IMPLEMENTING DODD-FRANK: A REVIEW OF THE CFTC'S RULEMAKING PROCESS

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

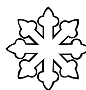
COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

APRIL 13, 2011

Serial No. 112–10



Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

66–248 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
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IMPLEMENTING DODD-FRANK: A REVIEW OF THE CFTC'S RULEMAKING PROCESS

WEDNESDAY, APRIL 13, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 1300, Longworth House Office Building, Hon. K. Michael Conaway [Chairman of the Subcommittee] presiding.

Members present: Representatives Conaway, Neugebauer, Schmidt, Crawford, Gibson, Hultgren, Schilling, Boswell, McIntyre, Kissell, McGovern, David Scott of Georgia, and Courtney.

Staff present: Tamara Hinton, John Konya, Kevin Kramp, Josh Mathis, Ryan McKee, Matt Schertz, Debbie Smith, Liz Friedlander, Clark Ogilvie, and Jamie Mitchell.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

The CHAIRMAN. Let's call the hearing to order. The hearing of the Subcommittee on General Farm Commodities and Risk Management entitled, *Implementing Dodd-Frank: A Review of the CFTC's Rulemaking Process,* will now come to order.

Mr. Berkovitz, thank you for being here this morning.

Today, we continue our series of hearings to review the CFTC's implementation of the derivatives provisions of the Dodd-Frank Act.

The CFTC is currently engaged in what is easily said to be a pretty colossal effort to write dozens and dozens of new regulations for a market that is critically important to our economy. This effort is unmatched in its scope and implication for a domestic and global financial system. Yet, by all accounts, it seems the CFTC has placed speed over deliberation. Rules have been proposed in a sequence that has created confusion and made it difficult for the public to orchestrate their input. There has been a lack of consideration regarding costs and benefits of the Commission's proposed regulations.

The CFTC has proposed rules that we believe exceed Congressional intent and demonstrate a lack of regulatory focus among a shortage of resources. It has made clear to me that the statutory deadlines for Title VII simply do not give regulators enough time to do this right. The old adage, there is never enough time to do

it right, but there is always time to do it over seems to come to mind.

It should be noted that the derivatives provisions contained within Dodd-Frank will impact thousands of end-users across the country that engage in hedging responsibly and who had no role in the financial crisis that Dodd-Frank seems to proffer to fix. Rushing to regulate will have a harmful and punitive impact on non-financial businesses if we don't get this correct.

Moreover, the short timeframes have been exacerbated by the sequence of rule proposals and have had a negative impact on the ability of stakeholders to actually understand the impact of the regulations on their businesses, and to know whether or not they should comment or not.

The cost-benefit analysis performed at the CFTC appears to be the bare minimum needed to comply with the CEA. To date, projections of costs have been vague and inaccurate; and in one instance, when the CFTC has tried to quantify them, they were 4,000 times lower than the estimates performed by the stakeholders themselves. Yet when I joined with Chairman Lucas to ask Chairman Gensler to voluntarily adhere to the President's Executive Order that demanded a higher standard of regulatory review, I was told that the requirements of CEA were specific enough to preclude the CEA from adherence to the Executive Order.

In addition, we have heard concerns from many stakeholders that several of the proposed rules exceed what is required by Dodd-Frank or intended by Congress. For example, both the proposed rules relating to ownership and governance of DCOs, DCMs, and SEFs and on position limits directed the CFTC to issue rules only after that review determined that they were appropriate. Yet the CFTC has dedicated significant resources to proposing these rules without such finding.

In another example, the CFTC's proposed business conduct standard rules, that rule, according to the Department of Labor regulations, makes swap dealers fiduciaries to pension plans, despite Congress' specific omission of such a standard in Dodd-Frank.

Last, there are several areas in which the CFTC proposals are inconsistent with those of other regulatory agencies. Rules governing swap execution facilities, real-time reporting and, just yesterday, larger requirements for swap entities have all shown inconsistencies that will only make it more difficult and confusing to comply.

I look forward to exploring these topics in more detail with our witnesses today.

[The prepared statement of Mr. Conaway follows:]

Prepared Statement of Hon. K. Michael Conaway, a Representative in Congress from Texas

Today, we continue our series of hearings to review the CFTC's implementation of the derivatives provisions in Dodd-Frank.

The CFTC is currently engaged in a colossal effort to write dozens of new regulations for a market that is critically important to the economy. This effort is unmatched in its scope and implication for the domestic and global financial system.

Yet, by all accounts, it seems the CFTC has placed speed over deliberation. Rules have been proposed in a sequence that has created confusion and made it difficult for the public to provide input. There has been a lack of consideration regarding the costs and benefits of the Commission's proposed regulations. The CFTC has pro-

posed rules that exceed Congressional intent and demonstrate a lack of regulatory focus amid a shortage of resources. Further, there are inconsistencies among regulatory agency proposals, despite Congressional directives to coordinate.

It has been made clear to me that the statutory deadlines for Title VII simply do not give regulators enough time to get this right. It should be noted that the derivatives provisions contained within Dodd-Frank will impact thousands of end-users across the country that engage in hedging responsibly and had no role in the financial crisis. Rushing to regulate will have a harmful and punitive impact on non-financial businesses that were not a part of the problem.

Moreover, these short timeframe have been exacerbated by the sequence of the rule proposals that have had a negative impact on the ability for stakeholders to comment or to understand the impact it will have on their businesses and customers.

The cost-benefit analysis performed by the CFTC has been the bare minimum simply to tout compliance with the CEA. To date, projections of costs have been vague and inaccurate; in one instance when the CFTC has tried to quantify them, they were 4,000 times lower than estimates performed by stakeholders. Yet, when I joined with Chairman Lucas to ask Chairman Gensler to voluntarily adhere to the President's Executive Order that demanded a higher standard of regulatory review, I was told that the requirements of the CEA were specific enough to preclude the CFTC from adherence to the Executive Order.

In addition, we have heard many concerns from stakeholders that several of the proposed rules exceed what is required by Dodd-Frank or intended by Congress. For example, both the proposed rules relating to ownership and governance of DCO's, DCM's and SEF's, and on position limits, directed the CFTC to issue rules only after review by the Commission determined that they were appropriate. Yet, the CFTC has dedicated significant resources to proposing these rules without any such finding. In another example, the CFTC has proposed business conduct standard rules that would, according to Department of Labor regulations, make swap dealers fiduciaries to pension plans, despite Congress' specific omission of such a standard in Dodd-Frank.

Last, there are several areas in which the CFTC's proposals are inconsistent with those of the other regulatory agencies. Rules governing Swap Execution Facilities, real-time reporting, and—just yesterday—margin requirements for swap entities, have all shown inconsistencies that will only make it more difficult and confusing for businesses to comply.

I look forward to exploring these topics in more detail and to hearing from our witnesses today.

The CHAIRMAN. I now turn to our Ranking Member for his statement, if any.

OPENING STATEMENT OF HON. LEONARD L. BOSWELL, A REPRESENTATIVE IN CONGRESS FROM IOWA

Mr. BOSWELL. Thank you, Mr. Chairman; and I want to thank you and our witnesses for coming today to review the CFTC's rulemaking process for implementation of the Wall Street Reform and Consumer Protection Act.

The law and regulation we are reviewing today, and in the future, are critical to Americans in all of our districts. More than 38 million U.S. citizens, whether they are farmers, manufacturers, accountants, or municipal workers, are employed with a business that uses derivatives to hedge risk and protect against market volatility.

The reason this legislation, it would appear, was crafted today is to protect the pensions of hardworking Americans from vulnerability and ensure our market is protected against epic job loss like the eight million they lost in 1 year due to the financial crisis on Wall Street. It is not to penalize the end-users who, like consumers, were victims in the financial crisis. Our efforts instead should focus on preventing the markets from enriching a few play-

ers and making sure that never again are American taxpayers left with the bill.

To ensure greater transparency in the markets, we must provide an open process; and I want to thank the Chairman and my colleagues for working together with the CFTC, SEC, and market participants to provide a clear picture of our progress and shed light on areas that need more work.

As you know, Members of Congress face important and difficult decisions regarding our nation's budget. However, we also have a responsibility to assess our nation's needs and priorities.

I am particularly interested in the state of the infrastructure and technology in place for the implementation of the Wall Street Reform and Consumer Protection Act. Are the personnel and the tools available to implement this Act?

I look forward to comments from the witnesses. I believe our partnership is crucial for the future of market regulations. I am committed to working with you to ensure this market is regulated with efficiency and transparency without hindering its practical uses. Your thoughts and comments are greatly appreciated.

And thank you, Mr. Chairman, for having this hearing.

The CHAIRMAN. Mr. Boswell, thank you.

Members are reminded or asked to submit their opening statements for the record so that our witnesses may begin their testimony to assure that there is ample time for questions.

So, with that, we welcome the first panel. I guess a single person can testify as a panel, Mr. Berkovitz. But at any rate, nonetheless, our first panel is Dan Berkovitz, General Counsel, Commodity Futures Trading Commission.

We look forward to hearing your comments. Thank you for being here.

STATEMENT OF DAN M. BERKOVITZ, GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. BERKOVITZ. Good morning, Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee. Thank you for inviting me to today's hearing.

My name is Dan Berkovitz, and I serve as the General Counsel of the Commodity Futures Trading Commission. I am pleased to testify before you today regarding the CFTC's Dodd-Frank rulemaking process.

The CFTC is working deliberatively and efficiently to issue the rules needed to implement the Dodd-Frank Act. This process is guided by two basic principles: First, the CFTC seeks to ensure that its rules implement the substantive requirements of the statute and follow the intent of Congress. Second, the CFTC is relying extensively on consultation with other regulators, both domestic and international, and public participation.

Rulemakings are conducted in compliance with the Administrative Procedure Act and other applicable laws. The CFTC is committed to an open and transparent rulemaking process. The staff has solicited written comments on rulemakings prior to the proposal stage. The agency has received thousands of written comments on proposed rules, issued several advance notice of public

rulemakings, held public roundtables, met with hundreds of market participants and members of the public, and established comment mailboxes and files on the CFTC website.

The Commission has held 13 public meetings to issue proposed rules. The CFTC has engaged in extensive consultation and cooperation with other Federal financial regulators, both foreign and domestic, to harmonize regulations.

Domestically, the CFTC has worked closely with the SEC, the Federal Reserve, and other prudential regulators. The CFTC is consulting and coordinating with international regulators to harmonize the approach to swaps oversight globally. Discussions have focused on clearing and trading requirements, clearinghouses generally, and swaps data reporting issues, among many other topics.

The CFTC has now issued proposals in most of the rulemaking areas. As the Commission receives comments from the public, it is looking at the entire mosaic of rules and how they interrelate. The Commission will begin considering final rules only after the staff can analyze, summarize, and consider comments; the Commissioners are able to review the comments and provide guidance to the staff; and the Commission consults with fellow regulators.

The CFTC has certain flexibility to tailor the timing of the implementation of the rules to the ability of entities subject to the new Dodd-Frank regulations to develop the systems, processes, and capabilities necessary to comply with the new requirements.

The Commission has been seeking comments from market participants and interested members of the public on the phase-in of the regulatory requirements that will be established in the final rules. Yesterday, the CFTC and the SEC announced a joint 2 day staff roundtable discussion with market participants and interested members of the public on how to phase in implementation of the Dodd-Frank requirements. The staffs are seeking comments on: whether to phase in implementation dates, based on a number of factors related to the ability to transition into compliance with the new requirements including: the type of swap, the type of market participant, the speed with which entities can meet the new requirements, and whether market infrastructures such as exchanges or clearinghouses or swap execution facilities or participants might be required to have policies and procedures in place ahead of compliance with such policies and procedures by persons entering into transactions on such facilities or with such participants.

In summary, the Commission has established a transparent rulemaking process to implement Dodd-Frank. The Commission encourages public comments on the rules and their implementation and will continue to consult and coordinate with other Federal regulators and our international counterparts prior to issuing final rules.

Thank you, and I would be happy to answer any questions.

[The prepared statement of Mr. Berkovitz follows:]

PREPARED STATEMENT OF DAN M. BERKOVITZ, GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee. I am Dan Berkovitz, and I am privileged to serve as the General Counsel at the Commodity Futures Trading Commission ("CFTC" or "Commission"). I thank you for inviting me to today's hearing on the CFTC's rulemaking process

to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Act. The Act amended the Commodity Exchange Act ("CEA") to establish a comprehensive new regulatory framework for swaps and made similar amendments to securities laws for security-based swaps. Title VII of the Dodd-Frank Act was enacted to reduce risk, increase transparency and promote market integrity within the financial system. To accomplish these goals, the Act:

1. Provides for the registration and comprehensive regulation of swap dealers and major swap participants;
2. Imposes clearing and trade execution requirements on standardized derivatives products;
3. Creates robust record-keeping and real-time reporting regimes; and
4. Enhances the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

The Dodd-Frank Act brings to the swaps markets the same basic regulatory goals of transparency and risk reduction that have governed the regulation of the futures and securities markets since the 1930s. The measures provided in the Act to lower risk and improve transparency are intended to improve the ability of American businesses to use these markets and derivatives to reduce their risks and costs.

Rulemakings

The Dodd-Frank Act generally requires the CFTC to issue rules that are required to implement the provisions of the Act within 360 days from the date of enactment. Under Dodd-Frank, the effective date of any such rule shall be at least 60 days after publication of the final rule implementing such provision.

The CFTC is working deliberatively and efficiently to issue these rules. The rulemaking process is guided by two basic principles. First, the CFTC is working to ensure that its rules implement the substantive requirements of the statute and follow the intent of Congress. Second, the CFTC is relying extensively on consultation with other regulators, both domestic and international, and the participation of market participants and other interested members of the public. The Commission's rulemakings are conducted in compliance with the Administrative Procedure Act and other applicable laws.

Rulemaking Teams

As the Congress was finalizing the Dodd-Frank Act, the CFTC formed 30 rulemaking teams to begin to implement the Act's rulemaking requirements. Each team consists of a team leader from one of the CFTC divisions, as well as staff from the other CFTC divisions. Chairman Gensler held the first meeting with the 30 team leads the day before the President signed the Act into law.

A number of months ago the CFTC created a 31st rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Dodd-Frank Act. The CFTC has thus far proposed rulemakings or interpretive orders in 28 of the 31 areas.

Public Participation

The CFTC is committed to a transparent and open rulemaking process. The Commission has encouraged public participation throughout this process. The CFTC's rulemakings to implement the Dodd-Frank Act have included the following opportunities for public participation:

Public participation during rulemakings. Immediately after the Dodd-Frank Act was passed, the CFTC solicited comments from the public regarding the rules required to be proposed under the Act. These pre-proposal initiatives included staff roundtables, meetings with market participants, several advance notices of proposed rulemakings, and the establishment of public comment mailboxes and files on the CFTC website. As of this past Monday, we had received 2,907 submissions from the public through these e-mail inboxes. The Commission also encourages the public to submit comments once rules are proposed, and provides a number of ways for comments to be submitted. As of Monday, we had received 8,991 comments in response to notices of proposed rulemaking.

Transparency of all public comments and meetings. The CFTC posts all written comments received and summaries of all meetings with the public on Dodd-Frank Act rulemakings on the Commission's website, at *cftc.gov*. These summaries

of meetings identify the participants and the issues discussed. Any written materials provided to the agency for these meetings are posted on the CFTC website. As of this past Monday, we have had 675 such meetings.

Open meetings. The Commission has utilized thirteen public meetings to issue proposed rules under the Dodd-Frank Act. The meetings are broadcast live via webcast and a call-in telephone number is available for the public to connect to a live audio feed. Archived webcasts are available on our website as well.

Consultation and Coordination

The CFTC has engaged in extensive consultation and cooperation with other Federal financial regulators, both foreign and domestic, to seek input on the rulemakings and to harmonize the regulations of the swaps markets to the fullest extent practical.

Domestically, the CFTC has worked closely with the Securities and Exchange Commission ("SEC"), the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Controller of the Currency and other prudential regulators. The consultation and collaboration with these agencies includes sharing many of the staff memos, term sheets and draft documents. The CFTC also is working closely with the Treasury Department and the new Office of Financial Research. As of last Friday, CFTC staff has had 598 meetings with other U.S. regulators on implementation of the Act.

In addition to working with the agency's domestic counterparts, the CFTC has reached out to, and is consulting and coordinating with, international regulators to harmonize the approach to swaps oversight globally. As with domestic regulators, the CFTC is sharing memos, term sheets and draft documents with international regulators as well. Discussions have focused on clearing and trading requirements, clearinghouses generally and swaps data reporting issues, among many other topics.

Specifically, the CFTC has been consulting directly and sharing documentation with the European Commission ("E.C."), the European Central Bank, the United Kingdom Financial Services Authority and the new European Securities and Markets Authority. Three weeks ago, Chairman Gensler traveled to Brussels to meet with the European Parliament's Economic and Monetary Affairs Committee and discussed the most important features of swaps oversight reform.

The CFTC also has shared documents with the Japanese Financial Services Authority and consulted with Members of the European Parliament and regulators in Canada, France, Germany and Switzerland. Through its consultation with these foreign regulators, the CFTC has sought to bring consistency to regulation of the swaps markets.

In September of last year, the E.C. released its swaps proposal. Similar to the Dodd-Frank Act, the E.C.'s proposal covers the entire derivatives marketplace—both bilateral and cleared—and the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. The proposal includes requirements for central clearing of swaps, robust oversight of central counterparties and reporting of swaps. The E.C. also is considering revisions to its existing Markets in Financial Instruments Directive ("MiFID"), which includes a trade execution requirement, the creation of a report with aggregate data on the markets similar to the CFTC's Commitments of Traders reports and accountability levels or position limits on various commodity markets.

The CFTC has now issued proposals in most of the rulemaking areas. As the Commission receives comments from the public, it is looking at the entire mosaic of rules and how they interrelate. The Commission will begin considering final rules only after staff can analyze, summarize and consider comments, the Commissioners are able to review the comments and provide guidance to staff, and the Commission consults with fellow regulators on the rules. The Commission has stated that it hopes to move forward in the spring, summer and fall with final rules.

Administrative Procedure Act

The Commission's rulemakings to implement the Dodd-Frank Act are conducted in accordance with the procedural requirements for informal rulemakings under the Administrative Procedure Act ("APA") and other applicable laws. The Commission has provided opportunities for public comment in addition to those specified in the APA, such as providing an opportunity for public comment prior to the issuance of a notice of proposed rulemaking as discussed above.

For most of the proposed rulemakings, the Commission has solicited public comments for a period of 60 days. On some occasions, the public comment period lasted 30 days. The Commission also has discretion to accept late comments. The CFTC website informs persons interested in submitting comments:

"The Commission invites comments on proposed rules. To be assured consideration by the Commission, comments must be filed prior to the close of the official comment period. Comments filed after the close of the official comment period may be considered, at the Commission's discretion. After the close of the comment period, persons may continue to submit comments through this website."

To date, the Commission has accepted and intends to consider all late-filed comments.

The Subcommittee also has requested information regarding the standard for determining when a rule must be re-proposed. The Commission's actions in this respect also are governed by the APA. In general, the APA requires that an agency provide the public a meaningful opportunity to participate in an agency rulemaking. The first step in the rulemaking process is the publication of a notice of proposed rulemaking ("NPRM") that includes the substantive terms of the proposed rule and informs the public of the issues that are likely to be significant to the agency's decision.

The APA does not require the final rule to be identical to the proposed rule. Indeed, in issuing final rules, agencies are expected to consider and respond to comments on the proposed rule. When reviewing a final rule to determine if there was adequate notice and opportunity for comment, the courts will examine whether the connection between the NPRM and the final rule is sufficient for the final rule to be considered a "logical outgrowth" of the proposed rule. For example, courts consider a final rule to be a logical outgrowth if the NPRM expressly asks for comments on a particular issue or otherwise makes clear that the agency is considering a particular course of action.

Phased Implementation

The Commission has specifically requested comment from market participants and interested members of the public on the phase-in of the regulatory requirements that will be established in the final rules.

The CFTC has certain flexibility to set implementation or effective dates of rules promulgated to implement the Act, consistent with the Act's statutory deadlines and requirements. This flexibility allows the Commission to tailor the timing of the implementation of the rules to the ability of entities subject to the new Dodd-Frank regulations to develop the systems, processes, and capabilities to comply with the new requirements. Accordingly, the Commission is considering whether to phase implementation dates based upon a number of factors related to the ability to transition into compliance with the new requirements, including asset class, type of market participant, and whether the requirement would apply to market infrastructures or to specific transactions. The order in which the rules are finalized by the Commission therefore will not necessarily mean that the rules themselves will become effective in that same order, or that the implementation requirements will follow that same sequence.

For example, the Commission may require one asset class or one group of market participants to comply with certain regulatory requirements before other asset classes or other groups of market participants. Similarly, the Commission may require market infrastructure facilities to be in compliance with certain regulatory requirements prior to requiring market participants to use those facilities. Effective dates and implementation schedules for certain rules may be conditioned upon other rules being finalized, their effective dates and the associated implementation schedules. For instance, the effective dates of some final rules may come only after the CFTC and SEC jointly finalize certain definitions rules.

