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Chairman Huizenga, Ranking Member Maloney and distinguished Members of the Subcommittee, it is an honor to appear before you today at this important hearing on ways to improve the U.S. regulatory regime for over-the-counter ("OTC") derivatives.

By way of background, I am the current chairman of the National Association of Corporate Treasurers ("NACT"), an organization of treasury professionals from several hundred of the largest public and private companies in the country. I also represent the NACT on the steering committee of the Coalition for Derivatives End-Users (the "Coalition"), which is comprised of over 300 end-user companies and trade associations. The Coalition's member companies employ OTC derivatives to manage commercial and operational risks in their day-to-day business activities, principally through the dedicated efforts of their corporate treasurers. I am testifying today on behalf of the Coalition.

The end-user community is appreciative of this Subcommittee's historical and continued support in providing end-users with relief from some of the costliest regulations promulgated under financial reforms, including, specifically, Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1]. In spite of your efforts and those of agencies that have worked with the Coalition on sensible regulations, Main Street businesses remain burdened by a number of Dodd-Frank rules. For example, U.S. prudential regulators,[2] acting in accordance with their Dodd-Frank mandates, have continued to issue rules that have resulted in increased costs for end-users' risk mitigation activities. The cumulative effects of these burdens and costs have threatened the ability of American businesses to affordably protect against risks associated with their day-to-day commercial operations.

While the Commodity Futures Trading Commission ("CFTC"), the Securities and Exchange Commission, and the prudential regulators have implemented important reforms to better protect commercial end-users and the OTC derivatives markets generally, the implementation of many of these new, well-intended measures have adversely impacted American business investment,

[1] See Pub. L. 111-203, 124 Stat. 1376 (2010).

[2] Depending on the context, the term "U.S. prudential regulators" generally refers to the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Farm Credit Administration or the Federal Housing Finance Agency.

acquisitions, research and development and job creation. Hence, the Coalition is very pleased that this Subcommittee today is examining legislation to provide relief to end-users. And I would like to express the Coalition's support for a number of these bills.

As I will explain later in my testimony, the Coalition expressly supports the following four legislative proposals: (i) the proposal creating an end-user exemption from the credit valuation adjustment ("CVA"); (ii) the proposal ensuring end-user fairness in the Dodd-Frank "financial entity" definition; (iii) the proposal exempting internal risk management practices between affiliates from myriad Dodd-Frank swap requirements; and (iv) the proposal fixing the statutory centralized treasury unit ("CTU") relief.

First, however, allow me to provide context on how end-users use OTC derivatives and what role end-users play in OTC derivatives markets, and how targeted regulatory relief can help end-users continue to drive the economy and create good jobs here in the United States.

I. End-Users and Today's OTC Derivatives Markets

End-users are fundamentally different from most other participants in the OTC derivatives markets in that they only employ derivatives to reduce risks arising from their business operations. I think a simple example will help explain this point. Consider a U.S.-based agricultural chemicals manufacturer that sells products in Brazil. One of the company's customers in Brazil needs to purchase crop-protection chemicals at planting time, but can only pay six months in the future, at harvest time. During this six-month period, the Brazilian farmer faces both commodity price risk and currency risk. The U.S. chemicals manufacturer arranges a trade with the Brazilian farmer, whereby the farmer agrees to pay in bushels of soybeans at harvest time, six months forward, and the U.S. manufacturer agrees to provide the chemicals that the farmer needs to apply at planting time. Through that trade, the farmer has transferred the commodity price risk to the U.S. chemicals manufacturer, which can enter into a customized OTC commodity derivative, which locks in the U.S. dollar price six months in the future, thereby hedging its risk in the derivatives market.

By reducing the overall volatility of its business results, the OTC derivative executed by the U.S. chemicals manufacturer contributes to the stability and predictability of its business. Additionally, it supports U.S. exports, manufacturing, research and development, and ultimately employment of U.S. workers. However, that U.S. chemicals manufacturer cannot sustain this beneficial transaction without being able to offset the manufacturer's risks by trading with a bank counterparty, which provides liquidity. And the U.S. chemicals manufacturer also cannot provide that service in Brazil if the transaction pricing for its offsetting trade with the bank is too high.

