Testimony of
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On behalf of
Commodity Markets Council

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Chairman Conaway, Ranking Member Scott and Members of the Subcommittee: thank you for holding this hearing to review the reauthorization of the Commodity Futures Trading Commission ("CFTC"). My name is Lance Kotschwar, Senior Compliance Attorney for Gavilon Group, LLC. I am testifying today on behalf of the Commodity Markets Council ("CMC").

CMC is a trade association that brings together commodity exchanges and their industry counterparts. The activities of CMC members include the complete spectrum of commercial end users of all futures markets including energy and agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Kansas City Board of Trade, Minneapolis Grain Exchange and the New York Mercantile Exchange. CMC is well-positioned to provide the consensus views of commercial end users of derivatives. My comments represent the collective view of the CMC membership.

All CMC member firms depend upon the efficient and competitive functioning of the risk management products traded on U.S. futures exchanges. CMC and its members support well-regulated markets, and while the financial crisis of 2008 had nothing to do with commodity markets, we recognize the need for the Dodd-Frank Act and support its goals. In turn, that regulation should be efficient and reasonable rather than overly prescriptive and complex.

Regulatory initiatives that lack clarity or evolve to be at cross-purposes with the core principles on which the Commission was founded are concerning to CMC members. Such regulatory disparities generate market inefficiencies and costs, which widen price margins between producers and consumers of energy and agricultural commodities, as well as those finished food, energy, and consumer products that derive from the underlying commodities.

Most agricultural commodities are produced seasonally yet consumed continuously, whereas energy commodities are produced continuously and consumed seasonally. We manage that flow of physical commodity and dynamically hedge it, allowing us to offer higher prices to producers and lower prices to consumers. As Congress seeks to once again reauthorize the

CFTC, we would like to emphasize several points starting with this: undue regulatory interference with the hedging mechanism introduces risk that must be priced into the chain, negatively affecting both ends and everything in between.

At this critical juncture in Dodd-Frank rule writing and implementation, CMC members are concerned that the CFTC's efforts to implement new swap regulatory rules has now morphed into a crusade of rewriting many long-standing futures market regulations that Congress, via Dodd-Frank, never contemplated. Even more problematic is that this regulatory barrage is occurring almost entirely without consideration of real costs on commodity producers or consumers. The additional regulatory costs that the CFTC is forcing upon end-users and commercial participants will ultimately be passed on to the consumers of commodity products and will also reduce market liquidity, further raising the costs of risk management, and ultimately the cost of finished agricultural and energy goods.

Issues of Concern

Generally our ideas for legislative changes fall into two main categories: improvements to the protection of customer collateral in derivatives markets and concerns related to the implementation of various provisions of the Dodd-Frank Act with respect to the impacts on commercial end-users.

Protection of Customer Collateral

Given recent events surrounding the collapse of two Futures Commission Merchants ("FCMs") and the mismanagement and disappearance of customer collateral, we request that the Committee consider the various market driven proposals to further protect these assets, as they are vital to our member companies and all other market participants seeking to manage risk in the derivatives markets. Ideas of alternative collateral segregation regimes and insurance programs have been floated, and we encourage both this Committee and other relevant Congressional committees to fully examine and vet these proposals to allow for further protection of customer collateral.

CFTC Customer Protection Proposal

CMC commends the efforts of the National Futures Association ("NFA") and the CFTC to improve certain aspects of how customer collateral is treated, although there is one particular issue raised by the CFTC in a recent proposed rule that has generated serious concern among our members. Specifically, CMC strongly believes that the proposed requirement that FCMs maintain a residual amount sufficient to cover on a constant basis the aggregate of customer margin deficits could create considerable liquidity issues and increase costs for FCMs, producers, and end-users. Such a decrease in liquidity could be substantial and limit the number and type of transactions FCMs clear, the number of customers they service, and the amount of financing they provide. The proposal would require FCMs to fund accounts holding their customers' collateral with proprietary assets in excess of the aggregated margin deficiencies of all its clients on a continuous basis. The proposal also appears to require executing FCMs to collect collateral for give-ups so that customer positions are fully margined in the event a clearing FCM rejects a trade. If the proposed residual interest provision were to be finalized, FCMs may be forced to take steps such as over-margining clients, requiring clients to pre-fund their margin accounts, imposing punitive interest rate charges on margin deficit balances, and introducing intra-day margin calls. Such steps would dramatically increase the cost of using futures markets and may force many end-users to decrease or discontinue hedging and risk management practices, which is the reason these markets were created.