The Commission is examining issues related to the phasing in of regulatory requirements with respect to the entire set of rules that are being proposed, the regulatory requirements that would thereby be established and the degree of flexibility allowed by the applicable law. The Commission is seeking comments from market participants and regulators, both in the U.S. and abroad, regarding the phasing of implementation of these requirements.

The Subcommittee has also asked about the potential circumstance in which various provisions of the Dodd-Frank Act may become effective prior to the promulgation of implementing regulations. The staff is evaluating these potential circumstances and developing for consideration alternatives within the Commission's authorities in order to ensure that transactions will not be disrupted solely as a result of such transition to the new regulatory regime.

Conclusion

The Commission has established a rulemaking process to implement the Dodd-Frank Act in compliance with the Act's requirements and Congressional intent. The

rulemakings are being conducted in an open and transparent manner. The Commission seeks, encourages, and considers public comments. The Commission also will continue to consult and coordinate with other Federal regulators and our international counterparts prior to issuing final rules.

Thank you, and I'd be happy to answer questions.

The CHAIRMAN. Mr. Berkovitz, thanks for coming.

I will remind our Members that you will be recognized for questioning in order of seniority for those who were here at the beginning of the hearing. Others will be recognized in the order of arrival.

We will start the 5 minute clock with me.

Mr. Berkovitz, again, thank you for being here today.

Up until about 3 weeks or so ago, it seemed to me that the Commission was continuing to bluff that they could get all of this done by July 15; and, since then, now it has been clear that that is not going to happen, that you are not going to make the deadline. And while we in Congress can't encourage you to disobey the law, as my opening statement, you were given an impossible task to get that done.

I have a couple of questions in that regard. One, is it time now for the Commission to openly request additional time so that you can get this done under the law? Or should we just—is it your recommendation that you continue to ignore the law's July 15 date or July 21 date, whichever one it is, with respect to making these rules final?

And the second half of that is, without rules being in place by that time frame, the law is in effect for those folks who participate in all these markets. So what guidance can you give them who have to obey the law without the regulations being in place, and what risks do they run during that gap between the guidance that you are intending to give them with respect to how the law should be implemented *versus* the law being out there and their risk that there are plaintiffs' lawyers all over the country just salivating at the opportunity to come after some of these folks because they are not in compliance with the law and the regulations out there?

So could you give us quick comments on both of those?

Mr. BERKOVITZ. Thank you, Mr. Chairman.

As you mention, the law does establish a 1 year global time frame for our rulemakings, and the Commission is working diligently to meet that deadline. I think, as you recognize and the Chairman has stated, that there are going to be some rules—a number of rules that are going to be finalized after that deadline.

The Chairman has established an overall goal to issue a number of the rules in final form this summer. So the goal is to have a number of these rules finalized by the summer, and then obviously there will be a number of them finalized after that.

The Chairman has not asked for any statutory change to accomplish that. I think we can accomplish that within the current statutory authority and current statutory timetable. There is not going to be a penalty if we don't meet that July deadline for these final rules.

Regarding the transition, I think the statute also provides the agency with sufficient flexibility to address that transition period between the time when certain provisions of the Act may be effective, and the time when certain other regulations may be effective.

We believe the statute provides the agency with flexibility, both Dodd-Frank and the existing underlying Commodity Exchange Act, to address that interim period

The CHAIRMAN. So you are saying that protects the industry, by and large, from the law being effective and the regulations not being there, that somehow they are protected through—that there is no risk of being out of compliance with the law itself during this time frame, that a cause of action can be brought against them that they are somehow protected by this cloak that you are referring to?

Mr. BERKOVITZ. Well, we believe we have sufficient authority to address that situation. A number of market participants——

The CHAIRMAN. I am not talking about the implementation phase-in. I understand you have the authority to do that. But how do you protect the industry? Do you then weigh in on their behalf if a court case is brought against them?

Mr. BERKOVITZ. Well, we believe there is sufficient authority within the Commodity Exchange Act, as it currently exists, to address those concerns. We are looking at—we are examining a number of these specific instances, what happens before certain rules come into effect, and developing alternatives for the Commission's consideration, how to address that very concern.

The CHAIRMAN. Most of us have been pretty dissatisfied with the cost-benefit analysis that we have been allowed to see, pretty cavalier statements that the costs are small and the benefits are great and so this rule goes forward.

I guess the other question is, there are other agencies in the past who have been sued over their lack of proper cost-benefit analysis work done. Is the Commission somehow protected under the CEA for those kind of causes of action being brought by folks who disagreed with your cost-benefit analysis work and that, if it was flawed, then the underlying regulation itself shouldn't have gone into place because you didn't really analyze what should have happened, or what was going to happen when you put it in place?

Mr. BERKOVITZ. The guiding principles here, the statutes that guide us in the cost-benefit analysis are section 15(a) of the Commodity Exchange Act, and we believe that our proposed rules have been in compliance and our cost-benefit analyses have been in compliance with section 15(a).

In terms of the rulemakings themselves, the other statute that would guide the agency in judicial review and where other agencies—we have looked at the cases—get challenged is the Administrative Procedure Act and ensuring that the rulemakings are based upon a reasoned and rational basis and the agencies are obligated to respond to comments and ensure that the decisions are based upon fact and reasoned analysis. And so the Commission is also guided by the Administrative Procedure Act, and we intend to follow that as well. And if we follow the APA and the Commodity Exchange Act, our rules should be found—upheld.

The CHAIRMAN. Okay. I will come back at you a little bit later on when it is my turn again.

So, Mr. Boswell, for 5 minutes.

Mr. BOSWELL. Well, thank you, Mr. Chairman.

Kind of along that line, just to carry on a little bit, Chairman Gensler testified repeatedly about the Commission's requirement for cost-benefit analysis in his rulemaking. This requirement had been in place long before Dodd-Frank; and with regard to the Commission's efforts to meet this statutory cost-benefit requirement, is the Commission staff doing anything different now with the Dodd-Frank rules than it did in the rulemaking prior to Dodd-Frank, or even different from when the Commission had their previous Chairman?

Mr. BERKOVITZ. Congressman Boswell, we have adopted and we put to the statute—section 15(a) of the Commodity Exchange Act is really unaffected by Dodd-Frank. Dodd-Frank did not amend section 15(a) which governs cost-benefit analysis. So the underlying statutory requirement prior to Dodd-Frank is the same as after Dodd-Frank, and the agency has adopted the same cost-benefit approach.

In Dodd-Frank, however, we have received a lot of comments. As I mentioned to Chairman Conaway's questions, we have received a number of comments on our cost-benefit analysis, and we are considering those comments in the context of the rulemaking, and the agency is evaluating the comments and would respond appropriately in the final rule.

Additionally, the President, in January, issued an Executive Order regarding cost-benefit analysis.

So, as the Chairman has testified, we are looking at the Executive Order and seeing what principles of that Executive Order can be included within our cost-benefit analysis consistent with the basic statutory requirements in section 15(a).

Mr. BOSWELL. Thank you.

Your testimony states that the Commission tends to accept and I think, again along with some of the questions of the Chairman, consider all late-filed comments. However, it would seem at some point you have to stop. After all, how do you consider a comment if it comes in the day before the Commission is scheduled to vote on the final rule? And how late can comments be, and how can we and the comment offerer be sure it will be considered before it is submitted to the whole Commission for approval?

Mr. BERKOVITZ. The Commission does have discretion to consider late comments. To date, the late comments that have been submitted have been accepted, and the staff intends to consider them. At some point, when we are—as you have noted, just before a rule is imminent, just before it goes final, it actually may be too late to consider a comment as a matter of practicality. In that situation, the Commission would be unable to exercise its discretion or would exercise its discretion not to accept the comment. It can't be an open-ended, never-ending comment period. But provided that it doesn't delay the rulemaking, the general practice has been to accept the late-filed comment.

Mr. BOSWELL. Thank you.

In your written testimony, you talk about increased scrutiny by the courts of economic arguments about government agencies when proposing new rules. Has the CFTC seen such increased scrutiny by the courts and rules? Historically, have any challenges been filed against the Commission regarding rules or orders?

Mr. BERKOVITZ. We have not had many challenges against rules or orders in the last few years. The amount of rulemaking under Dodd-Frank is significantly greater than what the Commission has experienced in previous years. So we are devoting significant resources to our rulemakings. We have rulemaking teams established for each of the rules, with a number of staff from the various divisions, from the Office of General Counsel in order to ensure that these rules follow all the requirements and are sound and will survive any review, any challenge that people may bring

Mr. BOSWELL. Mr. Chairman, I will yield back. We are going to have another round probably. I yield back.

The CHAIRMAN. The gentleman yields back.

Mrs. Schmidt, from Ohio, for 5 minutes.

Mrs. SCHMIDT. Thank you, and I apologize if some of these questions have been asked, since I was outside.

I am concerned about the timing of the rules and how they are going to pan out in application. But, given the Dodd-Frank's emphasis on consistency and comparability, do the CFTC and the SEC intend to adopt consistent and comparable schedules, both for promulgation and implementation of the rules for swaps and security-based swaps? In other words, is the timing going to be the same or is the timing going to be different? Because I don't know how it is going to interact in the real world.

Mr. BERKOVITZ. We are coordinating with the SEC on that issue as well as on the substance of the rules themselves. We are coordinating both at the staff level and Chairman Gensler and Chairman Schapiro meet regularly and talk about these issues. So we are attempting to coordinate our schedules to the greatest extent possible.

There are two different Commissions with various different—slightly different rulemaking responsibility. So I don't know exactly how it is going to turn out, but we are attempting to do that.

Mrs. SCHMIDT. Well, if you can't get the timing together, how is it going to work?

Mr. BERKOVITZ. Well, we are attempting to do it as closely as possible together.

Mrs. SCHMIDT. Well, what happens if you don't? That is my question. What happens if you don't? How is it going to work in the real world if you have two different sets of rules out there?

Mr. BERKOVITZ. Well, it would depend on the particular requirements. Our requirements would go to swaps. Their requirements would go to security-based swaps. To the greatest extent possible, we would like those to be at the same time, and we are trying to avoid any differences in those two types of instruments in terms of the timing or the requirements themselves.

Mrs. SCHMIDT. Can you respond to concerns that the CFTC proposes to regulate swap dealers and major swap participants in the same fashion, even though one is the seller and one is the buyer? Take for example, sales practice rules applied to major swap participants when they are the buyer. I mean, aren't they two different groups?

Mr. BERKOVITZ. The statute directs the agency to promulgate certain standards, business conduct standards, certain clearing requirements equally applicable to the swap dealers and to the major

swap participants. To the extent that there are certain features about certain transactions or certain requirements that may be different, we are considering that in the comment period on the various particular requirements.

Mrs. SCHMIDT. So what assurances are we going to have that buyers and sellers are going to be treated differently instead of in the same mold?

Mr. BERKOVITZ. Well, it would depend again on the particular requirement what the particular standard is. We would have to consider that in the context of a particular requirement that may or may not be applicable to a buyer or to a seller as the case may be.

Generally, the statute treats them the same. So any differences would come when we were looking at a particular requirement to implement that statutory direction.

Mrs. SCHMIDT. But I think they are fundamentally different. It is like when you are buying a house or you are selling a house, there is a different set of rules out there for buyers and sellers with a realtor. So why would we have the same mold for a buyer and seller on these transactions?

Mr. BERKOVITZ. Well, the statute generally would impose a duty, for example, on a counterparty. If you are in a transaction with a counterparty, this is when the transaction should be reported, what your duty of disclosure may or may not be to a counterparty, things like that.

So if there is a particular instance when, as you have posed, that it really can only be done by a seller or really can only be done by a buyer, if it gets down to that level you would have to look at that, at the individual transaction level, which is what we intend to do.

Mrs. SCHMIDT. Okay. And, finally, in the few seconds I have left, what authority does the CFTC have to address issues of extraterritoriality? Can the CFTC exempt from regulation an entity that is subject to comparable regulation in their home country?

Mr. BERKOVITZ. We are looking at that issue also very closely. The Dodd-Frank Act states—the extraterritorial provision in Dodd-Frank states that it applies to an activity if there is a direct and significant connection with activities in or effect on U.S. commerce.

So we are looking in evaluating at what type of activities that reaches overseas. We are talking to U.S. banks and U.S. institutions that have activities overseas. We are talking with foreign banks that do activities in the U.S., and we are trying to determine what type of activities and what that connection is and, therefore, what the requirements might be and which ones may or may not apply.

Mrs. SCHMIDT. Okay. Thank you.

The CHAIRMAN. The gentlelady yields back.

Mr. David Scott, from Georgia, for 5 minutes.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. I appreciate your having the hearing.

Mr. Berkovitz, I have had quite a bit of discussion with a number of industries and companies. I have been very intimately involved in Dodd-Frank. I serve both on the Financial Services Committee as well as here on the Agriculture Committee.

The one chief concern that all of them have is the volume, the pace, and the phasing of the rules and regulations that the CFTC

must create. And, very interestingly, none have complained about wanting to defund or repeal the law. They have invested in understanding that this is an important law, that we have an important issue here. But there are some major, major concerns and points that I would like to ask you on a number of issues.

But, specifically, I want to ask you about the proposed rule on ownership of swaps execution facilities. What sort of weight are you giving to the Department of Justice's comments about aggregate ownership limits?

Mr. BERKOVITZ. Obviously, the Department of Justice is a very significant commenter; and, given their significant expertise in antitrust issues, issues of competitiveness, this is something—when they send us a letter, as any Federal agency would send us a letter, we give it great consideration. We have also received comments commenting upon the Justice Department letter, so we are evaluating the comments in response. But they have written us a very thoughtful letter, and we are giving that letter very thoughtful consideration.

Mr. DAVID SCOTT of Georgia. Do you not feel that, given the large capital requirements for new entrants into the field, that placing such a requirement could serve as a barrier to entry and would stifle competition?

Mr. BERKOVITZ. That is one of the factors that the agency is considering in determining where to come out on this issue.

Mr. DAVID SCOTT of Georgia. Mr. Berkovitz, what do you think? What do you think? Do you personally think it would stifle the competition?

Mr. BERKOVITZ. I personally haven't examined that issue in that great a detail. And my role would be—there are other folks in the agency who would be probably better suited to actually evaluate the merits on the competitiveness argument than myself. So I personally haven't weighed in on that

Mr. DAVID SCOTT of Georgia. But don't you think on the face of it, just looking at it, that it could be a barrier to entry?

Mr. BERKOVITZ. I am aware that that is one of the arguments; and we have arguments on the other side, too. So I personally would not be able to address that. The Commission itself is actually going to be addressing that very issue.

Mr. DAVID SCOTT of Georgia. Let me ask you one other thing. Can you say definitively that the CFTC has enough people and a sophisticated enough information technology infrastructure to do the work that you are tasked with under Dodd-Frank? I mean, we are in this era of budget cutting. But this is a very, very complicated field with an awful lot of different layers in the swaps and the derivatives and foreign markets. Our companies are having to compete with an array of rather fuzzy interpretations of what the rule might or might not say. So the question that I would like to get on the record from you is, do you feel that you need additional resources?

Mr. BERKOVITZ. We are thankful that in the latest—if the current—if the numbers that we are hearing now are enacted, that we probably have sufficient resources, as I am talking about just over $200 million for the rest of this fiscal year, if the reports are accu-

rate and that is indeed the number. We would have enough resources to get us through the rulemakings.

Mr. DAVID SCOTT of Georgia. Right now, with the budget as is?

Mr. BERKOVITZ. Correct.

Mr. DAVID SCOTT of Georgia. Let's suppose—because we are moving through some very choppy waters as far as the budget is concerned. Let me ask you this. What would happen to your ability to properly regulate these markets if your budget was slashed?

Mr. BERKOVITZ. Well, the President has requested—the budget request for Fiscal Year 2012 is $308 million. And that number is what the agency would really need to be able to effectively implement the Act.

The $200 million again, if it is accurate, if the deal is as reported and that is approved by the Congress and signed by the President, would get us through the rulemaking stage.

Mr. DAVID SCOTT of Georgia. Before my time is up, so you are saying it would in effect affect your ability to do the job if your budget is slashed? Is that what you are saying?

Mr. BERKOVITZ. Yes, Congressman, that is correct.

The CHAIRMAN. Mr. Schilling, from Illinois, for 5 minutes.

Mr. SCHILLING. Thank you, Mr. Chairman.

Welcome. I appreciate you coming out today. I just have a couple of questions.

Prior to the Dodd-Frank bill, I was told that the CFTC averaged about 5½ rulemakings a year; is that accurate?

Mr. BERKOVITZ. I don't have the exact number, but it sounds about right.

Mr. SCHILLING. Okay. And then, since this past October, I am told that the CFTC has proposed 43 new regulations to implement this law, and that is probably pretty accurate as well.

Mr. BERKOVITZ. That is correct.

Mr. SCHILLING. I think the one thing that I see—I am one of the new 87 freshmen Members coming into Congress, and as I have been out throughout the district, the big thing that we hear is the over-regulation and overreaching of the Federal Government is basically keeping a lot of our investors and people throughout the country sidelined; and that is one of our big concerns, of course. But can you respond to the concerns that the CFTC proposes to regulate swaps, the participants, the same, even though, one is a seller and one is a buyer?

Mr. BERKOVITZ. Well, generally, the statute provides for swap dealers and major swap participants certain business conduct standards, certain capital requirements, certain institutional requirements that the institution has to meet, regardless of whether a particular transaction is a buy or a sell. These are very large institutions, so—and, generally, they are going to be doing both types of transactions. So our regulations are designed to capture the transactions that these institutions do.

If there is a particular circumstance where a particular business conduct standard or a requirement may or may not be applicable to a seller or a buyer, we would look at that in the individual context of a particular rulemaking. But, generally, the swap dealers and major swap participants are very large institutions that do a lot of both buying and selling.

Mr. SCHILLING. Okay. Very good.

With that, I yield back.

The CHAIRMAN. The gentleman yields back.

The gentleman from Connecticut, Mr. Courtney, for 5 minutes.

Mr. COURTNEY. Thank you, Mr. Chairman; and thank you for this hearing. Again, I have great respect for your stewardship on this Committee, and I am glad we are holding this hearing.

I have to say I look at it a little bit differently than some of the other questioners this morning.

Yesterday, Reuters reported that Goldman Sachs analyzed oil prices and determined that the price per barrel was inflated by speculation to the tune of $27 per barrel. In Connecticut right now, we are paying $4 a gallon for gas. I mean, you can do the math pretty quickly, but that means basically motorists should be paying about $3 a gallon.

People who are getting their home heating oil are also overpaying because of the fact that we have markets which I think are highly dysfunctional. You know, businesses in my district who sell home heating oil have basically refused to get into the business of hedging right now. They will not sell lock-in contracts for next winter because this market is so dysfunctional.

And, frankly, CFTC had the authority to implement position limits back in January. And, if anything, from my perspective you are being too cautious in terms of moving ahead with what Dodd-Frank suggested.

And I would just say, following up Mr. Scott's question, in terms of your budget, Secretary Mabus testified at Armed Services that every time a price per barrel goes up $10 the Navy's annual fuel costs go up $300 million.

So, again, if you just do the math in terms of what Goldman Sachs reported yesterday, the taxpayer is paying double your budget that the President proposed because of the fact that we don't have a functioning system of rules in energy trading.

I have just got to tell you, Mr. Berkovitz, the impact on the economy in terms of energy prices right now is just potentially catastrophic in terms of trying to get a recovery moving forward. I hope that you are going to move forward on those position limits on energy trading as soon as possible. I mean, people are, in my opinion, getting ripped off because of the fact that the markets are not functioning in a way that is connected to supply and demand.

And I don't know if you would like to comment on that.

Mr. BERKOVITZ. Thank you, Congressman. I will take that back and will consider those comments.

I know that the Commission staff is devoting considerable time. We are receiving a lot—one of the most commented on rules—proposed rules we have out there is the position limits rule; and we have had thousands, literally thousands, of comments. Some of them are foreign comments, but, nonetheless, we have to go through and look at all of these. So we are going through those comments and evaluating that proposal very seriously.

Yesterday, I would also note that the agency—Chairman Gensler and the agency announced a joint effort with the Federal Trade Commission to look at some of these issues where the FTC has oversight authority over oil and gasoline prices, the actual com-

modity itself, market oversight there; and so we have announced a cooperative effort with them.

Mr. COURTNEY. Well, again, I just think it is important to also remember that there are end-users who now are shying away from getting involved in hedging. I mean, Hershey's announced the other day that it was pulling back because, again, the commodities market makes chocolate hedging almost impossible to really make an intelligent decision.

Commissioner Chilton sent a letter to my office a couple of days ago sort of walking through again the sequence that took place as far as the energy position limits. I know he supports moving forward; and I, again, think his advocacy hopefully will be heard by the rest of the Commission. I really believe that, for the sake of the economy, we have to get some stability in energy prices, because it just ripples through from every home owner, motorist, small business on up. And it is really bad out there.

Mr. BERKOVITZ. Thank you.

Mr. COURTNEY. I yield back.

The CHAIRMAN. Mr. Crawford, from Arkansas, 5 minutes.

Mr. CRAWFORD. Thank you, Mr. Chairman.

Mr. Berkovitz, it seems to me the most commonsense approach to the rulemaking process would have been to start with defining *swap*. Yet you proposed nearly all of your rules but have not defined what a *swap* is, and I wonder why you have waited until the very end to define a building block of the entire title.

