurisdiction are two different things. The best result is if the US sets the standard for meaningful and prudent regulation and the foreign jurisdictions meet that standard. The best way to achieve that goal is to strive for broad jurisdiction for the CFTC. This likely means that jurisdictions will overlap. But that has several benefits. First, it will mean that there are no jurisdictional gaps that can be exploited. Second, it will mean that US regulators will be in the best position to harmonize jurisdictional overlap under conditions in which the foreign rules are substantially comparable with US rules. And for the period in which foreign rules are not in place, US regulators can protect American taxpayers rather than allowing foreign activities to put the US financial system at risk.

The language of Section 722(d) of the Dodd-Frank Act strikes this balance wisely. It gives the CFTC jurisdiction over any activities that "have a direct and significant connection with activities in, or effect on, commerce of the United States." As stated above, the CFTC is not required to exercise this jurisdiction. It retains the option to tailor regulations to specific activities abroad. It is difficult to imagine any reason why the American public would *not* want to give our regulatory agencies jurisdiction over derivatives activities that have a "direct and significant connection" with the U.S. economy. If substituted compliance is appropriate, the CFTC can negotiate that out from a position of strength.

It is unwise to subject these kind of jurisdictional matters to the Administrative Procedures Act. The APA may be appropriate for the design of specific derivatives rules, but should not limit the proper application of these rules to all areas directly affecting the U.S. economy.

Further, the legislation would direct and limit the standard for comparability in a way that undercuts the discretion of the CFTC to work with foreign jurisdictions to achieve the standards that will protect the American public. The bill requires that, for G-20 member nations, the agencies make overall comparability determinations based on the "broad comparability" of the entire regime in another country to the entire derivatives regime in this country. This eliminates the CFTC's ability to determine the comparability of other national regimes in specific areas and to permit substituted comparability for some requirements and not others. Given the scope of derivatives requirements this regulatory flexibility is valuable. Indeed, it is possible that the ability to approve on a point-by-point basis will allow regulatory agencies to be more permissive in some cases (by permitting substituted requirements for a few requirements when the overall regime is not comparable). If substituted compliance is implemented, the CFTC should be empowered and encouraged to vigorously work through the elements of regulatory regimes on an ongoing basis to make certain that the high standards required by Congress and the American people are upheld in every jurisdiction that could be the source of grave harm to the American economy.

Finally, SEC extraterritoriality jurisdiction has its origin in a regulatory mandate that is very different from the CFTC. The nature of the derivatives markets regulated by the CFTC demands the standards set forth in Section 722(d). If the two standards were to be reconciled, it only makes sense that the language of Section 722(d) would prevail. In a world in which a financial meltdown can easily and quickly be transmitted throughout the international system, it makes no sense to make fine distinctions about jurisdictions of organization or physical locations of offices when it comes to the derivatives markets.

Bank Derivatives Subsidiaries

Perhaps the most dramatic example before you today of legislation that undermines the goals of the Dodd-Frank Act is H.R. 992, the "Swaps Regulatory Improvement Act". This would amend Section 716 of the Dodd-Frank Act, a provision that bans public bailouts of a broad range of derivatives dealing activities. This ban would require Federally supported banks to transact their derivatives dealing business in separate corporations, not guaranteed by the banks. HR 992 weakens this section enormously by greatly increasing the types of swaps dealing activities that are exempted from the Section 716 ban on public bailouts of derivatives dealing. It would significantly expand the range of derivatives dealing that insured depository institutions, the banks most susceptible to public bailout, would be permitted to engage in and to fund. It is truly remarkable that only a few years after the bailout of AIG and the public support provided to derivatives dealing at numerous Wall Street banks, that we would see a proposal that allows additional public bailouts of Wall Street derivatives activities. Yet this is exactly what H.R. 992 would do.

Opposition to Section 716 is really an issue of cost. The Section 716 ban on public support would effectively require the affected institutions to separately capitalize subsidiaries to engage in derivatives dealing. We do not dispute that it would be cheaper for the banks to support this business using the cheap funding available through insured deposits. But that is because the public is forced to subsidize the cost of their capital because the failure of the banks would be potentially damaging to the public at large. The real question here is whether the public should subsidize these derivatives businesses. AFR and many others believe that the public should not. If these businesses cannot be done profitably without taxpayer subsidy, they should not be done.

It may be argued that the increased cost of capital will adversely affect pricing for derivatives market participants. This argument is superficial, especially in its implication that costs will increase on a dollar-for-dollar basis. However, to the extent the elimination of the subsidy increases cost, taxpayers generally will be benefited from the reduction of the subsidy. The Federal government can always affect prices by granting taxpayer subsidies to any business. The use of subsidies in this area is a particularly dubious policy.

Any other result distorts the markets and constitutes a drag on the economy. The subsidized derivatives business has been immensely profitable for the banks. It has been estimated that devoting capital to support derivatives has been ten times more profitable than the use of that capital to support lending to American businesses and governments.[5] That figure is completely consistent with statements made to me by derivatives professionals. This is completely inconsistent with an efficient and transparent marketplace.