Market participants are active in developing methods of early detection of any improper transfer of customer funds due to errors or theft. For example the Chicago Mercantile Exchange ("CME") and the NFA have implemented various protective measures, including: 1) requirements regarding an FCM's residual financial interest in customer accounts, 2) restrictions on an FCM's disbursements from customer accounts, and 3) procedures that will facilitate monitoring of customer funds.

In order to detect an improper reporting of asset balances, CME and NFA have implemented a number of measures, most of which relate to confirmation of balances and review of bank statements and certain FCM information. Both designated self-regulatory organizations are using an aggregator to get bank balances reported to them electronically on a daily basis.

CME and NFA also perform limited reviews of the customer investments reported on the Segregated Investment Detail Reports to ensure compliance with the requirements of CFTC rules. CME performs detailed audit work on risk-based examinations, including a review of qualified depositories, third-party statements, reconciliations, mark-to-market schedules, valuation (readily marketable and highly liquid), obtaining confirmations, etc. Additionally, in April 2012, CME started performing limited reviews of customer segregated, secured, and sequestered statements on a surprise basis outside of the regular risk-based examination.

End-User Concerns

The CFTC has been working diligently since the passage of Dodd-Frank in July of 2010 and should be commended for the progress they have made thus far. CMC recognized and supported the need for reform in the over-the-counter (OTC) swaps market and believes that Dodd-Frank provided a foundation for an effective overhaul of this important risk-management market. However, there are various issues that have arisen as part of the implementation process which we believe the Committee should revisit going forward.

Part 1.35 Recordkeeping Requirements

A significant and concerning expansion of current data requirements beyond the scope of Dodd-Frank is related to recordkeeping requirements in Part 1 of Commission regulations. In accordance with Dodd-Frank, the CFTC expanded the futures recordkeeping requirements that existed for certain markets participants to swaps. However, they also significantly expanded the written requirements, as well as created a new requirement to record oral conversations.

Compliance costs have already been incredibly substantial now that compliance with the written requirements is mandatory and will only increase once compliance with the oral recording requirement comes into effect later this year. Again, the market is searching for a reason for and measurable benefit of all of this new information that must be maintained and archived in a particular way.

In addition, the rule is vague as to which communications must be retained, so in an abundance of caution, market participants are effectively saving every email, news article, or any other piece of information that might "lead to the execution of a transaction" and soon will have to begin recording every phone call that might "lead to the execution of a transaction." This vague "lead to... " language appears nowhere in any prior iteration of Rule 1.35 or in any prior CFTC Advisory relating to the rule, and operates to expand substantially the scope and burdens of the rule. Also, the application of the requirements to members of an exchange seems to have no regulatory rationale and only serves as a disincentive to be an exchange member.

Finally, the cost figures contained in the cost-benefit analysis in the final rule are not justified. Compliance costs are exponentially higher than they estimate, and in some cases the technology is not even available to market participants. Requests for clarification have not yet been answered, and CMC will be submitting a written request soon in a continued effort to clarify and hopefully narrow the scope of what must be retained and, therefore, reduce what we view as unnecessary compliance costs.

Scope of Swap Dealer Definition

The Commission's final rule defining who must register as a swap dealer, a regulatory category that carries an immense regulatory burden and was designed for large financial institutions, is altering trading activity between commercial market participants and pushing more swap activity into the large dealer banks. This is directly counter to the goal of Dodd-Frank to increase competition and reduce the concentration of risk in a few large financial firms. We do not believe that Congress intended to capture commercial end-users as swap dealers for swap activity that is ancillary to their physical commodity business, but that is exactly what the final CFTC rule accomplishes.

Many commercial market participants are curtailing trading activities with other end-users for fear of being captured by a complicated, capital-based regulatory regime designed for large financial institutions with which most end-users are incapable of complying. We do not believe this was the intent of Congress, and in fact seems to be the complete opposite outcome by further consolidating trading activity in a few large financial institutions. We urge the Committee to revisit this very important issue.