Mr. BERKOVITZ. The swap definition in rulemaking is a joint rulemaking with the Securities and Exchange Commission. We hope—and we are working with the SEC staff very closely. We hope to have that proposed rule out very soon, in the next few weeks, actually, is our hope. I obviously can't guarantee that, but we do intend to get that out very soon.

Mr. CRAWFORD. Okay. I have some real concerns about what this excessive rulemaking might do for end-users in my district, for example, the farmers. That under extreme pressure the Federal budget is tasked with taking some of the support away from farmers, and so they are going to have to move into a free market approach to how they cash-flow their operations. My concern is that the rules that we are seeing right now may hinder, may actually make it less attractive for them to avail themselves of these free market tools. Can you explain how this is going to affect the average—say, the average cotton farmer or the average soybean farmer and how they implement a strategy for risk management under these excessive rules?

Mr. BERKOVITZ. There are two possible risk management tools that people would use—or the ones that we would regulate that folks would use. That would be the futures market or the swaps market.

Most of Dodd-Frank and the rules that we are doing go to the swaps market. There are some of the rules that we do that affect the futures side. But those rules shouldn't fundamentally affect the ability—on the futures side shouldn't affect the fundamental ability of the farmer to use our futures market for hedging.

On the swap side, Congress has provided a number of exemptions for end-users, such as the exemption from clearing. So there

wouldn't be—if a farmer were using a swap rather than a future—and, generally, the agriculture swap market is not—folks use the futures market more than the swaps market. But if people didn't want to use swaps, didn't want to use these risk management tools, there would be the end-user exemption that a farmer, if they were using these for hedging, would qualify under.

So we have met a lot with farm co-ops, organizations of end-users, hearing those concerns. We have put out a proposed rule to implement the end-user exception which we have gotten a lot of comments on. And so we are meeting and we are—we hear the, as I talked about in my statement, the intent of Congress that folks that are using these markets for hedging and to mitigate their commercial risks, that those typical end-users are the lower risk activities and that there should be much—there should be less regulatory burden on those types of entities. And so we are meeting and trying to achieve that Congressional intent.

Mr. CRAWFORD. All right. Thank you, sir.

I yield back.

The CHAIRMAN. Mr. Kissell, from North Carolina, for 5 minutes.

Mr. KISSELL. Thank you, Mr. Chairman. Thanks to the witness for being here today. I apologize for being late.

But I want to follow up a little bit what my colleague, Mr. Courtney, was asking you about when he mentioned that Hershey's was pulling away from the market. Why do you think that might be? And what do you think it would take to calm those nerves so that people like Hershey's would have—get back in, have the confidence, so forth, so on? What are your thoughts on such a move?

Mr. BERKOVITZ. I wouldn't know why in particular a firm would or would not be using the market less right now. I don't know whether that would be related to if there is an increase in the commodity price that would increase the margin cost of a futures contract or something like that, or if it is a different type of business decision.

But, typically, when prices—in an area of higher prices, there might be higher costs for using these markets. But I don't know whether that is in fact the situation or not.

Mr. KISSELL. Okay. Mr. Gensler, when he testified, talked about, and Members talked a lot about, using the cost-benefit analysis to determine how certain things should be. But, that has been a requirement even prior to Dodd-Frank. I am just wondering if you see any different use of cost-benefit analysis and how they might be used to come up with some of the rules and how this bill moves forward.

Mr. BERKOVITZ. Yes. Our fundamental approach to cost-benefit analysis is still governed by section 15(a) of the Commodity Exchange Act. That is the section that directs us to do cost-benefit analysis. So it is not changed by Dodd-Frank. So, fundamentally, the agency's approach is the same under the statute as it had been prior.

We have gotten a lot of comments in response to specific cost-benefit analysis in specific rules in saying you didn't consider this cost adequately, you didn't consider that cost adequately, you didn't provide enough detail. So we have gotten specific comments, and we are addressing the comments on a rule-by-rule basis as they

come in on these specific analyses within the overall statutory framework.

In addition, the President's Executive Order in January had a number of principles in terms of how to conduct cost-benefit analysis. We are also looking at that to see where those principles are consistent with our statutory direction, whether those can also be incorporated. Because that has been somewhat of an overarching comment that we have received. So the fundamental approach is the same. The statute is the same as it has been. But in response to these comments and concerns, the President's Executive Order we are seeing how we can adjust what we do.

Mr. KISSELL. Okay. Thank you, sir.

Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from New York, Mr. Gibson, for 5 minutes.

Mr. GIBSON. Thank you, Mr. Chairman.

Mr. Berkovitz, I appreciate your being here. I am learning from your testimony here.

I represent a district in New York, and I am going to ask about a couple of different areas, the first one with regard to financial services and the other one with regard to our near and dear farmers.

The first one is listening carefully and reading Mr. Gensler's speeches, one of the things that he has talked about is harmonizing, going forward, our rules promulgation with Europe and Asian markets so that we can synchronize our efforts. And I appreciate those remarks very much. But are you concerned that if we get out in front of Europe and Asia in terms of effectuating these rules that we will lose jobs in financial services overseas?

Mr. BERKOVITZ. Congressman, as you mentioned, the agency and the Chairman have been spending a considerable amount of time on the harmonization and speaking with the Europeans. The potential job issue is one of a subset of the general notion that if the regulations are different that is going to affect—people may trade in jurisdictions that have lesser regulations and that would have effects on jobs and have effect on potentially the safety and soundness of our system. So that, overall, plays into the rationale for trying to get harmonization. So——

Mr. GIBSON. Well, indeed. And I want to affiliate myself with that and just say that that is what concerns me about the timing of all this, is that in the effort to work with the Chairman, work with Mr. Gensler in terms of harmonizing efforts, that we ought to take that into consideration, Mr. Chairman, when we look at the timing of the promulgation of rules. Thank you.

The second point, there is a perception back home among my farmers that how you make definitions and in particular—for example, an organization's co-bank, how they are defined will have an impact on farm credit and ultimately impact our farmers, restricting access to necessary credit. What would you say to me that I can carry back to them about how you would be sensitive to that so that our farmers will continue to have access to the credit they need, moving forward?

Mr. BERKOVITZ. The issue of farm credit is being looked at in the context of one of our rules where we have asked for public com-

ment on the end-user exception, and so we are accepting public comment on that very issue. So we have met with a number of farm cooperatives, smaller institutions, in terms of how the agricultural markets are structured and how farmers are able to hedge and use the markets to hedge and the institutions that are available there. So we have had a number of meetings with institutions, and that is a concern that has been brought to our attention, which we are considering in the various context of the rules.

Mr. GIBSON. Okay. I appreciate those remarks.

Mr. Chairman, I will just sum up by saying that these are two areas I am going to continue to monitor very closely. I think we can agree that we are not really in a place of certainty, so that more work needs to be done. I do want to express that I am concerned about the timing of all these rules promulgation and want us to be sensitive of that going forward.

And with that, Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman yields back.

I have a couple of other questions as well. Let's do another round if folks want. So we will start another 5 minutes on me.

The broad statement first in reference to some comments that our colleague from Connecticut made, is it the role of the CFTC to set prices for all these commodities?

Mr. BERKOVITZ. We are not a price-setting agency. Our mission is to ensure the markets are fair.

The CHAIRMAN. But he seemed to imply that somehow the CFTC could set the price for cocoa or gasoline or whatever. So I just wanted to make that clear.

Is there anything in 15(a), the CEA, that precludes you specifically from folding in the President's Executive Order into your cost-benefit analysis work? What gets excluded? Because you make kind of a little reference to that.

Mr. BERKOVITZ. Right. That is what we have been looking at to the extent that we can incorporate elements from the President's Executive Order into our analysis.

The CHAIRMAN. Okay. Let me ask you a broader question. You will soon have most all the rules proposed. Is there under the Administrative Procedures Act or your rules that would allow, for lack of a better phrase, an interim final set that would allow the industry to look at the entire mosaic of rules that are there that they are going to have to comply with? This way they have some period of time that would allow them to make comments that would say here is an unintended consequence that would then allow the agency the time to be able to respond to that before we get too far down the road with this big brush?

What I have heard the Chairman say, is that we have the rules out there and the industry can look at those, which implies that the proposed rules will be the final rules. And if that is the case, then all of this work that your testimony talks about—and the Chairman's done a great job of saying we are taking these comments, we are folding them in. Is there a way that, once the rules go final, that there will be a period where the agency can take account and the industry can show you where these things may have gotten cross-threaded because we have done them in various pieces? Is there something in the Administrative Procedures Act

that you guys can avail yourselves of that would get them final but yet not so final that you have to go through an Act of Congress, so to speak, to address unintended consequences if those final rules do something that we don't want to be done?

Mr. BERKOVITZ. I do think that the Administrative Procedure Act provides us flexibility for taking into account public comments as the process goes forward, and I think that is what we have attempted to do so far. We are nearing the completion, as I mentioned, of the proposed rule stage. We have three or four——

The CHAIRMAN. This speaks to us about beyond that. When you do decide this is what it ought to look like and you have it done across the entirety of what you are trying to do, then the industry has a chance to know whether or not they were a swap dealer, whether or not they are a major participant, all these things to fit together. If we see a gap in the regulations, or regulations that overlap and do too much before those get so ingrained into the system and caused harm to it that you could address that quickly and nimbly.

Mr. BERKOVITZ. I think so. I think the Act provides us that flexibility so that, as rules begin to finalize, if there is something in a final rule that affects—in one final rule that affects a rule that is still in the proposal stage, that people still would have potentially, depending on the exact sequence and the exact rule, the opportunity to comment and say, well, wait a minute. You just went final here. This affects something that is yet—that is still in the proposal stage.

The CHAIRMAN. I guess I was trying look for something like that once it is all done, once everything is final. All the final rules are done, the system would have a chance to look at all of that, you as well.

And I am apparently not being very articulate in asking the question, or you are being very artful in saying, no, there is no way that the agency can provide for an opportunity to look at all of these, once they are done. Is there a final rule—that may be an inappropriate term—but to look at the whole thing other than just piecemeal it across. As you see the bullet box come in, in whatever order that they decide that you are coming in, your view is that that is adequate for the industry to be able to respond, to be able to put in place systems that they are going to have put in place, even in spite of the fact of knowing unintended consequences.

Mr. BERKOVITZ. Well, I am not trying to avoid the question, but we are attempting to do that. What you have described is what the roundtables and the implementation roundtables are doing.

The CHAIRMAN. Those are going to happen, though, before anything is final.

Mr. BERKOVITZ. And whether a similar process would happen further down the road at the final stage, we could evaluate then.

The CHAIRMAN. Okay. I am not trying to be argumentative. I am just trying to get the best answer.

I mean, everybody knows that there is going to be some regulatory things that have to happen. But they ought to make sense, they ought to do the minimum damage, and they ought to cost—allow the industry to comply with them in the most cost-effective manner possible. And so I think that is the goal.

Mr. BERKOVITZ. If you are asking in terms of the Administrative Procedure Act is this something that procedurally would be permissible, I think the answer is, yes, and the Commission would decide at the time whether to do it.

The CHAIRMAN. Okay. Thank you.

Mr. Boswell for 5 minutes.

Mr. BOSWELL. I yield.

The CHAIRMAN. Anyone else?

Mr. Berkovitz, thank you for coming today. We appreciate this open exchange. I didn't mean to imply that you were evading the question. I just couldn't get you to say what I wanted you to say. But thank you for being here today. I appreciate that.

Hopefully, there will be enough difference between the proposed rules and the final rules that the industry can look at all those comments, the thousands of hours of work done and untold amount of lawyer fees invested in putting comments to you, that those had an impact, that had an effect on making these rules better as we move forward. So we continue to look forward to working with you on this whole process.

Mr. BERKOVITZ. Absolutely. Thank you.

The CHAIRMAN. We will now have our second panel, if you wouldn't mind coming to the table, and we will start our second round.

I want to welcome our second panel of witnesses. This actually is a panel, since there is more than one of you.

First up will be Terry Duffy, the Executive Chairman of CME, Inc., in Chicago, Illinois.

We will then hear from Mr. Hal Scott, Director of Committee on Capital Markets Regulation, Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School, Cambridge, Massachusetts.

We will then hear from Dr. James Overdahl, the Vice President of the National Economic Research Associates here in Washington, D.C.

Then, Ms. Karrie McMillan, General Counsel for the Investment Company Institute here in Washington.

And then, Mr. Michael Greenberger, Professor, University of Maryland School of Law, Baltimore, Maryland.

So, gentlemen, and lady, thank you for being here.

Mr. Duffy, if you wouldn't mind starting us off, please.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP, INC., CHICAGO, IL

Mr. DUFFY. Well, thank you. Thank you, Chairman Conaway, Ranking Member Boswell, Members of the Committee. And I thank you for the opportunity to testify on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

I am Terry Duffy, Executive Chairman of CME Group, which includes our clearinghouse and our four exchanges: the CME, the Chicago Board of Trade, New York Mercantile Exchange, and the COMEX.

In 2000, Congress adopted the Commodity Futures Modernization Act. This leveled the playing field with our foreign competitors and permitted us to recapture our position as the world's most in-

novative and successful regulated exchange and clearinghouse. As a result, we remain an engine of economic growth in Chicago, New York, and the nation.

The 2008 financial crisis focused attention on over-leveraged, under-regulated banks and financial firms. In contrast, regulated futures markets and futures clearinghouses operated flawlessly before, during, and after the crisis.

Congress responded to the financial crisis by reining in the OTC market to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. We support these goals, but we are concerned that the CFTC has launched an initiative to undo modern regulation of futures exchanges and clearinghouses.

We are not alone. Most careful observers and some Commissioners have concluded that many of the proposed regulations roll back principle-based regulation and unnecessarily expand the Commission's mandate. In so doing, the Commission acts outside of its rulemaking authority under the Dodd-Frank Act and, in many cases, undermines the intent behind Dodd-Frank.

When Dodd-Frank passed, Congress specifically maintained principles-based regulation for the futures market. It extended that approach to the newly regulated swaps market. This would create core principles for swap execution facilities as well as swap data repositories.

The intent of Dodd-Frank was not to fundamentally change the regulation of futures markets; rather, the primary goal was to close existing regulatory gaps. This would bring swaps which were largely unregulated into a regulated framework similar to that which was successful in futures markets. Instead, the CFTC has proposed to drastically alter the futures regulatory framework and create a parallel framework for swaps. The CFTC has proposed extraordinary prescriptive rules. This would, in effect, repeal the principles-based regulatory approach that has existed for more than a decade.

In short, the CFTC is attempting to change its role. It is an oversight agency. Its purpose is to assure compliance with sound principles. Now it appears as if they are trying to become a frontline decision-maker, empowered to impose its business judgments on every operational aspect of derivatives trading and clearing. This role reversal is inconsistent with Dodd-Frank.

The listed futures markets performed flawlessly throughout the financial crisis. Imposing needless regulatory burdens on these markets will create unnecessary strain on the Commission's staff and budget. It will also impose unnecessary costs on the industry and the end-users of derivatives. My written testimony includes numerous examples of proposed rules that exceed the boundaries of the Commission's rulemaking authority under Dodd-Frank.

Further, in proposing rules, the Commission has consistently failed to conduct a proper cost-benefit analysis, as required by Section 15 of the Commodity Exchange Act. Congress should require the CFTC to operate within the limitations of its authority under Dodd-Frank. This means encouraging a full and fair cost-benefit analysis on every proposal.

Also, by extending Dodd-Frank's effective date, it would permit a realistic opportunity to comment on a full package and its cost and benefits. Otherwise, we believe that the futures industry will be burdened by overly prescriptive regulations that are inconsistent with Dodd-Frank and sound industry practices. This will make it more difficult to reach Dodd-Frank's goal of increasing transparency and limiting risk.

Before I close, I would like to touch on one question that was asked by a Member about regulatory disparities amongst countries. The word we were looking for would be called *arbitrage.* And *arbitrage* means when there is one price at one particular place and one price at a different place. If we were to have regulations here in the United States somewhat different than is taking place in Europe or in Asia, that would be considered an arbitrage. People would go to the less-regulated marketplace because the costs are much different.

This will drive jobs away from the United States of America and drive capital and finance out of the United States of America. Mr. Berkovitz did not answer that question directly, but I would like to just, for the record, answer it. I do believe it will drive jobs out. Arbitrage is exactly what it is; it is inefficiencies. And if we have something and someone else doesn't, they are going to go to that platform.

I thank the Committee for its time and look forward to your questions.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP, INC., CHICAGO, IL

Subcommittee Chairman Conway, Ranking Member Boswell, Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to testify on the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111–203, July 21, 2010) ("DFA"). I am Terry Duffy, Executive Chairman of CME Group ("CME Group" or "CME"), which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc. the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, Inc. and the Commodity Exchange, Inc. (together "CME Group Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME also includes CME Clearing, a derivatives clearing organization and one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter ("OTC") derivatives transactions through CME Clearing and CME ClearPort®.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions executed in compliance with the applicable Exchange rules and cleared by CME's clearing house. In addition, CME Group distributes real-time pricing and volume data through a global distribution network of approximately 500 directly connected vendor firms serving approximately 400,000 price display subscribers and hundreds of thousands of additional order entry system users. CME's proven high reliability, high availability platform coupled with robust administrative systems represent vast expertise and performance in managing market center data offerings.

The financial crisis focused well-warranted attention on the lack of regulation of OTC financial markets. We learned a number of important lessons and Congress crafted legislation that, we hope, reduces the likelihood of a repetition of that dis-

aster. However, it is important to emphasize that regulated futures markets and futures clearing houses operated flawlessly. Futures markets performed all of their essential functions without interruption and, despite failures of significant financial firms, our clearing house experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk. Dodd-Frank was adopted to impose a new regulatory structure on a previously opaque and unregulated market—the OTC swaps market. It was not intended to re-regulate the robustly regulated futures markets.

For example, while Congress granted the Commission the authority to adopt rules respecting core principles, it did not direct it to eliminate principles-based regulation. DFA rather reinforced the principles-based regime for regulated futures exchanges and clearing houses by adding new core principle obligations and extending this principles-based regime to swap execution facilities ("SEFs") and swap data repositories as well. Yet the Commission has proposed specific requirements for multiple Core Principles—almost all Core Principles in the case of designated contract markets ("DCMs")—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

The Commission's almost complete reversion to a prescriptive regulatory approach converts its role from an oversight agency, responsible for assuring self regulatory organizations comply with sound principles, to a front line decision maker that imposes its business judgments on the operational aspects of derivatives trading and clearing. This reinstitution of rule-based regulation will require a substantial increase in the Commission's staff and budget and impose indeterminable costs on the industry and the end-users of derivatives. Yet there is no evidence that this will be beneficial to the public or to the functioning of the markets. In keeping with the President's Executive Order to reduce unnecessary regulatory cost, the CFTC should be required to reconsider each of its proposals with the goal of performing those functions that are mandated by DFA.

Further, the principles-based regime of the CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearing houses permitted U.S. exchanges to regain their competitive position in the global market. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA. Indeed, U.S. futures exchanges have operated more efficiently, more economically and with fewer complaints under this system than at any time in their history. The transition to an inflexible regime threatens to stifle growth and innovation in U.S. exchanges and thereby drive market participants overseas. As further discussed below, this will certainly impact the relevant job markets in the United States.

We support the overarching goals of DFA to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. Unfortunately, DFA left many important issues to be resolved by regulators with little or ambiguous direction and set unnecessarily tight deadlines on rulemakings by the agencies charged with implementation of the Act. In response to the aggressive schedule imposed by DFA, the Commodity Futures Trading Commission ("CFTC" or "Commission") has proposed hundreds of pages of new or expanded regulations.

In our view, many of the Commission's proposals exceed the boundaries of its authority under DFA, are inconsistent with DFA, not required by DFA, and/or impose burdens on the industry that require an increase in CFTC staff and expenditures that could never be justified if an adequate cost-benefit analysis had been performed. I will discuss below the Commission's failure to comply with the Congressionally mandated cost-benefit process, the need to sequence Dodd-Frank rulemaking appropriately, and the potential negative impact on U.S. markets of regulatory proposals.

A. Lack of Consideration of Costs of Regulatory Proposals

The Commission's rulemaking has been skewed by its failure to follow the plain language of Section 15 of the Commodity Exchange Act ("CEA"), as amended by DFA, which requires the Commission to consider the costs and benefits of its action before it promulgates a regulation. In addition to weighing the traditional direct costs and benefits, Section 15 directs the Commission to include in its evaluation of the benefits of a proposed regulation the following intangibles: "protection of market participants and the public," "the efficiency, competitiveness, and financial integrity of futures markets," "price discovery," "considerations of sound risk management practices," and "other public interest considerations." The Commission has

construed this grant of permission to consider intangibles as a license to ignore the real costs.

The explicit cost-benefit analysis included in the more than thirty rulemakings to date and the Commission's testimony in a number of Congressional hearings indicate that those responsible for drafting the rule proposals are operating under the mistaken interpretation that Section 15(a) of the CEA excuses the Commission from performing any analysis of the direct, financial costs and benefits of the proposed regulation. Instead, the Commission contends that Congress permitted it to justify its rule making based entirely on speculation about unquantifiable benefits to some segment of the market. The drafters of the proposed rules have consistently ignored the Commission's obligation to fully analyze the costs imposed on third parties and on the agency by its regulations.