Margin Requirements

The stated purpose of H.R. 634, entitled the "Business Risk Mitigation and Price Stabilization Act," is "To provide end user exemptions" from certain provisions of the Dodd-Frank Act. Those provisions deal with margining of swaps that are exempted from the clearing requirement. The collateralization of uncleared swaps is a vital area for the safety and soundness of both non-bank derivatives entities and for banks with extensive derivatives activities.

It is vital to understand that margin is collateral for real, not "technical" or imagined, extension of credit. If a swap moves out-of-the-money for a counterparty, the opposite counterparty is just as exposed to the credit of the out-of-the-money counterparty as if money had been loaned.[6] Variation margin collateralizes this credit exposure. But that is insufficient. The credit exposure is uncapped, so it can grow between the time variation margin was last posted and the time that a counterparty can react to the default of its opposite counterparty. Initial margin collateralizes that additional credit risk.

The bill would eliminate the authority of the CFTC and the SEC to require swap dealers and major swap participants who are not banks to include margining requirements for swaps affecting commercial end users. This is unnecessary. The agencies have already elected not to require margin for uncleared swaps that originate from a non-financial end user.[7] Not only is it unnecessary, it is potentially dangerous. Should the agencies discover in the future that unmargined swaps from commercial end users create a risk to the safety and soundness of non-bank swap dealers, they may wish to reassess elements of their current rules. This statutory change prevents them from doing so.

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[5] Corporation for Public Broadcasting, Frontline, "Money, Power and Wall Street," Episode 1, Remarks of Christopher Whalen, available at http://video.pbs.org/video/2226666502

[6] Mello, A, and Parsons, J., "The Collateral Boogeyman – Packaging Credit Implicitly and Explicitly," October 2010, available at http://bettingthebusiness.com/2010/10/.

[7] CFTC Proposed Rule, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732, available at http://cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_5_CapMargin/index.htm; SEC Proposed Rule, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 78 FR 4365 available at http://www.sec.gov/rules/proposed.shtml.

But the bill goes further. It may affect the ability of prudential regulators from requiring that banks set a limit on the amount of credit extended to commercial end user customers under derivatives before margin collateral is required. The prudential regulators have likewise not required margin of commercial end users in most circumstances, but they have required a bank-set credit limit to the extent of unmargined derivatives.[8] While technically, there is no limit to the credit loss if prices run away from the bank before the derivative position can be covered, this would at least limit the likely amount of credit exposure. The prudential regulators do not impose a credit limit; they simply require the bank to set one as an exercise of basic prudence.

I would note that this bill does appear to be drafted fairly narrowly, striking only at Dodd-Frank authorities for margin requirements for non-financial end users, and apparently not affecting authorities to require capital under Dodd-Frank or prudential authorities outside of Dodd-Frank. While we still believe the bill is at best unnecessary and at worst harmful, the narrow crafting of the bill is positive and must be preserved if this legislation is to move forward. It is critical that the exemption proposed in this bill does not affect the authority of prudential regulators to set reasonable credit limits in all cases, including the derivatives markets, and also that it does not affect the ability to require appropriate capital. That authority is critical to bank regulation. It also benefits end user customers, who for their own safety should not incur excessive levels of concealed debt through derivatives exposures.

Cost-Benefit Analysis

The stated purpose of H.R. 1003 is "To improve consideration by the Commodity Futures Trading Commission of the costs and benefits of its regulations and orders." This proposed legislation would unnecessarily add numerous additional requirements to the already existing statutory cost-benefit requirements for the CFTC. These requirements could effectively paralyze the CFTC's ability to implement laws passed by Congress to safeguard our financial system. The rules affected would range from those designed to prevent excessive speculation that drives up prices for gas and other commodities to derivatives oversight necessary to prevent the repeat of a crisis like that of 2008.

The requirement for consideration of costs and benefits should not create an opportunity to reconsider the decisions made by Congress. Congress enacted a comprehensive regulatory regime that is intended to serve the interests of the public by making the derivatives markets more transparent, fairer and safer. The CFTC has finalized 40 rules implementing Dodd-Frank and 20 more remain to be finalized. Each has its own benefits and each is beneficial as part of a mosaic of financial reform. The steps that are required in the bill for each element of each rule envision a reconsideration of those decisions, first by the agency an then by the Courts on review. This is an inappropriate balancing of the branches of government and does not serve the public's interests.

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8 76 FR 2764, Proposed Rule, Margin and Capital Requirements for Covered Swap Entities.

Existing law (Section 15(a) of the Commodity Exchange Act) already requires the CFTC to consider the costs and benefits of regulatory action before issuing a new regulation. Existing law also requires the agency to consider the effects of any new regulation on the efficiency and competitiveness of the markets it supervises. In addition to such consideration, prior to any rulemaking the CFTC must consult extensively with industry and other interested parties who submit comments to the agency. Over the last two years the CFTC has collected and reviewed thousands of public comments and held numerous public round tables on Dodd-Frank rules.