Current regulations have arbitrarily established a de minimis level, the breach of which requires registration as a swap dealer, at $8 billion with a drop to $3 billion following an unpredictable CFTC decision making process. The only certainty in the process is that a lack of action will result in the de minimis level declining in five years. This $3 billion level is also arbitrary and would significantly affect the number of firms defined and regulated as swap dealers. Changes should not be made through such a long and ill-defined process, which includes several unpredictable and difficult to follow steps for market participants. We need a more predictable process.

Reporting and Recordkeeping under Part 46

Part 46 of the Commission's regulations requires market participants to report swap trades entered into from July 21, 2010, when the Congress passed Dodd-Frank, until April 10, 2013. Included in the transactions subject to this requirement are energy swaps as well as cleared Exchange of Futures for Related Positions ("EFRP") trades, which were centrally cleared by the CME Group and Intercontinental Exchange. In these transactions, the original trade only occurs if it is accepted for clearing, and once it is, the original trade is terminated and replaced with two new trades with each of the original executing counterparties facing the clearinghouse. The original trade creates zero risk, and the reporting of the trade serves no regulatory purpose that we can discern. The reporting requirement does, however, create a significant compliance burden on end-users. Given that the data is available to regulators from the clearinghouses and the clearinghouses have reported the trades on the market's behalf, the CFTC should grant the multiple requests from market participants to waive the historical reporting requirement for end-users.

Real-Time Reporting

Under the real-time reporting rule, end-users have a longer time in which to report trades with other end-users. However, trades that involve a swap dealer or major swap participant must be reported in a much shorter time after execution. Because the rule requires trades between a non- dealer and a swap dealer be reported within the dealer's time limit, swap dealers and major swap participants have limited time to lay off risk before the trade is made public. While the delay may be sufficient for liquid markets, they are not sufficient for illiquid markets and time frames. When a dealer has to report such illiquid trades to the market quickly and the dealer may not be able to lay off the risk of that trade in the prescribed time, the dealer is taking a risk and will charge the counterparty (here, the commercial end-user) for that increased risk if they are willing to execute the trade at all. This increased cost and possible inability to trade in illiquid markets will hurt commercial end-users' ability to efficiently hedge.

Inter-Affiliate Transactions

Inter-affiliate trades are subject to recordkeeping requirements under Part 45, requiring that the records of inter-affiliate swaps are "full, complete, and systematic." We view this requirement as burdensome and providing very little benefit relative to the increased cost to our members. The information that the Commission is seeking is available through the visibility of market-facing swaps, as they are largely identical. Additionally, these inter-affiliate and market-facing trades are for the purpose of hedging or mitigating commercial risk and are documented pursuant to inter-affiliate agreements such that both parties must make payments and deliveries specified, although the transactions may be settled by an intercompany transfer or allocation. The internal documentation is done as necessary for internal purposes, but may not contain all information required or in the format required under Part 45.

With respect to mandatory clearing and the end-user exception, we appreciate the Commission's recent relief providing an exemption for swaps between commonly owned affiliates. The Commission still needs to clarify that swaps entered into by a centralized hedge function of a commercial entity are eligible for the end-user clearing exception when hedging on behalf of the commercial company, whether or not the entity housing the hedge function for the company is by definition a financial entity.

Position Limits Aggregation and Reporting of Daily Physical Positions

The CFTC's rule imposing position limits for swaps and futures was vacated in September 2012 [shortly before compliance became mandatory]. The part of the rule that addressed aggregation of entities for purposes of position limits was re-proposed but not finalized before the rule was vacated. That re-proposal required aggregation of entities in which one has ownership of the other of 50% or greater, and provided an exception from aggregation at 10% or lower ownership level. Between 10%-50%, there is a multi-factor test to determine if aggregation of required, with a presumption of control.

Although the rule has been vacated, the CFTC has both appealed the court's ruling and is drafting a new proposal. We urge the CFTC to adopt a rule that requires aggregation based on control, rather than percent ownership and not to include any presumption of control. Aggregation is appropriate only when one entity controls the trading activity of another entity or has unfettered access to trading information of such other entity that could be used to facilitate its own trading. Absent such control and access to information, aggregation should not be required, regardless of the percent ownership or equity interest in the owned entity. For example, in the context of a limited partnership, a limited partner may own a majority of the partnership and be entitled to the majority of its profits, although day-to-day control of the partnership actually vests with the general partner. Further, it is particularly true in connection with joint ventures that majority ownership does not necessarily equate to the majority owner's control of the owned entity's trading activity.