Commissioner Sommers forcefully called this failure to the Commission's attention at the CFTC's February 24, 2011, Meeting on the Thirteenth Series of Proposed Rulemakings under the Dodd-Frank Act.

> "Before I address the specific proposals, I would like to talk about an issue that has become an increasing concern of mine—that is, our failure to conduct a thorough and meaningful cost-benefit analysis when we issue a proposed rule. The proposals we are voting on today, and the proposals we have voted on over the last several months, contain very short, boilerplate 'Cost-Benefit Analysis' sections. The 'Cost-Benefit Analysis' section of each proposal states that we have not attempted to quantify the cost of the proposal because Section 15(a) of the Commodity Exchange Act does not require the Commission to quantify the cost. Moreover, the 'Cost-Benefit Analysis' section of each proposal points out that all the Commission must do is 'consider' the costs and benefits, and that we need not determine whether the benefits outweigh the costs."

Commissioner Sommers reiterated her concern with the lack of cost-benefit analysis performed by the Commission in her March, 30, 2011 testimony before the Subcommittee on Oversight and Investigations of the House Committee on Financial Services. Commissioner Sommers noted that "the Commission typically does not perform a robust cost-benefit analysis at either the proposed rule stage or the final rule stage" and noted that "while we do ask for comment from the public on the costs and benefits at the proposal stage, we rarely, if ever, attempt to quantify the costs before finalizing a rule."

B. Sequencing of Rulemakings Under Dodd-Frank

Chairman Gensler has recently disclosed his plan for the sequencing of final rulemakings under DFA. He has divided the rulemakings into three categories: early, middle and late. We agree that sequencing of the rules is critical to meaningful public comment and effective implementation of the rules to implement DFA. Many of the rulemakings required by DFA are interrelated. That is, DFA requires many intertwined rulemakings with varying deadlines. Market participants, including CME cannot fully understand the implications or costs of a proposed rule when that proposed rule is reliant on another rule that is not yet in its final form. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect.

We agree with many, but not all aspects of the Chairman's proposed sequencing agenda and have recently proposed an alternative sequencing agenda to the Commissioners. We recommend that in Phase 1 (early), the Commission focus on rules that are necessary to bring the previously unregulated swaps market into the sound regulatory framework that exists for futures markets. This set of major rulemakings represents the largest amount of change for the industry and cannot be satisfactorily addressed in a timely manner if key elements of the regulatory framework for swaps clearing are not determined until the middle or late stages of the rulemaking process. Further, the regulatory framework for reducing systemic risk in OTC derivatives was the central focus of DFA and therefore should have the highest priority.

We suggest that Phase II (middle) deal with exchange-trading requirements for swaps, including the definition of and requirements for swap trading facilities, business conduct standards for swap dealers and requirements for swap data repositories. While we support efforts to increase transparency in swaps markets, we believe these rulemakings are less critical in time priority than the clearing mandate and related clearing rules that will reduce systemic risk.

Finally, we recommend that the Commission leave those rulemakings that deal with DCMs and position limits for Phase III (late). As I mention throughout my testimony, the exchange-traded derivatives market operated flawlessly during the financial crisis, and the proposed rules affecting DCMs and position limits, which as

discussed below, often represent an overstepping of the Commission's authority under DFA, represent incremental changes to an already robust regulatory scheme.

With respect to the phasing in of the mandatory clearing rules for swaps, some have suggested that the clearing requirement first be applied to dealer-to-dealer swaps and then later applied to dealer-to-customer swaps. CME Group strongly disagrees with this approach insofar as it may limit clearing competition and customer choice and because, more importantly, it will disadvantage customers who are preparing for central counterparty clearing of swaps but are unable to complete their preparations due to the uncertainty associated with the lack of final rules. Sell-side and buy-side participants may elect to support or prefer different clearing solutions depending on how they are owned and operated, the membership requirements associated with each clearing house, and the risk management and default management features associated with each clearing solution. Different clearing houses have already adopted differing approaches to these features, enhancing competition and the proliferation of different business models. Sequencing dealer-to-dealer clearing prior to dealer-to-customer clearing lacks any rational justification and simply limits the availability of competing clearing models, potentially limiting competition, which Congress expressly provided for in DFA.

The theory behind phasing in dealer-to-dealer swaps first is that dealers will be prepared to begin clearing swaps before buy-side participants are likewise prepared. This rationale, however, is not based in fact. An overwhelming number of buy-side participants are already clearing or ready to clear or will be ready to clear in the near future. Ten buy-side firms are already clearing at CME Group. Another 30 are testing with us and have informed us that they are planning to be prepared to clear no later than July 15. Another 80 buy-side firms are in the pipeline to clear with us and would like to be ready to clear voluntarily approximately 3–6 months before mandated to do so. Also, UBS recently conducted a comprehensive study (March 10, 2011) of OTC derivatives market participants to gauge the readiness on the buy-side for this transition. Their study found that buy-side firms are increasingly prepared to clear OTC derivatives, reporting that 73% of firms are already clearing or preparing to clear, 71% expect to begin clearing within 12 months, and 82% expect that the majority of their OTC businesses will be cleared within 2 years. Claims that buy-side participants are not ready to clear are simply false and will disadvantage buy-side firms that wish to reduce bilateral clearing risks by adopting central counterparty clearing as soon as possible.

We believe that the most efficient way to implement the clearing mandate is to phase in the mandate on a product-class by product-class basis. Once the CFTC defines "class," it can mandate that large classes of instruments, such as 10 year interest rate swaps, be cleared regardless of the counterparties to the trade. This approach will (i) preserve customer choice in clearing, (ii) bring the largest volume of swaps into clearing houses as soon as possible, and (iii) allocate the Commission's limited resources in an efficient manner. CME Group's letter to Chairman Gensler, which discusses our position on both sequencing of rulemaking and sequencing of implementation of the clearing mandate in greater detail, is attached for your reference as *Exhibit A.*

The Commission should avoid creating an un-level playing field among large swap market participants—both in terms of freedom to choose among competing clearing offerings and in terms of their ability to reduce bilateral credit risks in a timely fashion. Congress wisely recognized that major swap participants that are not swap dealers can also pose systemic risks to the marketplace; hence the Commission should sequence rules applying to swap dealers and major swap participants at the same time.

This Congress can mitigate some of the problems that have plagued the CFTC rulemaking process by extending the rulemaking schedule so that professionals, including exchanges, clearing houses, dealers, market makers, and end-users can have their views heard and so that the CFTC will have a realistic opportunity to assess those views and measure the real costs imposed by its new regulations. Otherwise, the unintended adverse consequences of those ambiguities and the rush to regulation will impair the innovative, effective risk management that regulated exchanges have provided through the recent financial crisis and stifle the intended effects of financial reform, including the clearing of OTC transactions.

C. Impact of Regulatory Proposals on U.S. Markets

Several Commissioners clearly recognize the potential unintended consequences and the potential detrimental effects of a prescriptive, rather than principles-based, regime upon the markets. Commissioner Dunn, for example, expressed concern that if the CFTC's "budget woes continue, [his] fear is that the CFTC may simply become a restrictive regulator. In essence, [it] will need to say 'No' a lot more . . . No to

anything [it does] not believe in good faith that [it has] the resources to manage" and that "such a restrictive regime may be detrimental to innovation and competition."[1] Commissioner O'Malia has likewise expressed concern regarding the effect of proposed regulations on the markets. More specifically, the Commissioner has expressed concern that new regulation could make it "too costly to clear." He noted that there are several "changes to [the] existing rules that will contribute to increased costs." Such cost increases have the effect of "reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach"[2]

Additionally, concern has been expressed regarding unduly stringent regulation driving major customers overseas; indeed, we have already seen this beginning to happen with only the threat of regulation. For example, Commissioner Sommers has noted that she was troubled by the lack of analysis of swap markets and of whether the proposal would 'cause price discovery in the commodity to shift to trading on foreign boards of trade,' and that "driving business overseas remains a long standing concern."

Conclusion

Attached to my testimony are just a few examples where the Commission has proposed rules inconsistent with DFA or that impose unjustified costs and burdens on both the industry and the Commission. As previously noted, CME Group has great concern about the number of unnecessary and overly burdensome rule proposals aimed at the regulated futures markets. The goal of Dodd-Frank was to bring transparency, safety and soundness to the over-the-counter market, not re-regulate those markets which have operated transparently and without default. However, given the CFTC has determined to issue numerous rules above and beyond what is statutorily required by DFA, we ask this Congress to extend the rulemaking schedule under DFA to allow time for industry professionals of various viewpoints to fully express their views and concerns to the Commission and for the Commission to have a realistic opportunity to assess and respond to those views and to realistically assess the costs and burdens imposed by the new regulations. To this end, we urge the Congress to ensure that the Commission performs a proper cost-benefit analysis, taking into account real financial costs to market participants, before the proposal or implementation of rules promulgated under DFA. The imposition of unnecessary

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[1] Commissioner Dunn stated: "Lastly, I would like to speak briefly about the budget crisis the CFTC is facing. The CFTC is currently operating on a continuing resolution with funds insufficient to implement and enforce the Dodd-Frank Act. My fear at the beginning of this process was that due to our lack of funds the CFTC would be forced to move from a principles based regulatory regime to a more prescriptive regime. If our budget woes continue, my fear is that the CFTC may simply become a restrictive regulator. In essence, we will need to say 'No' a lot more. No to new products. No to new applications. No to anything we do not believe in good faith that we have the resources to manage. Such a restrictive regime may be detrimental to innovation and competition, but it would allow us to fulfill our duties under the law, with the resources we have available." Commissioner Michael V. Dunn, Opening Statement, Public Meeting on Proposed Rules Under Dodd-Frank Act (January 13, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/dunnstatement011311.html*.

[2] In *Facing the Consequences: "Too Costly to Clear,"* Commissioner O'Malia stated: "I have serious concerns about the cost of clearing. I believe everyone recognizes that the Dodd-Frank Act mandates the clearing of swaps, and that as a result, we are concentrating market risk in clearinghouses to mitigate risk in other parts of the financial system. I said this back in October, and unfortunately, I have not been proven wrong yet. Our challenge in implementing these new clearing rules is in not making it 'too costly to clear.' Regardless of what the new market structures ultimately look like, hedging commercial risk and operating in general will become more expensive as costs increase across the board, from trading and clearing, to compliance and reporting."

"In the short time I have been involved in this rulemaking process, I have seen a distinct but consistent pattern. There seems to be a strong correlation between risk reduction and cash. Any time the clearing rulemaking team discusses increasing risk reduction, it is followed by a conversation regarding the cost of compliance and how much more cash is required."

"For example, there are several changes to our existing rules that will contribute to increased costs, including more stringent standards for those clearinghouses deemed to be systemically significant. The Commission staff has also recommended establishing a new margining regime for the swaps market that is different from the futures market model because it requires individual segregation of customer collateral. I am told this will increase costs to the customer and create moral hazard by reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach?" Commissioner Scott D. O'Malia, *Derivatives Reform: Preparing for Change, Title VII of the Dodd-Frank Act: 732 Pages and Counting,* Keynote Address (January 25, 2011) *http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-3.html*.

costs and restrictions on market participants can only result in the stifling of growth of the U.S. futures industry, send market participants to overseas exchanges, and in the end, result in harm to the U.S. economy and loss of American jobs. We urge the Congress to ensure that implementation of DFA is consistent with the Congressional directives in the Act and does not unnecessarily harm hedging and risk transfer markets that U.S. companies depend upon to reduce business risks and increase economic growth.

APPENDIX

Concerns Regarding Specific Rulemakings

We are concerned that many of the Commission's proposed rulemakings go beyond the specific mandates of DFA, and are not legitimately grounded in evidence and economic theory. I will now address, in turn, several proposed rules issued by the Commission that illustrate these problems.

1. Advance Notice of Proposed Rulemaking on Protection of Cleared Swaps Customers Before and After Commodities Broker Bankruptcies[3]

In its Advanced Notice of Proposed Rulemaking ("ANPR") regarding segregation of customer funds, the Commission notes that it is considering imposing an "individual segregation" model for customer funds belonging to swaps customers. Such a model would impose unnecessary costs on derivatives clearing organizations ("DCOs") and customers alike. As noted in the ANPR, DCOs have long followed a model (the "baseline model") for segregation of collateral posted by customers to secure contracts cleared by a DCO whereby the collateral of multiple futures customers of a futures commission merchant ("FCM") is held together in an omnibus account. If the FCM defaults to the DCO because of the failure of a customer to meet its obligations to the FCM, the DCO is permitted (but not required), in accordance with the DCO's rules and CFTC regulations, to use the collateral of the FCM's other futures customers in the omnibus account to satisfy the FCM's net customer futures obligation to the DCO. Under the baseline model, customer collateral is kept separate from the property of FCMs and may be used exclusively to "purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers."[4] A DCO may not use customer collateral to satisfy obligations coming out of an FCM's proprietary account.

In its ANPR, the Commission suggests the possibility of applying a different customer segregation model to collateral posted by swaps customers, proposing three separate models, each of which requires some form of "individual segregation" for customer cleared-swap accounts. Each of these models would severely limit the availability of other customer funds to a DCO to cure a default by an FCM based on the failure of a customer to meet its obligations to the DCO. The imposition of any of these alternative models first, is outside of the Commission's authority under DFA and second, will result in massive and unnecessary costs to DCOs as well as to customers—the very individuals such models are allegedly proposed to protect.

CME Group recognizes that effective protection of customer funds is, without a doubt, critical to participation in the futures and swaps markets. This fact does not, however, call for a new segregation regime. The baseline model has performed this function admirably over the years, with no futures customers suffering a loss as a result of an FCM's bankruptcy or default. There is no reason to believe it will not operate as well in the swaps market. DFA did nothing to change this segregation regime as applied to futures, and a focus of Dodd-Frank is to bring the OTC swaps market into a regulatory scheme similar to that which allowed the futures markets to function flawlessly throughout the financial crisis. To this end, it is nonsensical that Congress would intend to require a different scheme of segregation of customer funds and as a result, a different margining and default model than that currently used in the futures markets. Imposing such a conflicting model would complicate the function of DCOs intending to clear both futures and swaps. Indeed, the statutory language adopted in Section 724 of DFA does nothing to compel such a result.

The imposition of a different customer segregation system could undermine the intent behind DFA by imposing significantly higher costs on customers, clearing members, and DCOs intending to clear swaps and injecting moral hazard into a system at the customer and FCM levels. A change from the baseline model would interfere with marketplace and capital efficiency as DCOs may be required to increase security deposits from clearing members. That is, depending on the exact methodology employed, DCOs may be forced to ask for more capital from clearing members.

[3] 75 *Fed. Reg.* 75162 (proposed Dec. 2, 2010) (to be codified at 17 CFR pt. 190).
[4] *See,* Reg. 1.20(a).

Based on CME Group's initial assessments, these increases in capital requirements would be substantial. For example, CME Group's guarantee fund would need to double in size. Aside from these monetary costs, adoption of a segregation model would create moral hazard concerns at the FCM level. That is, the use of the new proposed models could create a disincentive for an FCM to offer the highest level of risk managements to its customers if the oversight and management of individual customer risk was shifted to the clearing house and continue to carry the amount of excess capital they do today.

Imposition of the suggested systems could increase costs and decrease participation in the CFTC-regulated cleared-swaps market because customers may be unable or unwilling to satisfy resultant substantially increased margin requirements. FCMs would face a variety of increased indirect costs, such as staffing costs, new systems and compliance and legal costs and direct costs such as banking and custodial fees. FCMs would likely, in turn, pass these costs on to customers. Additionally, smaller FCMs may be forced out of business, larger FCMs may not have incentive to stay in business, and firms otherwise qualified to act as FCMs may be unwilling to do so due to the risk and cost imposed upon the FCM model by individualized segregation. This could lead to a larger concentration of customer exposures at fewer FCMs, further increases to margin and guarantee fund requirements, and further increased costs to customers. All of these consequences would lead to decreased participation in U.S. futures and swaps exchanges and result in loss of jobs in the United States.

2. Proposed Rulemaking on Position Limits [5]

A prime example of a refusal to regulate in strict conformance with DFA, is the Commission's proposal to impose broad, fixed position limits for all physically delivered commodities. The Commission's proposed position limit regulations ignore the clear Congressional directives, which DFA added to Section 4a of the CEA, to set position limits "as the Commission finds are necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of" a commodity.[6] Without any basis to make this finding, the Commission instead justified its position limit proposal as follows:

> The Commission is not required to find that an undue burden on interstate commerce resulting from excessive speculation exists *or is likely to occur in the future* in order to impose position limits. Nor is the Commission required to make an affirmative finding that position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices or otherwise necessary for market protection. Rather, the Commission may impose position limits prophylactically, based on its reasonable judgment that such limits are necessary for the purpose of "diminishing, eliminating, or preventing" such burdens on interstate commerce that the Congress has found result from excessive speculation. 76 *Federal Register* 4752 at 4754 (January 26, 2011), Position Limits for Derivatives. (emphasis supplied).

At the December 15, 2010, hearing of the General Farm Commodities and Risk Management Subcommittee of the House Agriculture Committee on the subject of the implementation of DFA's provisions respecting position limits, there was strong bipartisan agreement among the Subcommittee Members with the sentiments expressed by Representative Moran:

> "Despite what some believe is a mandate for the Commission to set position limits within a definite period of time, the Dodd-Frank legislation actually qualifies CFTC's position-limit authority. Section 737 of the Dodd-Frank Act amends the Commodity Exchange Act so that Section 4A–A2A states, 'The Commission shall, by rule, establish limits on the amount of positions as appropriate.' The Act then states, 'In subparagraph B, for exempt commodities, the limit required under subparagraph A shall be established within 180 days after the date of enactment of this paragraph.' When subparagraphs A and B are read in conjunction, the Act states that when position limits are required under subparagraph A, the Commission shall set the limits within 180 days under paragraph B. Subparagraph A says the position-limit rule should be only prescribed when appropriate.
>
> "Therefore, the 180 day timetable is only triggered if position limits are appropriate. In regard to the word 'appropriate,' the Commission has three distinct

[5] 76 *Fed. Reg.* 4752 (proposed Jan. 26, 2011) (to be codified at 17 CFR pts. 1, 150–51)

[6] My December 15, 2010, testimony before the Subcommittee on General Farm Commodities and Risk Management of the House Committee on Agriculture includes a more complete legal analysis of the DFA requirements.

problems. First, the Commission has never made an affirmative finding that position limits are appropriate to curtail excessive speculation. In fact, to date, the only reports issued by the Commission or its staff failed to identify a connection between market trends and excessive speculation. This is not to say that there is no connection, but it does say the Commission does not have enough information to draw an affirmative conclusion.

"The second and third issues relating to the appropriateness of position limits are regulated to adequacy of information about OTC markets. On December 8, 2010, the Commission published a proposed rule on swap data record-keeping and reporting requirements. This proposed rule is open to comment until February 7, 2011, and the rule is not expected to be final and effective until summer at the earliest. Furthermore, the Commission has yet to issue a proposed rulemaking about swap data repositories. Until a swap data repository is set up and running, it is difficult to see how it would be appropriate for the Commission to set position limits."

CME is not opposed to position limits and other means to prevent market congestion; we employ limits in most of our physically delivered contracts. However, we use limits and accountability levels, as contemplated by the Congressionally-approved Core Principles for DCMs, to mitigate potential congestion during delivery periods and to help us identify and respond in advance of any threat to manipulate our markets. CME Group believes that the core purpose that should govern Federal and exchange-set position limits, to the extent such limits are necessary and appropriate should be to reduce the threat of price manipulation and other disruptions to the integrity of prices. We agree that such activity destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery and we have the greatest incentive and best information to prevent such misconduct.

It is important not to lose sight of the real economic cost of imposing unnecessary and unwarranted position limits. For the last 150 years, modern day futures markets have served as the most efficient and transparent means to discover prices and manage exposure to price fluctuations. Regulated futures exchanges operate centralized, transparent markets to facilitate price discovery by permitting the best informed and most interested parties to express their opinions by buying and selling for future delivery. Such markets are a vital part of a smooth functioning economy. Futures exchanges allow producers, processors and agribusiness to transfer and reduce risks through *bona fide* hedging and risk management strategies. This risk transfer means producers can plant more crops. Commercial participants can ship more goods. Risk transfer only works because speculators are prepared to provide liquidity and to accept the price risk that others do not. Futures exchanges and speculators have been a force to reduce price volatility and mitigate risk. Overly restrictive position limits adversely impact legitimate trading and impair the ability of producers to hedge. They may also drive certain classes of speculators into physical markets and consequently distort the physical supply chain and prices.

Similarly troubling is the fact that the CFTC's proposed rules in this and other areas affecting market participants are not in harmony with international regulators. International regulators, such as the E.U., are far from adopting such a prescriptive approach with respect to position limits. Ultimately, this could create an incentive for market participants to move their business to international exchanges negatively impacting the global leadership of the U.S. financial market. Furthermore, exporting the price discovery process to overseas exchanges will likely result in both a loss of jobs in the U.S. and less cost-efficient hedging for persons in business in the U.S. As an example, consider the two major price discovery indexes in crude oil: West Texas Intermediate, which trades on NYMEX, and Brent Oil, which trades overseas. If the Commission places heavy restrictions in areas such as position limits on traders in the U.S., traders in crude oil, and with them the price discovery process, are likely to move to overseas markets.