OTC derivatives activity reduces business risk for thousands of end-user companies like the one in my Brazil example. From an end-user company's point of view, the OTC derivatives market should allow the efficient transmittal of risk from where it is incurred to where it can be matched and offset. Undue regulatory costs along the way, including those placed on its financial intermediaries, are ultimately borne by the end-user. This hedging activity does not create meaningful system risk and did not roil markets during the 2008 financial crisis. For perspective, end-users comprise less than 10 percent of the notional amount of the OTC derivatives market.

Now that I have provided some context regarding why end users employ OTC derivatives, I would like to turn to addressing how we believe certain OTC derivatives legislative proposals under consideration by the Subcommittee would likely address two underlying policy concerns affecting end-users. First, the Coalition expressly supports two proposals since they would likely help maintain the competitiveness of U.S. businesses when they do business overseas. Second, the Coalition expressly supports two other proposals since they would likely reduce the costs and burdens of existing Dodd-Frank regulations, which have had unintended, adverse consequences on end-users.

II. MAINTAINING THE COMPETITIVENESS OF U.S. BUSINESSES WHEN THEY DO BUSINESS OVERSEAS

Recognizing that the OTC derivatives markets are truly global, end-users should have a consistent, predictable and level regulatory playing field in which they do not suffer any relative disadvantages when compared to their foreign competition. Foreign regulators of many of our trading partners have granted exemptions to end-users that are not available under U.S. law, placing American end-users at an economic disadvantage compared to their foreign competitors. Moreover, financial end-users that use derivatives the same way as non-financial end-users(i.e., to manage business risks) should enjoy the same exemptions from clearing and margin requirements. The Coalition believes that the following two legislative proposals under consideration by the Subcommittee would directly address these policy issues:

- Proposal creating an end-user exemption from the CVA charge; and
- Proposal ensuring end-user fairness in the Dodd-Frank "financial entity" definition.

Proposal Creating an End-User Exemption from the Credit Valuation Adjustment

European policymakers have implemented capital charges on OTC derivatives positions significantly more favorable to their end-users than U.S. prudential regulators. The European approach recognizes that end-users' hedging activities are in fact reducing risks, and accordingly, exempts end-user derivatives transactions from the CVA capital charge.[3] In contrast, the CVA capital charge rules promulgated in the United States require U.S. banking institutions to calculate and hold capital to mitigate counterparty credit risk on all uncleared OTC derivatives transactions.[4] Since commercial end-users that transact OTC derivatives with U.S. banking institutions are not required to clear their transactions, all of those transactions are subject to the CVA charge. U.S. banking institutions pass along the costs associated with the CVA charge to their end-user counterparties in the form of higher transaction pricing. As a result, end-users pay more for their swaps executed with U.S. banking institutions.

[3] EU Capital Requirements Regulation, Article 382(4).

[4] The CVA capital charge requires a banking organization to retain additional capital to protect against potential mark-to-market losses in situations where their OTC derivatives counterparties' creditworthiness deteriorates. U.S. prudential regulators were given the statutory authority to promulgate CVA capital charge rules under the Basel III regulatory framework. Although the CVA is not discussed in Dodd-Frank, the underlying statutory authority of 12 U.S.C §§ 5371(b)(2) and 5365(b)(1) provides prudential regulators with the authority to promulgate risk-based standards, like the CVA under 12 C.F.R. §§ 217.132(e) and 324.132(e) (2016).

The lack of a CVA exemption in the United States significantly reduces the benefits of the statutory exemptions from clearing and margin requirements, which were granted by Congress under Dodd-Frank. An exemption would put U.S. businesses on equal footing with their non-U.S. counterparts. For those reasons, the Coalition supports a legislative proposal that explicitly requires U.S. prudential regulators to establish an exemption from the CVA capital charge for U.S. banking institutions' OTC derivative hedging transactions with commercial end-users.