The automatic application of the aggregation requirement to persons holding in excess of 50% ownership or equity interest would force market participants to share information and coordinate trading, which is exactly what the CFTC seeks to prevent. Such sharing of information may also raise antitrust concerns, notwithstanding the Commission's clarification that an information sharing exemption will be granted provided such initial sharing of information does not give rise to a "reasonable risk" of violating federal laws. Under the final position limits rule, affiliated entities will be required to assign position limits among several accounts that are presently traded independently of, and in competition with, each other. CMC is concerned that continuous correspondence and negotiations between affiliated entities will expose them to charges of collusive and anticompetitive behavior. Given the nature of trading, it is highly impractical to ask the opinion of counsel as to whether information sharing at any point during intra-day trading gives rise to a "reasonable risk" of federal antitrust laws being violated. As such, in practice, affiliated entities will be unable to avail themselves of the protection seemingly afforded by the information sharing exemption currently constructed in Part 151.7(i).

The vacated position limits rule also required the reporting of daily physical positions to justify hedge exemptions, which under the rule were only available to commercial market participants, rather than the historical requirement of monthly physical position reporting. The change would be virtually impossible for a global commodities firm to comply with. The industry viewed the change as unnecessary and overly burdensome, given that the Commission has always had the ability to ask for data to justify a hedge exemption. We do not believe it is an efficient or productive use of resources to devote the time that would be required to review all of the new data and, if those resources are not devoted to review all of the data, it is inefficient to constantly collect given that the CFTC may at any time ask for the data. We believe the CFTC should retain the historical requirement to report monthly positions in any new position limits proposal.

Bona Fide Hedging

Congress provided a definition of a bona fide hedge within Dodd-Frank that the CFTC has unnecessarily narrowed, including related to anticipatory hedging, and has created at least five different definitions in various rules of what constitutes a bona fide hedge. This is nonsensical and creates unnecessary confusion, while disrupting legitimate risk mitigation practices. We are committed to working with Congress to set clearer direction on bona fide hedges so that transactions that limit economic risks are viewed as bona fide hedges by the CFTC.

SUMMARY

Commodity derivatives markets continue to grow and prosper. They have become deeper and more liquid, narrowing bid/ask spreads, and improving hedging effectiveness and price discovery. All of these developments serve the interests of the trade as well as the public. The regulation of swaps has also motivated a general industry move toward the futures market, which has been termed "futurization." While we will continue to transact swaps especially for more tailored transactions, we support the transition to futures.

The swap reforms in Dodd-Frank were not necessary because of problems in physical commodity markets. Commercial end-users of agricultural and energy futures had no role in creating the financial crisis. In fact, the regulated futures market fared well throughout the financial crisis and futures markets generally provide greater regulatory certainty for our members than evolving swaps regulations.

We believe that as Congress considers how the CFTC is to regulate in the future, it should use the core principles on which the CFTC was created as its guide. A balance must be maintained between regulatory zeal and consideration as to how regulatory changes could result in negative consequences to not just CMC members in the middle of the food and energy chain, but also to the producers and consumers on each side of the chain. Given this, we strongly believe that the CFTC's current trend toward very prescriptive changes to futures market regulation will hinder rather than improve our economy's ability to manage commodity market risks.

While the independent regulatory agency that this Committee has oversight responsibilities over must continue to evolve in order to adequately regulate increasingly complex derivatives markets, many of these pending changes also introduce the potential for regulators to create risk and increase costs by going beyond their purview. Doing so without consideration of the consequences is dangerous and violates both the "do no harm" principle of being a regulator as well as the CFTC's core principles regulatory methodology.

At present, this barrage of new CFTC rules is causing compliance costs to skyrocket. In addition, significant regulatory uncertainty continues to exist, and despite the approximately 100 various letters issued by the Commission to clarify rule language or extend compliance dates, many compliance questions remain.

The objective of the Commodity Exchange Act has never been to discourage hedging, but rather to create a market and regulatory environment that maintains market integrity while promoting the economic benefits of risk management. Purposely adding complexity and regulatory uncertainty to the marketplace only adds unnecessary costs. Uncertainty, via additional regulation of the risk management tools that commodity market participants utilize, actually creates risk where it didn't previously exist.

Thank you for this opportunity to testify. We look forward to continuing to work with this Committee to strike the right balance.

I look forward to your questions.