3. Proposed Rulemaking on Mandatory Swaps Clearing Review Process [7]

Another example of a rule proposal that could produce consequences counter to the fundamental purposes of DFA is the Commission's proposed rule relating to the process for review of swaps for mandatory clearing. The proposed regulation treats an application by a DCO to list a particular swap for clearing as obliging that DCO to perform due diligence and analysis for the Commission respecting a broad swath of swaps, as to which the DCO has no information and no interest in clearing. In effect, a DCO that wishes to list a new swap would be saddled with the obligation

[7] 75 *Fed. Reg.* 667277 (proposed Nov. 2, 2010) (to be codified at 17 CFR pts. 1, 150, 151).

to collect and analyze massive amounts of information to enable the Commission to determine whether the swap that is the subject of the application and any other swap that is within the same "group, category, type, or class" should be subject to the mandatory clearing requirement.

This proposed regulation is one among several proposals that impose costs and obligations whose effect and impact are contrary to the purposes of Title VII of DFA. The costs in terms of time and effort to secure and present the information required by the proposed regulation would be a significant disincentive to DCOs to voluntarily undertake to clear a "new" swap. The Commission lacks authority to transfer the obligations that the statute imposes on it to a DCO. The proposed regulation eliminates the possibility of a simple, speedy decision on whether a particular swap transaction can be cleared—a decision that the DFA surely intended should be made quickly in the interests of customers who seek the benefits of clearing—and forces a DCO to participate in an unwieldy, unstructured and time-consuming process to determine whether mandatory clearing is required. Regulation Section 39.5(b)(5) starkly illustrates this outcome. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. Completion is determined in the sole discretion of the Commission. Only then does the 90 day period begin to run. This process to enable an exchange to list a swap for clearing is clearly contrary to the purposes of DFA.

4. Conversion from Principles-Based to Rules-Based Regulation [8]

Some of the CFTC's rule proposals are explained by the ambiguities created during the rush to push DFA to a final vote. For example, Congress preserved and expanded the scheme of principles-based regulation by expanding the list of core principles and granting self regulatory organizations "reasonable discretion in establishing the manner in which the [self regulatory organization] complies with the core principles." Congress granted the Commission the authority to adopt rules respecting core principles, but did not direct it to eliminate the principles-based regulation, which was the foundation of the CFMA. In accordance with CFMA, the CFTC set forth "[g]uidance on, and Acceptable Practices in, Compliance with Core Principles" that operated as safe harbors for compliance. This approach has proven effective and efficient in terms of appropriately allocating responsibilities between regulated DCMs and DCOs and the CFTC.

We recognize that the changes instituted by DFA give the Commission discretion, where necessary, to step back from this principles-based regime. Congress amended the CEA to state that boards of trade "shall have reasonable discretion in establishing the manner in which they comply with the core principles, unless otherwise determined by the Commission by rule or regulation." *See, e.g.,* DFA § 735(b), amending Section 5(d)(1)(B) of the CEA. But the language clearly assumes that the principles-based regime will remain in effect except in limited circumstances in which more specific rules addressing compliance with a core principle are necessary. The Commission has used this change in language, however, to propose specific requirements for multiple Core Principles—almost all Core Principles in the case of DCMs—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

The Commission's almost complete reversion to a prescriptive regulatory approach converts its role from an oversight agency, responsible for assuring self regulatory organizations comply with sound principles, to a front line decision maker that imposes its business judgments on the operational aspects of derivatives trading and clearing. This reinstitution of rule-based regulation will require a substantial increase in the Commission's staff and budget and impose indeterminable costs on the industry and the end-users of derivatives. Yet there is no evidence that this will be beneficial to the public or to the functioning of the markets. In keeping with the President's Executive Order to reduce unnecessary regulatory cost, the CFTC should be required to reconsider each of its proposals with the goal of performing those functions that are mandated by DFA.

Further, the principles-based regime of the CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearing houses permitted U.S. exchanges to regain their competitive position in the global market. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA. Indeed, U.S. futures exchanges have operated more efficiently, more economically and with fewer complaints under this system than at any time in their

[8] *See,* 75 *Fed. Reg.* 80747 (proposed Dec. 22, 2010) (to be codified at 17 CFR pts. 1, 16, 38).

history. The transition to an inflexible regime threatens to stifle growth and innovation in U.S. exchanges and thereby drive market participants overseas. This, I noted earlier, will certainly impact the relevant job markets in the United States.

(a) Proposed Rulemaking under Core Principle 9 for DCMs

A specific example of the Commission's unnecessary and problematic departure from the principles-based regime is its proposed rule under Core Principle 9 for DCMs—Execution of Transactions, which states that a DCM "shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market" but that "the rules of a board of trade may authorize . . . (i) transfer trades or office trades; (ii) an exchange of (I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps; or (iii) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]."

Proposed Rule 38.502(a) would require that 85% or greater of the total volume of any contract listed on a DCM be traded on the DCM's centralized market, as calculated over a 12 month period. The Commission asserts that this is necessary because "the price discovery function of trading in the centralized market" must be protected. 75 *Fed. Reg.* at 80588. However, Congress gave no indication in DFA that it considered setting an arbitrary limit as an appropriate means to regulate under the Core Principles. Indeed, in other portions of DFA, where Congress thought that a numerical limit could be necessary, it stated so. For example, in Section 726 addressing rulemaking on Conflicts of Interest, Congress specifically stated that rules "may include numerical limits on the control of, or the voting rights" of certain specified entities in DCOs, DCMs or SEFs.

The Commission justifies the 85% requirement only with its observations as to percentages of various contracts traded on various exchanges. It provides no support evidencing that the requirement will provide or is necessary to provide a "competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade," as is required under Core Principle 9. Further, Core Principle 9, as noted above, expressly permits DCMs to authorize off-exchange transactions including for exchanges to related positions pursuant to their rules.

The imposition of the proposed 85% exchange trading requirement will have extremely negative effects on the industry. It would significantly deter the development of new products by exchanges like CME. This is because new products generally initially gain trading momentum in off-exchange transactions. Indeed, it takes years for new products to reach the 85% exchange trading requirement proposed by the Commission. For example, one suite of very popular and very liquid foreign exchange products developed and offered by CME would not have met the 85% requirement for 4 years after it was initially offered. The suite of products' on-exchange trading continued to increase over 10 years, and it now trades only 2% off exchange. Under the proposed rule, CME would have had to delist this suite of products.[9]

Imposition of an 85% exchange trading requirement would also have adverse effects on market participants. If instruments that are most often traded off-exchange are forced onto the centralized market, customers will lose cross-margin efficiencies that they currently enjoy and will be forced to post additional cash or assets as margin. For example, customers who currently hold open positions on CME Clearport® will be required to post a total of approximately $3.9 billion in margin (at the clearing firm level, across all clearing firms).

(b) Proposed Comparable Fee Structures Under Core Principle 2 for DCMs

In the case of certain proposed fee restrictions to be placed on DCMs, the Commission not only retreats needlessly from principles-based regulation but also greatly exceeds its authority under DFA. DCM Core Principle 2, which appears in DFA Section 735, states, in part, that a DCM "shall establish, monitor, and enforce compliance with rules of the contract market including . . . access requirements." Under this Core Principle, the Commission has proposed rule 38.151, which states that a DCM "must provide its members, market participants and independent software

[9] More specifically, the product traded 32% off-exchange when it was first offered in 2000, 31% off exchange in 2001, 25 % in 2002, 20% in 2003, finally within the 85% requirement at 13% off-exchange in 2004, 10% in 2005, 7% in 2006, 5% in 2007, 3% in 2008, and 2% in 2009 and 2010.

vendors with impartial access to its market and services including . . . comparable fee structures for members, market participants and independent software vendors receiving equal access to, or services from, the [DCM].”

The CFTC’s attempt to regulate DCM member, market participant and independent software vendor fees is unsupportable. The CFTC is expressly authorized by statute to charge reasonable fees to recoup the costs of services it provides. 7 U.S.C. 16a(c). The Commission may not bootstrap that authority to set or limit the fees charged by DCMs or to impose an industry-wide fee cap that has the effect of a tax. *See, Federal Power Commission* v. *New England Power Co.,* 415 U.S. 345, 349 (1974) (“[W]hole industries are not in the category of those who may be assessed [regulatory service fees], the thrust of the Act reaching only specific charges for specific services to specific individuals or companies.”). In any event, the CFTC’s overreaching is not supported by DFA. Nowhere in the CEA is the CFTC authorized to set or limit fees a DCM may charge. To the extent the CFTC believes its authority to oversee impartial access to trading platforms may provide a basis for its assertion of authority, that attempt to read new and significant powers into the CEA should be rejected.

5. Provisions Common to Registered Entities [10]

The CFMA streamlined the procedures for listing new products and amending rules that did not impact the economic interests of persons holding open contracts. These changes recognized that the previous system required the generation of substantial unnecessary paperwork by exchanges and by the CFTC’s staff. It slowed innovation without a demonstrable public benefit.

Under current rules, before a product is self-certified or a new rule or rule amendment is proposed, DCMs and DCOs conduct a due diligence review to support their conclusion that the product or rule complies with the Act and Core Principles. The underlying rationale for the self-certification process which has been retained in DFA, is that registered entities that list new products have a self-interest in making sure that the new products meet applicable legal standards. Breach of this certification requirement potentially subjects the DCM or DCO to regulatory liability. In addition, in some circumstances, a DCM or DCO may be subject to litigation or other commercial remedies for listing a new product, and the avoidance of these costs and burdens is sufficient incentive for DCMs and DCOs to remain compliant with the Act.

Self-certification has been in effect for 10 years and nothing has occurred to suggest that this concept is flawed or that registered entities have employed this power recklessly or abusively. During 2010, CME launched 438 new products and submitted 342 rules or rule amendments to the Commission. There was no legitimate complaint respecting the self-certification process during this time. Put simply, the existing process has worked, and there is no reason for the Commission to impose additional burdens, which are not required by DFA, to impair that process.

Section 745 of DFA merely states, in relevant part, that “a registered entity may elect to list for trading or accept for clearing any new contract, or other instrument, or may elect to approve or implement any new rule or rule amendment, by providing to the Commission a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act).” DFA does not direct the Commission to require the submission of all documents supporting the certification nor to require a review of the legal implications of the product or rule with regard to laws other than DFA. Essentially, it requires exactly what was required prior to the passage of DFA—a certification that the product, rule or rule amendment complies with the CEA. Nonetheless, the Commission has taken it upon itself to impose these additional and burdensome submission requirements upon registered entities.

The new requirements proposed by the CFTC will require exchanges to prematurely disclose new product innovations and consequently enable foreign competitors to introduce those innovations while the exchange awaits CFTC approval. This, again, inhibits the ability of U.S. exchanges to compete, drives market participants overseas and impairs job growth in the United States. Moreover, given the volume of filings required by the notice of proposed rulemaking, the Commission will require significant increases in staffing and other resources. Alternatively, the result will be that these filings will not be reviewed in a timely manner, further disadvantaging U.S. exchanges. Again, we would suggest that the Commission’s limited resources should be better aligned with the implementation of the goals of DFA rather than “correcting” a well-functioning and efficient process.

[10] 75 *Fed. Reg.* 67282 (proposed Nov. 2, 2010) (to be codified at 17 CFR pt. 40).

First, the proposed rules require a registered entity to submit "all documentation" relied upon to determine whether a new product, rule or rule amendment complies with applicable Core Principles. This requirement is so vague as to create uncertainty as to what is actually required to be filed. More importantly, this requirement imposes an additional burden on both registered entities, which must compile and produce all such documentation, and the Commission, which must review it. It is clear that the benefits, if any, of this requirement are significantly outweighed by the costs imposed both on the marketplace and the Commission.

Second, the proposed rules require registered entities to examine potential legal issues associated with the listing of products and include representations related to these issues in their submissions. Specifically, a registered entity must provide a certification that it has undertaken a due diligence review of the legal conditions, including conditions that relate to contractual and intellectual property rights. The imposition of such a legal due diligence standard is clearly outside the scope of DFA and is unnecessarily vague and impractical, if not impossible, to comply with in any meaningful manner. An entity, such as CME, involved in product creation and design is always cognizant that material intellectual property issues may arise. This requirement would force registered entities to undertake extensive intellectual property analysis, including patent, copyright and trademark searches in order to satisfy the regulatory mandates, with no assurances that any intellectual property claim is discoverable through that process at a particular point in time. Again, this would greatly increase the cost and timing of listing products without providing any corresponding benefit to the marketplace. Indeed, the Commission itself admits in its NOPR that these proposed rules will increase the overall information collection burden on registered entities *by approximately 8,300 hours per year.*[11]

Further, these rules steer the Commission closer to the product and rule approval process currently employed by the SEC, which is routinely criticized and about which those regulated by the SEC complained at the CFTC–SEC harmonization hearings. Indeed, William J. Brodsky of the Chicago Board of Options Exchange testified that the SEC's approval process "inhibits innovation in the securities markets" and urged the adoption of the CFTC's certification process.

6. Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest[12]

The Commission's proposed rules regarding the mitigation of conflicts of interest in DCOs, DCMs and SEFs ("Regulated Entities") also exceed its rulemaking authority under DFA and impose constraints on governance that are unrelated to the purposes of DFA or the CEA. The Commission purports to act pursuant to Section 726 of DFA but ignores the clear boundaries of its authority under that section, which it cites to justify taking control of every aspect of the governance of those Regulated Entities. Section 726 conditions the Commission's right to adopt rules mitigating conflicts of interest to circumstances where the Commission has made a finding that the rule is "necessary and appropriate" to "improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest *in connection with a swap dealer or major swap participant's conduct of business with,* a [Regulated Entity] that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment." (emphasis added) The "necessary and appropriate" requirement constrains the Commission to enact rules that are narrowly-tailored to minimize their burden on the industry. The Commission failed to make the required determination that the proposed regulations were "necessary and proper" and, unsurprisingly, the proposed rules are not narrowly-tailored but rather overbroad, outside of the authority granted to it by DFA and extraordinarily burdensome.

The Commission proposed governance rules and ownership limitations that affect all Regulated Entities, including those in which no swap dealer has a material debt or equity investment and those that do not even trade or clear swaps. Moreover, the governance rules proposed have nothing to do with conflicts of interest, as that term is understood in the context of corporate governance. Instead, the Commission has created a concept of "structural conflicts," which has no recognized meaning outside of the Commission's own declarations and is unrelated to "conflict of interest" as used in the CEA. The Commission proposed rules to regulate the ownership of voting interests in Regulated Entities by any member of those Regulated Entities, including members whose interests are unrelated or even contrary to the interests

[11] 75 *Fed. Reg.* at 67290.

[12] 75 *Fed. Reg.* 63732 (proposed October 18, 2010) (to be codified at 17 CFR pts. 1, 37, 38, 39, 40).

of the defined "enumerated entities." In addition, the Commission is attempting to impose membership condition requirements for a broad range of committees that are unrelated to the decision making to which Section 726 was directed.

The Commission's proposed rules are most notably overbroad and burdensome in that they address not only ownership issues but the internal structure of public corporations governed by state law and listing requirements of SEC regulated national securities exchanges. More specifically, the proposed regulations set requirements for the composition of corporate boards, require Regulated Entities to have certain internal committees of specified compositions and even propose a new definition for a "public director." Such rules in no way relate to the conflict of interest Congress sought to address through Section 726. Moreover, these proposed rules improperly intrude into an area of traditional state sovereignty. It is well-established that matters of internal corporate governance are regulated by the states, specifically the state of incorporation. Regulators may not enact rules that intrude into traditional areas of state sovereignty unless Federal law compels such an intrusion. Here, Section 726 provides no such authorization.

Perhaps most importantly, the proposed structural governance requirements cannot be "necessary and appropriate," as required by DFA, because applicable state law renders them completely unnecessary. State law imposes fiduciary duties on directors of corporations that mandate that they act in the best interests of the corporation and its shareholders—not in their own best interests or the best interests of other entities with whom they may have a relationship. As such, regardless of how a board or committee is composed, the members must act in the best interest of the exchange or clearinghouse. The Commission's concerns—that members, enumerated entities, or other individuals not meeting its definition of "public director" will act in their own interests—and its proposed structural requirements are wholly unnecessary and impose additional costs on the industry—not to mention additional enforcement costs—completely needlessly.

7. Prohibition on Market Manipulation [13]

The Commission's proposed rules on Market Manipulation, although arguably within the authority granted by DFA, are also problematic because they are extremely vague. The Commission has proposed two rules related to market manipulation: Rule 180.1, modeled after SEC Rule 10b–5 and intended as a broad, catch-all provision for fraudulent conduct; and Rule 180.2, which mirrors new CEA Section 6(c)(3) and is aimed at prohibiting price manipulation. *See* 75 *Fed. Reg.* at 67658. Clearly, there is a shared interest among market participants, exchanges and regulators in having market and regulatory infrastructures that promote fair, transparent and efficient markets and that mitigate exposure to risks that threaten the integrity and stability of the market. In that context, however, market participants also desire clarity with respect to the rules and fairness and consistency with regard to their enforcement.

As to its proposed rule 180.1, the Commission relies on SEC precedent to provide further clarity with respect to its interpretation and notes that it intends to implement the rule to reflect its "distinct regulatory mission." However, the Commission fails to explain how the rule and precedent will be adapted to reflect the differences between futures and securities markets. *See* 75 *Fed. Reg.* at 67658–60. For example, the Commission does not provide clarity as to if and to what extent it intends to apply insider trading precedent to futures markets. Making this concept applicable to futures markets would fundamentally change the nature of the market, not to mention all but halting participation by hedgers, yet the Commission does not even address this issue. Rule 180.1 is further unclear as to what standard of *scienter* the Commission intends to adopt for liability under the rule. Rule 180.2 is comparably vague, providing, for example, no guidance as to what sort of behavior is "intended to interfere with the legitimate forces of supply and demand" and how the Commission intends to determine whether a price has been affected by illegitimate factors.

These proposed rules, like many others, have clearly been proposed in haste and fail to provide market participants with sufficient notice of whether contemplated trading practices run afoul of them. Indeed, we believe the proposed rules are so unclear as to be subject to constitutional challenge. That is, due process precludes the government from penalizing a private party for violating a rule without first providing adequate notice that conduct is forbidden by the rule. In the area of market manipulation especially, impermissible conduct must be clearly defined lest the rules chill legitimate market participation and undermine the hedging and price discovery functions of the market by threatening sanctions for what otherwise would be considered completely legal activity. That is, if market participants do not know

[13] 75 *Fed. Reg.* 67657–62 (proposed Nov. 3, 2010) (to be codified at 17 CFR pt. 180).

the rules of the road in advance and lack confidence that the disciplinary regime will operate fairly and rationally, market participation will be chilled because there is a significant risk that legitimate trading practices will be arbitrarily construed, *post-hoc,* as unlawful. These potential market participants will either use a different method to manage risk or go to overseas exchanges, stifling the growth of U.S. futures markets and affecting related job markets.

8. Anti-Disruptive Practices Authority Contained in DFA [14]

Rules regarding Disruptive Trade Practices (DFA Section 747) run the risk of being similarly vague and resulting in chilling market participation. The CFTC has recently issued a Proposed Interpretive Order which provides guidance regarding the three statutory disruptive practices set for in DFA Section 747.[15] CME Group applauds the Commission's decision to clarify the standards for liability under the enumerated disruptive practices and supports the Commission's decision to refrain from setting forth any additional "disruptive practices" beyond those listed in the statute. We believe, however, that in several respects, the proposed interpretations still do not give market participants enough notice as to what practices are illegal and also may interfere with their ability to trade effectively.

For example, the Commission interprets section 4c(a)(5)(A), Violating Bids and Offers, "as prohibiting any person from buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price" regardless of intent.[16] However, certain existing platforms allow trading based on considerations other than price. Without an intent requirement, these platforms do not "fit" under the regulations, and presumably will be driven out of business. Similarly, market participants desiring to legitimately trade on bases other than price will presumably be driven to overseas markets.

Further, the Commission states that section 4c(a)(5)(B), Orderly Execution of Transactions During the Closing Period, applies only where a participant "demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period." However, the Commission goes on to state that "market participants should assess market conditions and consider how their trading practices and conduct affect the orderly execution of transactions during the closing period." In so stating, the Commission seems to impose an affirmative obligation on market participants to consider these factors before executing any trade. This, first, directly conflicts with the *scienter* requirements also set forth by the Commission and thus interferes with the ability of market participants to determine exactly what conduct may give rise to liability. Second, such an affirmative obligation will interfere with the ability of market participants to make advantageous trades, especially in the context of a fast-moving, electronic trading platform. The end result of both these issues is that, if the Interpretive Order goes into effect as written, market participation will be chilled, participants will move to overseas markets and jobs will be lost in the U.S. futures industry.