HR 1003 would add numerous additional requirements to these already extensive procedures. It would also force the agency to measure costs and benefits of a new rule before that rule was even implemented or market data resulting from the rule was available. The new requirements imposed by this bill also include enormously broad and vague mandates such as determining whether a regulation imposes the 'least burden possible' among all possible regulatory options. A court could overturn the CFTC's decision in any case where it found any one of the numerous analyses required here to be inadequate. The vagueness of mandates like the 'least burden possible' means that court challenges or court decisions could rest on claims that are essentially speculative and theoretical. These new mandates would not increase the quality of the regulatory process, they would stop it in its tracks,

These extensive new procedural requirements are being proposed even as the CFTC is being starved of the resources it needs to do its job. The massive new requirements added by HR 1840 would make the problem much worse. Any attempt to improve the analytic capacities of the CFTC and its capacities to assess the effectiveness of its rules must start with additional funding, not with piling on unnecessary additional mandates and requirements that will trigger additional litigation.

Swap Dealer Business Conduct Standards and Dealer Registration Rules Applicable to Governmental Entities

The stated purpose of HR 1038 is "To provide equal treatment for utility special entities using utility operations-related swaps, and for other purposes." This is a subject near and dear to my heart since I devoted most of my professional career to assistance of governmental enterprises in their capital-raising activities. Section 731 of the Dodd-Frank Act imposes enhanced business conduct standards on swap dealers transacting with "special entities," a term that includes state and local government agencies and Federal agencies. HR 1038 would carve out governmental electricity and gas utilities and Federal power marketing agencies. I suppose the "equal treatment" that is called for by the bill means equal treatment with far more sophisticated corporations rather than equal treatment with other governments and their agencies and instrumentalities.

In my career, I have had the uncomfortable opportunity to witness sales calls by derivatives specialists on governmental utilities. I have seen the technique of fostering a sense of trust,

encouraging an advisory relationship that can be exploited to sell an immensely profitable derivative when other alternatives could be better. I have also seen the influence that can be brought to bear through politicians who have appointment power with regard to these utilities. Too often, derivatives can be structured to disguise debt from the public, a tempting alternative for officials who are concerned with public opinion.

As pointed out earlier, even the most sophisticated financial institutions struggle with evaluating the risks associated with derivatives. It is completely unreasonable to expect that governmental utilities will have the ability to measure the risks of derivative transactions. This is especially so given the massive incentives of swap dealers to ingratiate themselves as functional advisors and obfuscate the costs and risks and the complex influences on public servants. This means that registered swap dealers must be constrained in their dealings with governmental utilities. Their business conduct standards should be enhanced, not undercut. They are at a major disadvantage in negotiating with swap dealers and the public's interest is in rectifying this imbalance, not facilitating it.

It also means that firms that specialize in work with special entities, including governmental utilities, should register as swap dealers even though their business volumes are lower than the general registration thresholds. Special entities need the protection of swap dealer registration more than the typical market participants.

Interaffiliate Rules

H.R. 677, "The Interaffiliate Swaps Clarification Act" would create a broad and sweeping exemption to Title VII margin, capital, clearing, and execution requirements between affiliated entities, so long as neither entity is an insured depository bank. "Affiliated" is defined broadly, as any two entities that do financial reporting on a consolidated basis.

This bill is ignores the careful work performed by regulators in making expert judgments concerning the implementation Act. The supporting materials for this bill claim that inter-affiliate swaps do not create systemic risk, and also that the Dodd-Frank Act should exempt them but does not. Yet the CFTC, in a lengthy and carefully reasoned proposal on the regulation of interaffiliate swaps, outlined numerous ways in which interaffiliate swaps can in fact create systemic risk. In addition, the CFTC proposal creates a balanced approach which partially exempts interaffiliate swaps from some Title VII requirements while still retaining basic requirements for risk management, a limited use of margin to back swaps trades, and clearing in appropriate cases. Indeed, Americans for Financial Reform criticized the CFTC proposal for relaxing Title VII requirements excessively.

H.R. 667 would replace this framework with a sweeping and excessively broad exemption that would effectively leave interaffiliate swaps completely unregulated under Title VII, with the exception of some reporting requirements.

The bill includes a number of limiting clauses restricting the effect of these exemptions on prudential regulation and insurance regulation. Last year prudential regulators insisted that these clauses be added to the prior version. This is because the control and regulation of interaffiliate transfers of risk has been at the center of both banking and insurance regulation for over 50 years, since the passage of New Deal financial regulations and the passage of the Bank Holding Company Act. Of course, swaps are one of the most direct and effective ways to transfer risk. The centrality of the regulation of interaffiliate risk transfers to oversight of large financial institutions should tell us that it is deeply misguided to completely exempt interaffiliate transfers from the Title VII framework. Maintaining some of the basic requirements of Title VII for interaffiliate swaps while granting exemptions only in the areas where it is appropriate, as the CFTC has recommended, is the correct approach.

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Thank you for the opportunity to provide the foregoing testimony. I hope that it is useful for your deliberations.