Proposal Ensuring End-User Fairness in the Dodd-Frank "Financial Entity" Definition

The Coalition believes that all end-users employing derivatives to manage business risk should be treated equally. Under Dodd-Frank, Congress established status-based exceptions and exemptions from several requirements, including mandatory clearing, mandatory trading, and the requirements under the CFTC's and U.S. prudential regulators' final uncleared margin rules. That is, eligibility for an exemption or exception from a particular Dodd-Frank requirement turned primarily on an entity's status as a financial entity. Falling under Dodd-Frank's definition of "financial entity" means that an entity is automatically precluded from qualifying for or otherwise electing any of exceptions or exemptions. Essentially, Dodd-Frank treats entity status—financial versus non-financial—as a proxy for the potential riskiness an entity poses to the U.S. financial system irrespective of the types of activities in which the entity engages (i.e., speculative versus hedging activities). As a result, less risky end-users are captured within the broad "financial entity" definition (such as special-purpose vehicles and other similar structures) and must clear their OTC derivatives at clearinghouses, trade their OTC derivatives on regulated exchanges and exchange margin on their uncleared OTC derivatives transactions, notwithstanding the fact that those transactions were entered to hedge or mitigate legitimate commercial risks.

Consider a real estate company, which owns and manages factory buildings and supporting infrastructure, and leases them to manufacturers. To the extent the company is organized as a real estate fund, it is characterized under current rules as financial and cannot hedge its business exposures in the derivatives markets without being subject to the full range of regulations applied to financial counterparties. The unifying characteristic for the end-user exemption should be maintaining a book that matches a derivative with an underlying business exposure, not whether the end-user is engaged in certain activities which might be financial in nature.

Foreign policy makers and regulators in Europe, Canada and other jurisdictions have taken a different view.[5] These jurisdictions have determined that eligibility to claim exemptions and exceptions from OTC derivatives rules should be based on an entity's activity-levels within their markets. In most cases, these jurisdictions focus on the types and size of an entity's activities in determining the entity's riskiness to their financial markets and, in turn, the entity's eligibility to elect exemptions and exceptions from certain requirements. To that end, these jurisdictions have established *de minimis* tests to determine an entity's eligibility.

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[5] See European Market Infrastructure Regulation (EU) No. 648/2012 (Dec. 12, 2012). See also Canadian Securities Administrators, National Instrument 94-1010 (Jan. 19, 2017). See also Monetary Authority of Singapore, Securities and Futures (Clearing of Derivatives Contracts) Regulations 2015, ch. 289.

In order to level the playing field for American businesses, the Coalition fully supports legislative proposals that would narrow Dodd-Frank's broad definition of "financial entity" by including a *de minimis* threshold. This approach would be consistent with the approaches taken by foreign jurisdictions and would more appropriately measure an entity's riskiness based on actual OTC derivatives activity. This approach was also expressly supported by CFTC Chairman J. Christopher Giancarlo[6] and supported in principle by the U.S. Department of the Treasury in its Capital Markets Report.[7] Last year, Chairman Giancarlo testified before the House Agriculture Committee that the definition "is perhaps [one of a couple of] areas where the rules have been overly broad and overly restrictive."[8] Treasury's Capital Markets Report further expressed support for a legislative amendment to the Commodity Exchange Act ("CEA") clarifying the scope of the "financial entity" definition and allowing non-prudentially regulated entities that are financial in nature to become eligible for an exception to the clearing requirement that is appropriately conditioned on, among other things, the size and nature of swaps activities.[9]

III. Removing the Costs and Burdens of Well-Intended Regulatory Measures with Unintended, Adverse Consequences

After more than seven years of Dodd-Frank implementation, the comprehensive harmful impacts that the full suite of Dodd-Frank regulations have had on end-users' opportunities to manage, effectively and cost-efficiently, their exposures to volatile market risks and access the capital markets are well-known to corporate treasurers. The Coalition believes that two of the legislative proposals currently under consideration by the Subcommittee will mitigate harmful impacts. In particular, those two proposals would:

- Exempt internal risk management practices between affiliates from myriad Dodd-Frank swap requirements; and
- Fix the statutory centralized treasury unit relief.