Section 747 of DFA, which authorizes the Commission to promulgate additional rules if they are reasonably necessary to prohibit trading practices that are "disruptive of fair and equitable trading," is exceedingly vague as written and does not provide market participants with adequate notice as to whether contemplated conduct is forbidden. If the Interpretive Order does not clearly define "disruptive trade practices," it will discourage legitimate participation in the market and the hedging and price discovery functions of the market will be chilled due to uncertainty among participants as to whether their contemplated conduct is acceptable.

9. Effects on OTC Swap Contracts

DFA's overhaul of the regulatory framework for swaps creates uncertainty about the status and validity of existing and new swap contracts. Today, under provisions enacted in 2000, swaps are excluded or exempt from the CEA under Sections 2(d), 2(g) and 2(h) of the CEA. These provisions allow parties to enter into swap transactions without worrying about whether the swaps are illegal futures contracts under CEA Section 4(a). DFA repeals those exclusions and exemptions effective July 16, 2011. At this time, it is unclear what if any action the CFTC plans to take or legally could take to allow both swaps entered into on or before July 16, and those swaps entered into after July 16 from being challenged as illegal futures contracts. To address this concern, Congress and the CFTC should consider some combination of deferral of the effective dates of the repeal of Sections 2(d), 2(g) and 2(h), exercise of CFTC exemptive power under Section 4(c) or other appropriate action. Otherwise

[14] 75 *Fed. Reg.* 67301 (proposed November 2, 2010) (to be codified at 17 CFR pt. 1).
[15] 76 *Fed. Reg.* 14943 (proposed March 18, 2011).
[16] 76 *Fed. Reg.* 14946 (proposed March 18, 2011).

swap markets may be hit by a wave of legal uncertainty which the statutory exclusions and exemptions were designed in 2000 to prevent. This uncertainty may, again, chill participation in the swap market and impair the ability of market participants, including hedgers, to manage their risks.

The CHAIRMAN. Thank you, Mr. Duffy.

Mr. Scott for 5 minutes.

STATEMENT OF HAL S. SCOTT, J.D., DIRECTOR, COMMITTEE ON CAPITAL MARKETS REGULATION; NOMURA PROFESSOR AND DIRECTOR, PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, HARVARD LAW SCHOOL, CAMBRIDGE, MA

Mr. SCOTT. Thank you, Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee, for permitting me to testify before you today.

I am testifying in my own capacity and do not purport to represent the views of the Committee on Capital Markets Regulation. My testimony is focused on the implementation of the Dodd-Frank Act, with emphasis on the CFTC.

The 44 rules that the CFTC—it was 46, actually, given yesterday—has promulgated so far and the rules that are yet to come will work a total revolution on the regulation of the over-the-counter derivatives market. I think we should understand the massive nature of the regulatory effort that we are engaged in here.

The CFTC has finished proposing most of its rules, and we are just 3 months away from the July deadline, by which time many of the most important rules must be finalized. Unfortunately, the proposals have come out in a somewhat scattershot order. And, before we move forward toward finalizing and implementing the rules, we need to have a more comprehensive and rational approach.

Once all of the rules have been proposed, CFTC should develop a public published statement as to how all of its rules fit together and in what order the final rules should be issued. The joint CFTC and SEC roundtable on implementation, planned for May 2 and 3, is a first step in that direction but only a first step.

After it has put all this together, it then should do a re-proposal of the entire package of rules and permit another round of comment on the substance of this package, which should include, as I said, plans for implementation.

The Federal Reserve should play a key part in this rulemaking process, as it plays a large role in regulating the risk of the major participants in the derivatives clearinghouses as well as the clearinghouses themselves. A failure of a clearinghouse would be a major systemic shock to the financial system. Indeed, for this reason, in my view, the Fed should approve the substance and implementation of the plans of these Commissions.

I should also emphasize the importance of the SEC and CFTC conducting proper cost-benefit analyses before finalizing these rules. Although neither agency is subject to the Executive Order President Obama issued in January, requiring review of the cost-benefit analysis by the Office of Information and Regulatory Affairs, OIRA, within the Office of Management and Budget, the heads of both of these Commissions have said they will comply with its principles. Neither has, however, in my view, come close.

Without better cost-benefit analysis, these rules risk overturn in the D.C. Circuit. The D.C. Circuit has overturned other regulatory rules for lack of proper foundation. And it is not enough to consider cost and benefits. They have to be analyzed, and conclusions have to be made.

I also want to talk a little bit about the international situation. As you know, other jurisdictions, and in particular the European Union, are working on a very similar regulatory overhaul of their over-the-counter derivatives regulation.

Now, although the E.U. proposal is similar to the U.S. system, or system of proposals, with respect to its emphasis on central clearing, there are many important differences. For example, the European Union places less emphasis on exchange trading, on price transparency, and creates a broader end-user exemption.

So, to some extent, these differences are a matter of the statutes, Dodd-Frank *versus* what this proposed directive of the E.U. is. But the CFTC does have the power to bring its regulation of clearinghouse risks closer to that of Europe. Both Europe and the U.S. will recognize a foreign clearinghouse for participation by the firms that it is regulating, but only if that clearinghouse is subject to similar requirements of those in its home country. So the E.U. is going to look at our rules and say, are they basically equivalent to the E.U. rules? And we are going to look at their rules and say, are they basically equivalent to our rules?

Now, if they diverge too much, we are going to have a stalemate situation. Our firms aren't going to be able to be in the E.U. because those rules are not equivalent, and their firms aren't going to be able to be here because they are not equivalent. This is a very undesirable outcome. It would be, actually, better if we had a complete arbitrage than to have a stalemate. So, the point being that, in this whole consideration of the re-proposal, in my view, more has to be done to coordinate our approach with the E.U.

Finally, I agree with Mr. Duffy that, overall, the approach of the CFTC, now and shortly, has been micro-management. I think what we need is more of a principles-based approach. And I actually congratulate the SEC on sticking to that approach.

Thank you.

[The prepared statement of Mr. Scott follows:]

PREPARED STATEMENT OF HAL S. SCOTT, J.D., DIRECTOR, COMMITTEE ON CAPITAL MARKETS REGULATION; NOMURA PROFESSOR, AND DIRECTOR, PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, HARVARD LAW SCHOOL,[1] CAMBRIDGE, MA

Thank you, Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee for permitting me to testify before you today on the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2] I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although much of my testimony is based on the past reports and statements of the Committee on Capital Markets Regulation.

I will focus my remarks on the regulatory implementation of the portions of the Dodd-Frank Act relating to derivatives, with emphasis on the role of the Commodity Futures Trading Commission (CFTC). As you know, these rules will have a profound

[1] Biography with disclosures on compensated activities available at *http://www.law.harvard.edu/faculty/hscott*.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (hereinafter Dodd-Frank Act).

long-term impact on our financial system. It is important to get them right the first time, or else we risk making the U.S. financial system more risky and less competitive internationally.

The Dodd-Frank Act requires many of its most important rules to be finalized by late July 2011, just over 3 months away. The CFTC has the major role in writing the rules governing derivatives and Chairman Gensler has stated that the CFTC is almost finished issuing its proposals—*albeit* some important ones remain. On the other hand, the CFTC has yet to issue a major final rule about derivatives and at least some major rules will likely slip past the July finalization deadline. I do not fault the CFTC for missing deadlines. In fact, in testimony I delivered in January before the Committee on Financial Services, I said, "the most important objective should be to get the rules right, not to act quickly."[3] I still believe this is the case.

The proposed rulemaking process has unfortunately been scattershot. It was difficult for the public or markets to understand how the issuance of 44 proposed rules over 5 months would fit together. Before finalizing these rules the CFTC (as well as the SEC) should re-propose all of these rules and describe how they fit together to achieve their objectives, along with an analysis of their costs and benefits. It should then permit another round of comment on the rules as a whole. It should also make sure that the Federal Reserve concurs with its proposals and that they are coordinated with those of the SEC and other major countries. The CFTC should then, with the collaboration of the other agencies, sequence the implementation of these rules in a way to minimize transition costs.

I. The CFTC Implementation Process

Of the 31 major rulemaking areas the CFTC identified, it has proposed rules in 28 areas. *Appendix A* shows the CFTC's rulemaking progress to date. Before it begins to finalize and implement these rules, however, it is important to consider whether any lessons can be drawn from the process the CFTC used to propose the rules over the last several months.

Unlike the SEC, the CFTC has not published a clear timetable outlining which rules would be proposed when, and it is not obvious that much thought was given to which proposed rules should come first. I call this the scattershot approach. This has left the public in the dark about what was coming down the pipeline. The public and markets could not understand how the rules fit together before filing comments. Some of the CFTC's earliest proposed rules turned on important terms that had yet to be defined, such as "major swap participant." It also issued optional proposals, not required by Dodd-Frank, such as those on segregation of collateral, before it proposed some of the major mandatory rules.[4] It was also concerned with the governance of clearinghouses before addressing the relatively more important issue of risk management.

Another general problem with the proposal process has been the lack of sufficient understanding of the industry in formulating the proposals. Showcase "roundtable" discussions and meetings with firms are not enough. Regulators need to gather information from the markets as to how they operate and then discuss their understanding of this information with industry and outside experts. The rush to propose rules generally did not allow this to happen. When the rules were proposed comment periods were far too short, usually only 30 days for the earliest proposals until the agencies yielded to pressure to extend the comment periods. This process can be compared to the deliberate and multi-year deliberation process the SEC went through before deciding in 2007 that foreign companies could issue shares in the United States under international financial reporting standards without reconciling their statements to U.S. GAAP,[5] a decision of relatively less importance than the entire transformation of the regulation of OTC derivatives.

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[3] *Promoting Economy Recovery and Job Creation: The Road Forward: Hearing Before the H. Comm. On Finc. Servs.,* 112th Cong. 14–15 (Jan. 26, 2011) (testimony of Hal S. Scott) (hereinafter January Testimony).

[4] *See, e.g., Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies,* 75 FED. REG. 75162 (Dec. 2, 2010); *see also* Sixth Series of Proposed Rulemakings Under the Dodd-Frank Act: Opening Statement of Comm'r Jill E. Sommers Before the U.S. Commodity Futures Trading Comm. (Dec. 1, 2010), *http://www.cftc.gov/pressroom/speechestestimony/sommersstatement120110.html* ("a number of the regulations that we have already considered, and a number of regulations that we are considering today, are not required by Dodd-Frank. Commission staff has spent months and months drafting proposed regulations that are purely voluntary").

[5] *See, Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP,* 73 FED. REG. 986 (Jan. 4, 2008).

Although the CFTC did not appropriately prioritize its rulemakings during the proposal stage, it now has the opportunity to prioritize the two most important parts of the rulemaking process, final rules and implementation. Chairman Gensler calls the CFTC's rules a "whole mosaic." [6] Once all of the rules have been proposed, the CFTC should pause and develop a public, published plan for how that mosaic fits together and in what order the final rules should be issued. It should then permit another round of comment on the rules as a whole. This is essential given the shortcomings of the piecemeal proposal process.

The CFTC should then give careful consideration to the sequence of implementation. Chairman Gensler has already outlined a helpful broad tentative order.[7] He has suggested that the final rules be grouped into three broad categories, beginning in the spring and ending in the early fall. While this timetable is too aggressive, some of the ordering is quite sensible: the rules involving definitions, registration, and mandatory clearing should come first. In other cases, however, the schedule is less justified. For example, Chairman Gensler mentions capital and margin as part of the last group, even though those rules are among the most important for risk management.

The Federal Reserve should play a key part in the rulemaking process. The Fed should review and approve the substance and implementation of the Commission's plans. Under the Dodd-Frank Act, the Fed has a major role to play in monitoring and managing the systemic risk of clearinghouses, so it is important to have the Fed sign off on the rules before they are finalized. First and foremost, the Fed supervises the large dealer banks that do most of the derivatives trading, as well as other systemically important nonbank financial institutions that may be designated by the Financial Stability Oversight Council (FSOC). The Fed also plays a central role in the regulation of risk in systemically important clearinghouses. Furthermore, the Fed can extend discount window privileges to a clearinghouse in "unusual or exigent circumstances" [8] subject to any conditions it prescribes, which could include conditions relating to risk management systems. The Fed may also object to the SEC and CFTC's rules concerning systemically important clearinghouses, in which case FSOC has the authority to resolve the conflict.[9] Considering the major role of the Fed, the SEC and CFTC should make sure the Fed agrees with their final rules before they are implemented.

With respect to implementation sequencing, a primary objective should be, as recommended by the Committee on Capital Markets Regulation, avoiding disrupting the markets.[10] For example, rules concerning the threshold for publicly reporting details of block trades should be phased in so the Commissions can be certain that the rules will not dry up liquidity. The Commissions can start with broad, principles-based rules while they monitor the markets and collect the data necessary to determine whether implementation of more specific and limiting rules are necessary. This sequencing schedule should be disclosed to the public, and, ideally should itself be subject to comment. Although the proposed rules came out in an order that was more haphazard than necessary, the CFTC can avoid repeating that mistake in the coming months.

II. Cost-Benefit Analysis

In my January testimony to the House Financial Services Committee, I emphasized the need for the independent regulatory agencies to perform sound cost-benefit analysis before proposing rules. The CFTC is required by statute to "consider the costs and benefits" of its rules, and the SEC is generally required to consider whether its rules "will promote efficiency, competition, and capital formation." [11] In January, the President issued an Executive Order that reaffirmed the importance of con-

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[6] Implementing the Dodd-Frank Act: Remarks of Chairman Gensler Before FIA's Annual International Futures Industry Conference (Mar. 16, 2011), *http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-73.html*.

[7] *See, id.*

[8] Dodd-Frank Act § 806(b).

[9] Dodd-Frank Act § 804(a); *see also* Letter from Hal S. Scott to Chairman Gensler Regarding The Federal Reserve's Authority Over Clearinghouses 1 (Aug. 25, 2010), *http://www.capmktsreg.org/pdfs/2010.09.15__Genser__Letter__Release.pdf.*

[10] *See* Comm. on Capital Mkts. Regulation, comment to Commodity Futures Trading Comm'n Notice of Proposed Rulemaking, *Real-Time Public Reporting of Swap Transaction Data,* 75 FED. REG. 76140 (filed Jan. 18, 2011); Comm. on Capital Mkts. Regulation, comment to Securities Exchange Comm'n, *Regulation SBSR—Reporting and Dissemination of Security Based Swap Information,* 75 FED. REG. 75208 (filed Jan. 18, 2011).

[11] 7 U.S.C. § 19(a) (CFTC); 15 U.S.C. § 78c(f) (SEC); *see also* 15 U.S.C. § 78w(a)(2) (SEC required to consider burden on competition).

ducting cost-benefit analysis when writing new regulations.[12] Although the Executive Order does not apply to independent agencies such as the CFTC and SEC, the heads of both agencies have suggested they will comply with its principles.[13]

The new Executive Order and the one that came before it subject agencies' cost-benefit analysis to review by the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget.[14] OIRA has published, with an interagency group, a set of "best practices" to guide those agencies bound by the Executive Order.[15] Neither the CFTC nor the SEC comes close to observing this guidance.

The CFTC typically begins its cost-benefit analysis with boilerplate text explaining that under its interpretation of its statutory mandate, it is not required to quantify costs and benefits.[16] It then usually devotes only a few paragraphs to identifying some costs and benefits of the proposed rules. Yet even this qualitative analysis falls short. Yesterday the Committee on Capital Markets Regulation filed a comment letter with the SEC and CFTC regarding its proposed rules on reporting by private funds (Form PF).[17] In that letter, the Committee listed the three "costs" the CFTC identified in the single paragraph devoted to the subject. It identified the "costs" as: (1) "Without the proposed reporting requirements . . . FSOC will not have sufficient information"; (2) "the proposed reporting requirements, once finalized will provide the CFTC with better information"; and (3) "the proposed reporting requirements will create additional compliance costs."[18] The first two points are asserted benefits, not costs. The reference to compliance costs is perfunctory and so general as to be meaningless.

Sound cost-benefit analysis measures costs and benefits against a baseline. The OIRA guide of best practices instructs agencies to set the baseline as the world without the proposed regulation.[19] Yet in most proposals the CFTC evaluates the overall costs and benefits of the system required by the Dodd-Frank Act, rather than the particular implementation the agency proposed. Likewise, OIRA instructs agencies to evaluate alternatives to the proposed regulations.[20] This is especially important when, as in the case of rules requiring reporting of information, many different systems could satisfy the statutory requirement, perhaps with lower costs. Yet the agencies have not identified alternatives. Nor do the agencies engage in incremental or marginal analysis, which would consider whether the benefits of each element of the proposed rule outweigh its costs. Instead, they typically take a gestalt approach to the rules as a whole.

For the last 30 years, a period spanning nearly five Presidents, a series of Executive Orders has required non-independent agencies to comply with additional requirements to the rulemaking process, yet the independent agencies have not been covered by these requirements.[21] Cass Sunstein, presently the Administrator of OIRA, has long called for subjecting the independent agencies to OIRA review.[22] In

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[12] Exec. Order No. 13563, § 1(b), 76 *Fed. Reg.* 3821 (Jan. 21, 2011).

[13] *See Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act:* Hearing Before the H. Comm. On Agric., 112th Cong. (Feb. 10, 2011) (testimony of Chairman Gary Gensler), *http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html* (CFTC Chairman Gary Gensler: "the CFTC's practices are consistent with the Executive Order's principles."); Testimony of Chairman Mary Schapiro Before the Subcomm. on Fin. Servs.: Hearing Before the H. Appropriations Comm., 112th Congress (Mar. 15, 2011), *http://appropriations.house.gov/_files/031511SECFY12BudgetTestimonyFINAL.pdf* (SEC Chairman Mary Schapiro: "while the Executive Order doesn't apply to us, we're trying to act as though it does.").

[14] See Exec. Order No. 12866, § 6(a)(3), 58 *Fed. Reg.* 51735 (Oct. 4, 1993); Exec. Order No. 13563, § 1(b), 76 *Fed. Reg.* 3821 (Jan. 21, 2011).

[15] Office of Management and Budget, *Economic Analysis of Federal Regulations Under Executive Order 12866* (Jan. 11, 1996), *http://www.whitehouse.gov/omb/inforeg_riaguide* (hereinafter OIRA CBA Guide).

[16] *See, e.g.,* R*eporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,* 76 FED. REG. 8068, 8087 (Feb. 11, 2011).

[17] Comm. on Capital Mkts. Regulation, comment to Commodity Futures Trading Comm'n and Securities Exchange Comm'n Joint Proposed Rules, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,* 76 FED. REG. 8068 (filed Apr. 12, 2011).

[18] *Reporting by Investment Advisers on Form PF, supra* note 16, 76 FED. REG. at 8087.

[19] OIRA CBA Guide, *supra* note 15, § III.A.1.

[20] OIRA CBA Guide, *supra* note 15 § III.A.2.

[21] *See* Exec. Order No. 12866, § 6(a), 58 *Fed. Reg.* 51735 (Oct. 4, 1993); Exec. Order No. 13563, § 1(b), 76 *Fed. Reg.* 3821 (Jan. 21, 2011); 44 U.S.C. § 3502(5).

[22] See Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis,* 150 U. PA. L. REV. 1489, 1531–37 (2002);

my January testimony, I proposed a moderate system of OIRA review that would avoid any separation of powers issues involved with independent financial agencies.[23] This approach would have OIRA file comments with the agency for important rulemakings. OIRA's comments would evaluate the agency's cost-benefit analysis.[24] Although OIRA's comments would not be binding on the agencies, any final rules would still be subject to review in court. I also called for extending and strengthening the statutory provisions requiring the independent agencies to perform cost-benefit analysis so that each of the financial regulators is required to determine whether the costs of its rules exceed the benefits.[25] The rules proposed in the last 2 months have only strengthened my opinion that the independent financial regulators, particularly the CFTC and SEC, need stronger external requirements to conduct sound cost-benefit analysis.

III. Coordination

In order to write the best rules possible and to avoid unnecessary friction in the system, the Federal agencies should coordinate with each other and with their foreign counterparts.

A. Domestic Coordination

The Dodd-Frank Act anticipates that the SEC and CFTC in particular should work together to regulate the derivatives markets. So far they have not coordinated as much as they should. In many of the proposed rules, the CFTC and the SEC have taken different approaches to swaps and security-based swaps, respectively. For example, the Commissions took different approaches to rules concerning public reporting of swap and security-based swap transactions,[26] conflicts of interest in ownership and governance of various swaps and security-based swap clearinghouses,[27] and risk management in clearinghouses.[28] The approaches of the CFTC and the SEC should diverge only when required by real differences between the types of derivatives they are regulating. If the Commissions do not take a unified approach, then they will unnecessarily raise compliance costs as market participants who are subject to two different regimes will have to comply with different rules governing similar conduct. Furthermore, it will not always be clear whether a swap falls with the jurisdiction of the CFTC or SEC—different rules will encourage transactors to design derivatives to fit into the rules they like best.

The legislative solution to this coordination problem is real structural reform. In 2009, the Committee on Capital Markets Regulation called the financial regulatory structure "an outmoded, overlapping sectoral model," and called for its reorganization.[29] I regard it as dysfunctional. The Dodd-Frank Act did little to solve the problem. Although it eliminated one agency, the Office of Thrift Supervision, it created three more: FSOC, the Federal Insurance Office, and the Bureau of Consumer Financial Protection.[30] FSOC, the agency tasked with some oversight and coordination roles, is not a solution to the large structural problem. It has little direct supervisory authority and power over other agencies, in part because many of its actions

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see also Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State,* 62 U. CHI. L. REV. 1, 4 (1995).