Proposal Exempting Internal Risk Management Practices Between Affiliates from Myriad Dodd-Frank Swap Requirements

Currently, Dodd-Frank provisions added to the CEA and CFTC regulations that were promulgated under those provisions indiscriminately apply many requirements to inter-affiliate derivatives transactions as if those transactions were executed between unaffiliated, third-parties. While the CFTC has issued final rules and staff no-action letters to provide relief from various Dodd-Frank requirements in recognition of the fact that inter-affiliate derivatives transactions are not

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[6] See Congressional Testimony Transcript, CFTC Chairman J. Christopher Giancarlo before the Committee on Agriculture, House of Representatives, Examining the 2017 Agenda for the CFTC, 115th Congress, First Session, Oct. 11, 2017, Serial No. 115–12, ("Giancarlo's House Agriculture Testimony"), available at https://agriculture.house.gov/uploadedfiles/115-12_-_27184.pdf.

[7] See U.S. Dept. of the Treasury Report, A Financial System That Creates Economic Opportunities – Capital Markets, pp. 141-142, available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf ("Treasury's Capital Markets Report").

[8] See Giancarlo's House Agriculture Testimony at p.40.

[9] Id. at 142.

speculative and do not raise the systemic risk concerns that Dodd-Frank is intended to address, the CFTC's rules and staff no-action letters have created uncertainty and impose complex conditions on end-users' internal risk management practices.

Rather than having each affiliate separately execute swaps, it is a common for derivatives end-users to engage in the risk-reducing best practice of operating a single market-facing entity within a corporate group in order to centralize hedging expertise. The end-user company employing this practice gains the benefit of reducing the exposure it needs to hedge with a financial counterparty by netting out opposite-way trades within its corporate group. This model allows for risks to be managed across a corporate group, with the appropriate specialized expertise and operations, in the appropriate entity, jurisdiction, or time zone subject to overall direct corporate control and compliance supervision.

The Coalition believes that the legislative proposal under consideration today would more permanently clarify that these internal, risk-reducing transactions are not subject to regulatory burdens that were designed to be applied only to certain market-facing swaps. The proposal would ensure that commercial end-users can net inter-affiliate derivatives and thereby enter into fewer external swap transactions with third-party financial counterparties, allowing them to use these inter-affiliate transactions to manage their commercial risks without unnecessary and costly burdens being imposed on such transactions. Moreover, initial margin requirements for inter-affiliate trades of end-users' counterparties, and the related collateral segregation requirements for such entities, impose additional cost burdens that directly increase transaction prices for commercial end-users. Ensuring that inter-affiliate transactions for both end-users and their counterparties are exempt from economically inefficient regulation would help to reduce costs and would not contribute to the systemic risk that Dodd-Frank was intended to address.

Proposal Fixing the Statutory Centralized Treasury Unit Relief

CTUs are centralized corporate departments of Coalition companies that aggregate and manage the enterprise-wide treasury needs of a derivatives end-user. Rather than each subsidiary engaging in its own derivatives hedging transactions, CTUs serve as a singular unit to oversee the financial needs of the organization, creating costs savings and making for a more efficient and financially sound enterprise. In 2014, CFTC staff first provided relief to CTUs from the CFTC's mandatory clearing requirements through the issuance of a no-action letter.[10] A year later, Congress sought to provide identical relief to CTUs by enacting a statutory exemption for CTUs.[11] Congress' statutory exemption, however, included slightly different language, which created certain interpretive gaps. These gaps now threaten the cost-saving efficiencies and risk management practices that end-users have established through their corporate structures.

The Coalition supports the legislative proposal under consideration by the Subcommittee that would harmonize the language in Congress' statutory exemption with CFTC staff's relief in order to remove uncertainty for both end-users and market regulators. In our view, this proposal would

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[10] See CFTC No-Action Letter 14-144 (Nov. 26, 2014), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/14-144.pdf.

[11] 7 U.S.C. § 2(h)(7)(D).

address the clear, unintended consequences resulting from Congress' well-intended statutory exemption.

IV. CONCLUSION

The Coalition appreciates the Subcommittee's interest in considering measures to improve the U.S. OTC derivatives regulatory framework and stands ready to help move these important bills forward. The Coalition believes that legislative efforts to address the specific concerns with Dodd-Frank that I highlighted today will reduce burdens and costs placed on American Main Street businesses and will improve America's global competitiveness.

I will do my best to address any questions that you may have.