[23] For a discussion of these issues *see* Hahn & Sunstein, *id.,* 150 U. PA. L. REV. at 1531–37; Pildes & Sunstein, *id.,* 62 U. CHI. L. REV. at 24–33; *see also* Elena Kagan, *Presidential Administration,* 114 HARV. L. REV. 2245, 2319–31 (2001).

[24] January Testimony, *supra* note 3, 10.

[25] January Testimony, *supra* note 3, 11.

[26] *See, Real-Time Public Reporting of Swap Transaction Data,* 75 FED. REG. 76140 (proposed Dec. 7, 2010) (CFTC); *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information,* 75 FED. REG. 75208 (proposed Dec. 2, 2010) (SEC). The Commissions use different fields for the reporting systems.

[27] *See, Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest,* 75 FED. REG. 63732 (proposed Oct. 18, 2010) (CFTC); *Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps Under Regulation MC,* 75 FED. REG. 65882 (proposed Oct. 26, 2010) (SEC). The SEC Proposed Rules mandate that a higher percentage of board directors be independent but provides for fewer mandatory committees.

[28] *See, Risk Management Requirements for Derivatives Clearing Organizations,* 76 FED. REG. 3698 (proposed Jan. 20, 2011) (CFTC); *Clearing Agency Standards for Operation and Governance,* 76 FED. REG. 14472 (proposed Mar. 16, 2011) (SEC). The CFTC takes a much more detailed approach to margin requirements.

[29] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 1, 203 (May 2009).

[30] *See* Dodd-Frank Act §§ 312(b) (eliminating the Office of Thrift Supervision), 111(a) (FSOC), 502 (Federal Insurance Office), 1011(a) (Bureau of Consumer Financial Protection).

require a ⅔ supermajority vote.[31] On the other hand, it is the only game in town and Secretary Geithner, its Chairman, needs to be more proactive in insuring agency coordination.

B. International Coordination

International coordination is equally important. Last September, the European Union proposed regulations for its derivatives markets.[32] Although the E.U. proposal and the U.S. system are similar, particularly with their joint emphasis on central clearing, there are many important differences, most of which can only be changed by bringing the U.S. and E.U. legislation closer. For example, the E.U. proposal has a much more generous end-user exception and puts less emphasis on exchange trading. Furthermore, the United States and European Union differ significantly when it comes to the regulation of trade repositories. The Dodd-Frank Act provides for detailed regulation of trade repositories, including specific mechanisms for the disclosure of information to U.S. and foreign regulators.[33] The E.U. proposal, on the other hand, provides general requirements for trade repositories and does not specifically address disclosure of information to E.U. and non-E.U. regulators.[34]

But the regulation of clearinghouses provides a risk of conflict that is not inherent in Dodd-Frank. Under the proposed E.U. regulations, in order for a U.S. or other foreign clearinghouse to be recognized by the European Union, the European Securities and Markets Authority (ESMA) must determine that there is equivalent home state regulation, authorization, and supervision provisions, as well as cooperation arrangements with the ESMA.[35] Similarly, under the Dodd-Frank Act, U.S. regulators may exempt a foreign clearinghouse from certain regulations only if the foreign organization is subject to comparable and comprehensive home state regulation.[36] These equivalence determinations may be difficult if E.U. and U.S. regulation divide on major matters like risk management and governance. Will the European Union permit E.U. firms to use U.S. clearinghouses that admit members with less capital than is required for E.U. clearinghouses?[37] I am not suggesting that the CFTC abandon its approach to member capital, but rather that it detail how the clearinghouses can be structured to be as safe with such lowered capital requirements for members. Conversely, will the CFTC permit U.S. firms to use dealer-owned clearinghouses in the European Union while insisting that there be limitations on dealer ownership in the United States?[38] This would be unwise. Yet, not doing so could lead the major dealers to use European rather than U.S. clearinghouses. Or will the Fed permit U.S. banks to use E.U. clearinghouses that do not have access to the ECB discount window when the Fed permits such access here, albeit under unusual and exigent circumstances? These important issues must be resolved before going live with the new rules.

IV. Micromanagement

Overall the SEC seems to embrace the principles-based approach of the Dodd-Frank Act more than the CFTC, which has tended to propose rules that would micro-manage the industry. For example, the CFTC proposed a detailed rule concerning block trades, while the SEC took a simpler approach.[39] Similarly, the CFTC's rules about margin in clearinghouses are far more specific than the SEC's.[40]

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[31] January Testimony, *supra* note 3, 18.

[32] *Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories,* COM (2010) 484 final (Sept. 15, 2010) (hereinafter E.U. Proposal).

[33] Dodd-Frank Act § 728.

[34] E.U. Proposal, Article 64.

[35] E.U. Proposal, Article 23.

[36] Dodd-Frank Act § 738(a).

[37] *See, Risk Management Requirements for Derivatives Clearing Organizations* § 39.12, 76 FED. REG. 3698, 3719 (proposed Jan. 20, 2011) ($50 million requirement).

[38] *See* Dodd-Frank Act § 726(a); *Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest* § 39.25, 75 FED. REG. 63732, 63750 (proposed Oct. 18, 2010) (imposing limits on ownership).

[39] *See, Real-Time Public Reporting of Swap Transaction Data* § 43.5, 75 FED. REG. 76140, 76174–76 (proposed Dec. 7, 2010) (CFTC); *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information* § 242.902, 75 FED. REG. 75208, 75285 (proposed Dec. 2, 2010) (SEC); *see also* Letter from the Comm. on Capital Mkts. Reg. to David Stawick, Sec'y of the Comm'n, Commodity Futures Trading Comm'n and Elizabeth Murphy, Sec'y, Sec. and Exch. Comm'n 4 (Jan. 18, 2011), *http://www.capmktsreg.org/pdfs/2011.01.18_Swaps_Reporting_Comment_Letter.pdf.*

[40] *See, Clearing Agency Standards for Operation and Governance* § 240.17Ad–22(b)(2), 76 FED. REG. 14472, 14538 (proposed Mar. 16, 2011) (SEC); *Risk Management Requirements for Deriva-*

When developing its rules for Swap Execution Facilities, the CFTC described a Request for Quote system that required sending requests to at least five members, while the SEC gave more freedom.[41] In general, a broad, principles-based approach is preferable to an approach of micromanagement, unless there are specific reasons to think that a detailed rule is necessary. A broad approach is particularly important when, as here, dozens of rules will reshape an industry in ways that cannot be predicted. As I have described, a staged implementation approach could begin with broad, principled rules and gradually phase in more specific rules when they are necessary and after the Commissions can be more confident that they will not unnecessarily disrupt the market.

Thank you and I look forward to your questions.

APPENDIX A

CFTC Proposed Rules to Date Concerning Derivatives under the Dodd-Frank Act[42]

Proposed Date	CFTC Category	Rule
10/14/2010	VII: DCO Core Principle Rulemaking, Interpretation & Guidance X: Systemically Important DCO Rules Authorized Under Title VIII	Financial Resources Requirements for Derivatives Clearing Organizations
10/18/2010	IX: Governance & Possible Limits on Ownership & Control	Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest
10/26/2010	XIX: Agricultural Swaps	Agricultural Commodity Definition
10/27/2010	XXX: Fair Credit Reporting Act and Disclosure of Nonpublic Personal Information	Business Affiliate Marketing and Disposal of Consumer Information Rules
10/27/2010	XXX: Fair Credit Reporting Act and Disclosure of Nonpublic Personal Information	Privacy of Consumer Financial Information; Conforming Amendments Under Dodd-Frank Act
11/2/2010	XXIX: Reliance on Credit Ratings	Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings
11/2/2010	XXVI: Position Limits, including Large Trader Reporting, *Bona Fide* Hedging Definition & Aggregate Limits	Position Reports for Physical Commodity Swaps
11/2/2010	VIII: Process for Review of Swaps for Mandatory Clearing	Process for Review of Swaps for Mandatory Clearing
11/2/2010	XXIV: Disruptive Trading Practices	Anti-disruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act
11/2/2010	XV: Rule Certification & Approval Procedures (applicable to DCMs, DCOs, SEFs)	Provisions Common to Registered Entities
11/3/2010	XXIX: Reliance on Credit Ratings	Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions
11/3/2010	XXIII: Anti-Manipulation	Prohibition of Market Manipulation
11/17/2010	IV: Internal Business Conduct Standards	Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers
11/19/2010	IV: Internal Business Conduct Standards	Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant
11/19/2010	XIV: New Registration Requirements for Foreign Boards of Trade	Registration of Foreign Boards of Trade
11/23/2010	IV: Internal Business Conduct Standards	Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants

tives Clearing Organizations § 39.13(g), 76 FED. REG. 3698, 3720 (proposed Jan. 20, 2011) (CFTC).

[41] *Registration and Regulation of Security-Based Swap Execution Facilities* § 242.801, 76 FED. REG. 10948, 11054 (proposed Feb. 28, 2011) (SEC); *Core Principles and Other Requirements for Swap Execution Facilities,* § 37.9(a)(ii)(A), 76 FED. REG. 1214, 1241(proposed Jan. 7, 2011) (CFTC).

[42] This table does not contain interim rules, corrections, extensions, or other variations.

CFTC Proposed Rules to Date Concerning Derivatives under the Dodd-Frank Act[42]—Continued

Proposed Date	CFTC Category	Rule
11/23/2010	IV: Internal Business Conduct Standards	Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants
11/23/2010	I: Registration	Registration of Swap Dealers and Major Swap Participants
12/3/2010	VI: Segregation & Bankruptcy for both Cleared and Uncleared Swaps	Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy
12/6/2010	XXV: Whistleblowers	Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act
12/7/2010	XVIII: Real Time Reporting	Real-Time Public Reporting of Swap Transaction Data
12/8/2010	XVII: Data Recordkeeping & Reporting Requirements	Swap Data Recordkeeping and Reporting Requirements
12/9/2010	XVII: Data Recordkeeping & Reporting Requirements	Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants
12/13/2010	VII: DCO Core Principle Rulemaking, Interpretation & Guidance	General Regulations and Derivatives Clearing Organizations
12/15/2010	VII: DCO Core Principle Rulemaking, Interpretation & Guidance	Information Management Requirements for Derivatives Clearing Organizations
12/17/2010	XVII: Data Recordkeeping & Reporting Requirements	Reporting Certain Post-Enactment Swap Transactions
12/21/2010	II: Definitions, such as Swap Dealer, Major Swap Participant, Security-Based Swap Dealer, and Major Security-Based Swap Participant, to be Written Jointly with SEC	Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”
12/22/2010	III: Business Conduct Standards with Counterparties	Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties
12/22/2010	XII: DCM Core Principle Rulemaking, Interpretation & Guidance	Core Principles and Other Requirements for Designated Contract Markets
12/23/2010	XVI: Swap Data Repositories Registration Standards and Core Principle Rulemaking, Interpretation & Guidance	Swap Data Repositories
12/23/2010	XI: End-user Exception	End-User Exception to Mandatory Clearing of Swaps
12/28/2010	IV: Internal Business Conduct Standards	Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants
1/6/2011	IX: Governance & Possible Limits on Ownership & Control	Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest
1/7/2011	XIII: SEF Registration Requirements and Core Principle Rulemaking, Interpretation & Guidance	Core Principles and Other Requirements for Swap Execution Facilities
1/20/2011	VII: DCO Core Principle Rulemaking, Interpretation & Guidance	Risk Management Requirements for Derivatives Clearing Organizations
1/26/2011	XXVI: Position Limits, including Large Trader Reporting, *Bona Fide* Hedging Definition & Aggregate Limits	Position Limits for Derivatives
2/3/2011	XIX: Agricultural Swaps	Commodity Options and Agricultural Swaps
2/8/2011	IV: Internal Business Conduct Standards	Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants
2/8/2011	IV: Internal Business Conduct Standards	Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants
2/11/2011	XXVII: Investment Adviser Reporting	Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF
2/11/2011	XXVII: Investment Adviser Reporting	Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations

CFTC Proposed Rules to Date Concerning Derivatives under the Dodd-Frank Act [42]—Continued

Proposed Date	CFTC Category	Rule
3/3/2011	XXXI: Conforming Amendments	Amendments to Commodity Pool Operator and Commodity Trading Advisor Regulations Resulting From the Dodd-Frank Act
3/9/2011	XXXI: Conforming Amendments	Registration of Intermediaries
3/10/2011	VII: DCO Core Principle Rulemaking, Interpretation & Guidance	Requirements for Processing, Clearing, and Transfer of Customer Positions

The CHAIRMAN. Thank you, Mr. Scott.

And now, Dr. Overdahl, your comments for 5 minutes.

STATEMENT OF JAMES A. OVERDAHL, PH.D., VICE PRESIDENT, NATIONAL ECONOMIC RESEARCH ASSOCIATES, WASHINGTON, D.C.

Dr. OVERDAHL. Thank you for the invitation to appear here today and offer my perspective on the role of economic analysis in the rulemaking process of the CFTC. Because of the CFTC's important role in implementing Dodd-Frank, understanding this process is also important.

My perspective is based on my experience as a former chief economist at the CFTC, as well as the SEC. My remarks today are my own and do not reflect the views of NERA or its clients.

Several statutes include provisions that require some form of economic analysis or cost-benefit analysis in the CFTC's rulemaking process. First, Section 15(a) of the Commodity Exchange Act requires the Commission to, *consider,* cost and benefits in the rulemaking process. Second, the Paperwork Reduction Act also requires cost-benefit analysis; however, this analysis applies only to a rule's paperwork burden and does not include a broader analysis of the economic effects of the rule.

Third, like other Federal regulatory agencies, the CFTC's rulemaking process is governed by the Administrative Procedure Act, which requires the Commission to justify its exercise of rulemaking authority and to avoid actions that are arbitrary or capricious. Recent court decisions citing the APA have turned on the adequacy of economic analysis considered by regulators when adopting new rules. The message from the courts is that regulators' economic arguments need to be adequately supported and that vigorous assertion is not a substitute for rigorous economic analysis.

In sum, the statutory requirements for conducting economic analysis are fairly minimal and easily satisfied. In this respect, the CFTC is similar to other independent regulatory commissions across the Federal Government.

Economic analysis can be used for more than just satisfying procedural requirements. It can help improve regulatory decision-making. I have found that data-driven economic analysis enhances the ability of Commissioners to ask better questions, better understand the tradeoffs and consequences associated with the proposed rule, and to make more informed decisions.

In my view, economic analysis goes beyond what is readily quantifiable and includes consideration of unintended consequences and potential effects of regulatory actions, including identifying poten-

tial changes in behavior of market participants. It also is helpful at the very earliest stages of the rulemaking process by helping frame the problem that is being addressed by the proposed regulatory action.

Internally, the CFTC requires the rulemaking divisions to consult with the Office of the Chief Economist. However, rulemaking divisions are not required to obtain formal sign-off from the office before proposing a rule. As a result, the economic staff is often used in the rulemaking process in a behind-the-scenes consulting role.

One obstacle to effectively apply economic analysis to the rulemaking process is the lack of relevant data. The CFTC has often relied on public comments to supply data and analysis. Although these comments can be extremely valuable, they rarely include the type of data and analysis that can serve as a substitute for the Commission conducting its own thorough analysis.

In closing, I would like to offer a few suggestions on how economic analysis can be better utilized at the CFTC.

First, I believe that some type of formal requirement is necessary to institutionalize economic analysis at the CFTC. Such a requirement could be adopted by the agency itself through its own internal policies and procedures and add to consistency in the process not only across the rulemaking agenda but across time.

Second, economic analysis needs to be included in the rulemaking process at an early stage, both for the proposed rules but also for the problem that the rule is aimed at addressing.

Third, the process of collecting data for analyzing proposed rules needs to be improved.

Fourth, I believe it would be helpful for regulatory agencies like the CFTC to have some very specific agency-specific guide to help guide the process of using economic analysis in its rulemaking process, similar to what Britain's FSA uses.

Fifth, experience has shown that the discipline, rigor, and overall quality of economic analysis improves when regulators know that their analysis will be reviewed by others. For Executive Branch agencies, OMB review serves this role. For independent agencies like the CFTC, there is no hardwired ongoing review of their analyses, and perhaps there should be.

Economic analysis is necessary because it enhances the ability of the Commission to make informed decisions. An added benefit is it will help improve the overall transparency and accountability of the process. And for these reasons, economic analysis in the rulemaking process should be a high priority.

Thank you, and I look forward to your questions.

[The prepared statement of Dr. Overdahl follows:]

PREPARED STATEMENT OF JAMES A. OVERDAHL, PH.D., VICE PRESIDENT, NATIONAL ECONOMIC RESEARCH ASSOCIATES, WASHINGTON, D.C.

Chairman Conaway, Ranking Member Boswell, and other Members of the Subcommittee. I appear before you today in my current role as a Vice President of National Economic Research Associates, or NERA, and as a former Chief Economist of the Commodity Futures Trading Commission (CFTC). I thank you for allowing me a chance to share my observations about the role of economic analysis in the rulemaking process at the CFTC.

In my testimony today I will address three topics. First, I will describe the current role and importance of economic analysis in the rulemaking process at the CFTC. Second, I will describe some of the obstacles limiting the effective application of eco-

nomic analysis to the process. Lastly, I will offer suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

I. The Current Role of Economic Analysis in the Rulemaking Process at the CFTC

The economics program at the CFTC is administered in the Office of the Chief Economist and staffed by approximately a dozen economists. Economists within this office perform the bulk of the Commission's analytical work with respect to policy and regulatory initiatives. Although these economists play a role in the Commission's rulemaking process, they perform other roles too such as providing litigation support in enforcement proceedings, gathering data and conducting analysis about emerging market issues, and responding to abnormal market events, such as the 2008 financial crisis, or last year's "flash crash." Outside of the Office of the Chief Economist, another four dozen or so industry economists are employed within the CFTC's operating divisions, primarily in the Division of Market Oversight, performing the day-to-day tasks of market surveillance.

Determining priorities and allocating the resources of the economics program at the CFTC is the job of the Chief Economist, who must consider the Chairman's priorities, the complexity of analysis required, the urgency of the rulemaking calendar, litigation risks, and the staff-to-staff working relationship with the drafters of the rule. These considerations have contributed to the inconsistent application of economic analysis across the rulemaking agenda at the CFTC.

The CFTC does not have a formal requirement for including economic analysis in the rulemaking process, aside from the requirements of the Regulatory Flexibility Act and the cost-benefit requirements of the Paperwork Reduction Act (PRA). However, the analysis required in the PRA applies only a rule's paperwork burden, and does not include an analysis of broader economic effects of a rule. The CFTC's authorizing statute, the Commodity Exchange Act, contains a provision in Section 15(a) requiring that the Commission "consider" costs and benefits in the rulemaking process. Section 15(a) requires that "[b]efore promulgating a regulation . . . or issuing an order . . . the Commission shall consider the costs and benefits of the action of the Commission." In addition Section 15(a) requires that:

> The costs and benefits of the proposed Commission action shall be evaluated in light of (A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations.

The CFTC, like other Federal regulatory agencies, is subject to the Administrative Procedure Act (APA) which requires the Commission to justify their exercise of rulemaking authority and avoid actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." Although this language falls short of a formal requirement for the application of economic analysis to the rulemaking process, recent court decisions have turned on the adequacy of economic support considered by regulators before exercising rulemaking authority under the APA. The prospect of scrutiny by the courts has caused regulatory agencies like the CFTC to pay more attention to the quality of their economic arguments when proposing new rules—at least for those rules likely to be challenged in court.[1]

Aside from requirements posed by statues and the courts for consideration of costs and benefits when proposing new rules, the CFTC has its own internal policies. Within the CFTC, Commission policy requires operating divisions to "consult" with the Office of the Chief Economist before proposing a new rule to the Commission. However, operating divisions are not required to obtain formal sign-off from the Office before proposing a rule.

In sum, the requirements for conducting economic analysis in the rulemaking process are fairly minimal and easily satisfied. In this respect, the CFTC is not unlike other independent regulatory commissions (IRCs). A recent study of the economic analysis used by IRCs finds that "the analysis conducted . . . is generally the minimum required by statute." The study also finds that:

> In many instances the IRCs appear to be issuing major regulation without reporting any quantitative information on benefits and costs—apart from the pa-

[1] *See, Chamber of Commerce of U.S.* v. *S.E.C.,* 412 F.3d 133 (D.C. Cir. 2005), and 443 F.3d 890 (D.C. Cir. 2006); *Am. Equity Investment Life Ins. Co.* v. *S.E.C.,* 572 F.3d 923 (D.C. Cir. 2009), and 2010 WL 2813600 (D.C. Cir. July 12, 2010); and *NetCoalition* v. *S.E.C.,* 2010 WL 3063632 (D.C. Cir. August 6, 2010).

> perwork burden—that would routinely be expected for Executive Branch agencies covered by E.O. 12866. Instead, there is only a qualitative discussion of the benefits and costs. The IRCs present this discussion without any formal review of alternatives. Their analyses generally do not consider behavioral change. They also do not estimate possible unintended effects. And perhaps most importantly, with the exception of the estimates of paperwork burden . . . their analyses of economic effects are not prepared to comply with any identifiable standards for such analysis.[2]

Although the study does not directly address the CFTC (it is one of several IRCs reviewed in the study) the results ring true based on my experience at the CFTC. The CFTC has good economists and good capability to formally analyze proposed rules, but the economics staff is typically used in the rulemaking process only in a behind-the-scenes consulting role.

Aside from the contribution economic analysis can have to satisfying procedural and statutory requirements, its broader contribution is to improving regulatory decision making. I found that Commissioners at the CFTC welcomed independent, data-driven economic analysis provided by the Commission economics staff. One reason for this welcoming attitude, I believe, is because interested parties constantly bombard Commissioners with iron-clad arguments on all sides of all issues. Transparent analysis, combined with high-quality data and rigorous analysis clearly enhanced the ability of Commissioners to ask better questions, better understand the trade-offs and consequences associated with a proposed rule, and make informed decisions. At times, Commissioners made decisions that more heavily weighed considerations outside the realm of economic analysis. Even in these cases, the accountability and transparency of the process was improved by having on-the-record economic analysis because it led Commissioners to publicly consider the economic evidence and then provide a reasoned basis for their decision.

Economic analysis can be useful at all stages of the rulemaking process, including the very earliest stage of identifying, clarifying, and framing the economic issues that can possibly be addressed by a regulatory action. Once an issue is identified, economic analysis can be helpful in evaluating alternative regulatory responses and in determining whether these responses improve upon the existing situation or dominate market-based solutions.

Within the regulatory process the role of what I am calling "economic analysis" is often referred to as "cost-benefit analysis" or "regulatory impact analysis." As Professor Chester Spatt, has observed, the meaning applied to these terms is not universally shared among regulators.[3] On the one hand, a narrow interpretation would imply that economic analysis is limited to cases where regulatory impacts can be quantified in dollars, such as out-of-pocket compliance costs. Under this interpretation, the analysis would involve toting up and comparing dollar costs and dollar benefits attributable to a proposed rule. On the other hand, a broader interpretation goes beyond what is readily quantifiable and includes qualitative factors associated with a proposed rule. Under a broader interpretation, economic analysis can enhance the regulator's understanding of the trade-offs, potential effects and unintended consequences of their actions, including identifying potential changes in behavior by market participants. The value of economic analysis to the regulator derives from its capacity to provide a clear, credible, and coherent framework for articulating the reasoned basis for regulatory action.

For the regulator, failure to adequately consider relevant economic evidence leaves an adopted rule vulnerable to a court challenge on the grounds that the agency's action lacked a reasoned basis under the requirements of the APA. In recent years, the courts have identified weaknesses in the application of economic analysis to SEC regulatory decisions, resulting in rules being sent back for further consideration. The message from the courts has been that regulators' economic arguments need to be adequately supported—that vigorous assertion is not a substitute for rigorous economic analysis. The SEC experience is relevant to the CFTC since its rulemaking process is also governed by the APA.

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[2] Arthur Fraas and Randall Lutter "On the Economic Analysis of Regulations at Independent Regulatory Commissions," Discussion Paper, Resources for the Future, April 2011.

[3] *See* Chester S. Spatt, "Economic Analysis and Cost-Benefit Analysis: Substitutes or Complements?" March 15, 2007. Available at *http://www.sec.gov/news/speech/2007/spch031507css.htm*.

II. Obstacles Limiting the Effective Application of Economic Analysis to the Rulemaking Process

Although there currently are no formal requirements for including economic analysis in the rulemaking process at the CFTC, this has not always been the case.[4] At one time the CFTC had a Division of Economic Analysis with full sign-off authority on proposed rules. However, as part of the CFTC's restructuring following the enactment of the Commodity Futures Modernization Act of 2000, the market surveillance portion of the Division was placed in a new Division of Market Oversight and the economic analysis function was spun-off into an independent Office of the Chief Economist. Although full sign-off authority for proposed rules resided with the new Division of Market Oversight, this authority was not retained for the new Office of the Chief Economist.

Across time, individual CFTC Chairmen have created requirements for the use of economic analysis in rulemaking, but these requirements were not institutionalized. Since the requirements simply reflected the preferences of individual chairmen, when these chairmen left, the requirements were discontinued or simply forgotten. The absence of an institutionalized role for economic analysis in the rulemaking process has been one obstacle limiting its effective application at the CFTC.

Another obstacle to applying rigorous economic analysis to the rulemaking process is that the rulemaking divisions of the CFTC have never fully bought into the idea. In some cases, particularly in cases where good working relationships existed between the economics staff and the staff of the operating divisions, the process worked well. Economists were routinely included at an early stage and their analyses were welcomed and integrated into the process. In other cases, those in the operating divisions who "held the pen" in drafting rules would take a proprietary view and regard the rules as their turf. In other instances the drafters of a rule would regard their product as an unassailable good work that could only be diminished by economic analysis. In these cases, intruders were not welcome until the process was sufficiently far along so that the rule would be recommended to the Commission with only superficial (and last minute) input from the economics staff.

Another obstacle to effectively applying economic analysis to the rulemaking process has been a lack of relevant data. In my view, this problem is related to the fact that economists are often not consulted in the rulemaking process with sufficient lead time to locate or generate useful data. Without useful data, the power of economic analysis is severely degraded.

Often, the CFTC has relied on public comments to supply data and analysis. Although public comments can be extremely valuable to providing some types of information, they rarely include the type of data and analysis that can truly inform the process and serve as a substitute for the Commission conducting its own analysis. Often, the most useful information from public comments is that which addresses compliance costs associated with proposed rules. To draw out this type of data, the CFTC will often pose specific questions on these topics in proposed rules. As with Commission staff, members of the public also require sufficient lead time to locate useful data and conduct meaningful analysis of proposed rules. The time constraints of the public comment process often limit the ability of the public to provide useful analysis for the record before the comment period expires.

Another problem in obtaining useful data and analysis from the public are constraints imposed under the Paperwork Reduction Act (PRA) that limit the ability of regulators to survey members of the public who may possess useful data and information relevant to a proposed rule. The PRA requires OMB approval of surveys involving more than nine entities. The time required to gain OMB approval of a survey design that would include a larger group of respondents can take nearly as long as the Commission's rulemaking process itself. As a result, the CFTC rarely uses surveys of more than nine people in forming cost estimates for proposed rules. This limitation necessarily reduces the quality of cost estimates. The CFTC will rely on the public comment process to challenge the cost estimates published as part of the proposed rule. A related problem involves the confidentiality of cost data supplied to the regulator to inform the rulemaking process. Businesses in a position to supply useful data and analysis often do not do so because they do not want to publicly disclose information that could deprive them of a competitive advantage.

I will note that there is evidence that the quality of information supplied through the public comment process has started to improve in response to recent court decisions. I have found that parties potentially affected by proposed rules now regard the notice and comment rulemaking process as if it was part of a legal proceeding.

[4] At one point, in the early 1990s, three of the CFTC's five Commissioners were Ph.D. economists, who presumably conducted their own economic analysis of rules they proposed.

Affected parties are increasingly viewing the comment process as an opportunity to place on the public record factual information about likely compliance costs and suggested alternative means of meeting the objectives of regulators. Because of the potential for litigation, parties commenting on proposed rules are directing their comments not only to the members of the regulatory commission involved in adopting rules, but also to the judges who may be reviewing the public record for rules that are challenged through the courts. Because the outcome of recent court challenges to Federal rules have turned on the adequacy of the economic support considered by regulators when they adopted new rules, parties submitting comments to the public record are paying particular attention to the quality of their economic arguments.

III. Suggestions on How Economic Analysis Can Be Better Utilized to Craft Regulations

In closing, I would like to offer a few suggestions on how economic analysis can be better utilized to help craft cost-effective regulations, help enhance the accountability of regulatory agencies to the public, and help improve the overall transparency of the rulemaking process.

First, economic analysis needs to be included in the rulemaking process at an early stage. It is at the early stages where a rule's "term sheet" is developed by the rulemaking division. The term sheet is a high level overview describing the proposed rule and identifying the market problem the rule is designed to address. I believe it would be useful at this stage to also include a high level economic review of both the rule and the problem. This review would be performed before the term sheet advances outside of the division proposing the rule. This review should include some analysis indicating whether the rule is likely to be a major or minor rule in terms of its economic impact. Determining at an early stage whether a rule is likely to be major or minor can help devote sufficient resources to those rules likely to have a major economic impact. An early review would provide lead time for the economics team to assess the complexity of the analysis required and to begin gathering data that could be applied to analyzing the proposed rule.

In my view, an early "term sheet review" will likely require a formal policy adopted by the Commission to guide the rulemaking process. A formal policy would add consistency to the process. Crafting such a formal policy holds the potential for making an already cumbersome process even more cumbersome. However, without sufficient lead times, regulators cannot effectively use economic analysis to help them identify and frame problems, evaluate alternatives, and have data-driven analyses available to inform their deliberations.

Another way to improve the quality of economic analysis is to improve the data collection process. One way to do this would be to streamline the process by which regulators can survey firms for information about potential compliance costs. Another way to do this is to allow a process where firms could confidentially disclose to the regulator cost information that would be useful in evaluating the potential impact of a rule. Another way to gather data is for the regulator, whenever possible, to run pilot programs that can generate useful data for analysis. In the past, such pilot programs have proven useful to the deliberations of regulators. One advantage of pilot programs is that data generated from the program can be made available to the academic community for analysis in addition to being available for the regulator's own staff. Finally, those providing public comments on proposed rules can improve the process by paying particular attention to the quality of their economic arguments and by providing data and analysis when appropriate.

Experience has shown that the discipline, rigor, and overall quality of economic analysis considered by regulators as part of their rulemaking process improves when the regulator knows that their analysis will be reviewed by others.[5] We see some evidence of this as a result of recent court cases. Congressional oversight can also play an important role. For executive branch agencies, OMB review serves this role. But for independent regulatory agencies like the CFTC there is no hard-wired, ongoing review of their analyses. It is not clear how such a review could be implemented for independent agencies or if a formal review structure is even desirable. One solution would be for independent regulatory agencies like the CFTC to make their analyses publicly available so that they can be reviewed and evaluated by professional peers.

Even in a rulemaking process that includes rigorous economic analysis, there will always be considerable uncertainty about a rule's economic impact. Therefore, it

[5] *See,* for example, Richard D. Morgenstern, "Reflections on the Conduct and Use of Regulatory Impact Analysis at the U.S. Environmental Protection Agency," Discussion Paper, Resources for the Future, April 2011.

may be helpful to have an ongoing post-adoption review of rules to determine the actual economic impact of a rule's implementation.

I believe it would be helpful for the CFTC to develop a guide for the use of economic analysis in its rulemaking procedures. Britain's Financial Services Authority (FSA) has produced such a guide that could serve as a useful starting point for developing a similar guide for the United States.[6] I understand that the SEC has been working on developing such a guide for its internal use. I believe that such a guide would be more helpful that current OMB guidance or the guidance offered in current or past Executive Orders that are difficult to apply directly to financial market regulation. I believe that such guidance can enhance consistency in the process both across the rulemaking agenda and across time. Such guidance would need to be adopted in the CFTC's internal policies and procedures.

In the end, economic analysis is more than about satisfying procedural requirements for regulatory rulemaking. Improving the power and consistency of economic analysis at the CFTC is important because it will enhance the ability of regulators to make informed decisions. An added benefit is that it will also help enhance the overall transparency and accountability of the rulemaking process.

I look forward to your questions.

The CHAIRMAN. Thank you, Doctor.

Ms. McMillan for 5 minutes.

STATEMENT OF KAREN H. MCMILLAN, GENERAL COUNSEL, INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Ms. MCMILLAN. Thank you, Chairman Conaway and Representative Boswell, and thank you to the Subcommittee for the opportunity to offer the views of the Investment Company Institute on these important topics.

My name is Karrie McMillan, and I am the General Counsel of the ICI. ICI is the national trade association of mutual funds and other investment companies, and our members are entrusted with managing $13 trillion on behalf of 90 million shareholders.

The fund industry has long recognized that efficient, effective, and evenhanded regulation is crucial to protecting investors and the markets. We have a lot of experience with regulation. Funds are regulated by all four of the Federal securities laws.

Developing effective regulation, however, can be very difficult. And that is clearly demonstrated by the rules that the CFTC and the SEC are developing now to implement Dodd-Frank's provisions on derivatives. ICI and other trade associations have pointed out that the short and strict deadlines imposed by Dodd-Frank have made it difficult to fully analyze these very important rule proposals.

Coming into compliance with these proposals will be equally challenging. If the rules are unclear or if they are overly restrictive, market participants could withdraw from the derivatives markets and have liquidity leave those markets, as well.

A clear example of this sort of process is the agency's decision to propose requirements for swap dealers and major swap participants before even defining who those players are. It is awfully hard to analyze and comment upon rules when you don't know whether your business is in or out of the affected groups.

The answer, we think, is for the agencies to take a somewhat slower approach to ensure that there is time for the thoughtful and comprehensive analysis that these important rules deserve. And a slower approach should give affected parties more time to comment

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[6] *See* Financial Services Authority Central Policy, "Practical Cost-Benefit Analysis for Financial Regulators" June, 2000, available online at: *http://www.fsa.gov.uk/pubs/foi/cba.pdf*.

on the proposals, and to comply with them when they are finally adopted.

Surprisingly, though, the CFTC has chosen to make its own workload heavier by taking an expansive new rulemaking that is not mandated by Dodd-Frank nor, as far as we can see, based on harm to investors or to the markets. I am speaking of the CFTC's proposal to amend Rule 4.5, which currently exempts funds regulated by the SEC from a second layer of regulation by the CFTC if they use futures, options, and swaps as part of their investment strategy.

The CFTC maintains that it needs to stop the practice of registered investment companies offering futures-only product without CFTC oversight. But the proposal goes far beyond the handful of funds that could reasonably be described as futures-only products. Instead, the amendments are sweeping and could bring in hundreds, if not thousands, of funds.

Clearly, we object to the substance of these rules. As I mentioned earlier, funds are already comprehensively regulated with regulation that ensures thorough disclosure to investors, limits their use of leverage, promotes diversification, ensures the safe custody of fund assets, and governs conflicts of interest.

It is important to emphasize that, if this rule were to go forward, these two sets of regulation that would be imposed on funds would be both duplicative and contradictory. And the funds affected could include some as basic as S&P 500 stock funds or tax-exempt bond funds that are used by investors saving for retirement and other long-term goals, not the speculators in futures and options markets.

So we have to ask, why now? Why, in the middle of this rush to implement Dodd-Frank, is the CFTC diverting its resources, and, honestly, those of funds in their shareholders, on a proposal with so little justification? Why does the Commission want to sweep hundreds of new registrants into an oversight system that is already strained and add a second layer of regulation?

We also have to ask how the CFTC can impose costly and burdensome new regulation on funds with a cost-benefit analysis that is cursory at best. As both Chairman Conaway and Chairman Lucas previously observed, "The CFTC is failing to adequately conduct cost-benefit analysis," a concern also shared by some Commissioners of the CFTC. This rule clearly falls into that pattern.

Mr. Chairman, we recognize that the financial regulatory agencies are facing an unprecedented task in developing rules under Dodd-Frank. We commend them for their diligence and dedication. But we would urge them to make their own burden lighter by slowing down, getting the rules right, and not embarking on excursions into areas that are not mandated by the legislation.

Thank you, and I look forward to your questions.

[The prepared statement of Ms. McMillan follows:]

PREPARED STATEMENT OF KAREN H. MCMILLAN, GENERAL COUNSEL, INVESTMENT COMPANY INSTITUTE, WASHINGTON, D.C.

Executive Summary

- Registered investment companies, or "funds," use swaps and other derivatives in a variety of ways. ICI and its members thus have a strong interest in ensur-

ing that the new regulatory framework for the derivatives markets supports and fosters markets that are highly competitive, transparent, and liquid.

- ICI commends the CFTC and SEC for their diligence and dedication in the very difficult task of developing an appropriate regulatory framework and avoiding unintended consequences. We do, however, have concerns with the order in which rules have been published for public comment and the length of the respective comment periods. We also have urged the CFTC and SEC to phase-in application of new regulatory requirements over a reasonable period of time.
- ICI is particularly concerned with the CFTC's decision in late January to issue a sweeping proposal to revise or rescind several of its rules, including Rule 4.5, which currently provides an exclusion for funds and certain "otherwise regulated" entities from regulation as commodity pool operators. The proposal is *not* mandated or even contemplated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. And its issuance at this time is most unfortunate, because it has diverted attention away from the effort to implement the provisions of the Dodd-Frank Act.
- The proposed amendments to Rule 4.5 are premature and insufficiently developed. For example, the CFTC proposes a key trading restriction that would relate to margin levels on derivatives positions. ICI and its members cannot assess the full impact of this proposed restriction because it is not yet known which swaps will be subject to central clearing, what the margin requirements will be for cleared and uncleared swaps, and whether foreign exchange forwards and foreign exchange swaps will be exempted from the definition of "swap."
- If adopted in their current form, the proposed amendments to Rule 4.5 would subject funds—which are already subject to comprehensive regulation under all four of the major Federal securities laws—to duplicative and fundamentally inconsistent regulatory requirements. The CFTC has failed to demonstrate the need for imposing a second layer of regulation on funds. Moreover, its cursory cost-benefit analysis is wholly inadequate to justify the costly and burdensome regulation contemplated by the proposed amendments.
- Even if the proposed amendments to Rule 4.5 are appropriately scaled back, there are likely to be some funds (and their investment advisers) that would become subject to CFTC regulation. It is essential that the CFTC work closely with the SEC to reconcile the duplicative and conflicting regulatory requirements to which these funds would become subject, and to re-propose the harmonized regulations for public comment.

I. Introduction

My name is Karrie McMillan. I am General Counsel of the Investment Company Institute, the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). For ease of discussion, we refer in this testimony to all registered investment companies as "funds." Members of ICI manage total assets of $13.0 trillion and serve over 90 million shareholders.

ICI is pleased to offer its perspectives on rulemaking by the Commodity Futures Trading Commission (CFTC or Commission) to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). We also provide our views on the CFTC's recent decision to issue a sweeping proposal to modify or rescind several of its exemptive and exclusionary rules, a proposal that is not mandated (or even contemplated) by the Dodd-Frank Act. The proposed amendments to one of those rules—CFTC Rule 4.5—are premature and insufficiently developed. If adopted in their current form, those amendments would subject a large segment of the fund industry—which is already subject to comprehensive regulation—to duplicative and fundamentally inconsistent regulatory requirements.

II. ICI Views on CFTC Rulemaking To Implement the Derivatives Reform Provisions of the Dodd-Frank Act

Like many financial institutions, funds use swaps and other derivatives in a variety of ways. They are a particularly useful portfolio management tool in that they offer funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, equitizing cash that a fund cannot immediately invest in direct equity holdings (*e.g.,* if the stock market has already closed for the day), managing the fund's cash positions more generally, adjusting the duration of the fund's portfolio (*e.g.,* by seeking to maintain a bond fund's stated duration of 7 years as its holdings in fixed-income securities age or mature), managing bond positions in general (*e.g.,* in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or man-

aging the fund's portfolio in accordance with the investment objectives stated in its prospectus.

Implementation of the Dodd-Frank Act will dramatically change financial regulation in the United States by, among other things, establishing a new regulatory framework for the derivatives markets and participants in those markets.[1] ICI and its members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent, and that the regulation governing them encourages liquidity, fairness and transparency. ICI has therefore been closely monitoring the work of the CFTC and the Securities and Exchange Commission (SEC) as the agencies seek to develop this framework, and we have provided comment on a number of their rule proposals.[2]

Developing the appropriate regulatory framework for derivatives and avoiding unintended consequences is a very difficult task. It is one that requires thoughtful and comprehensive analysis, a deliberative approach, coordination between the CFTC and SEC when possible and appropriate, and careful consideration of comments and recommendations from the public. From time to time, re-proposals of certain rules may be necessary to ensure that they are workable and do not impose costs that are not justified by their benefits.

Getting the rules right is critical for protecting the swaps markets, market participants, and the broader financial system. And, in our view, the agencies have a much harder time getting the rules right if the public is limited in its ability to provide meaningful comment on proposed rules because of overly short comment periods or the order in which the rules are proposed.

Last December, ICI joined with nine other trade associations in sending a joint letter to the CFTC and SEC on their efforts to implement the derivatives provisions of the Dodd-Frank Act.[3] The letter began by commending the agencies "for their diligence and dedication with regard to this unprecedented rulemaking endeavor." It noted, in particular, that the Dodd-Frank Act imposes "short and strict deadlines" on each agency, and that many of the required rules "concern activities and products that are complex and new to regulatory oversight."

The joint letter did, however, raise concerns with aspects of the rulemaking process being followed by the two agencies and recommended certain changes. Among other issues, the letter expressed concern with the order in which the rules have been published for public comment. A prime example of this was the agencies' issuance of proposed requirements for "swap dealers" and "major swap participants" before they had proposed how these Dodd-Frank Act terms should be defined. Uncertainty regarding who might be covered by the proposed requirements made it very difficult for firms to know whether and to what extent the requirements might apply to them, and thus whether and how to provide meaningful comment.

The joint letter also expressed concern that participants in the derivatives markets "would be asked to do too much in too short a time" in regard to implementing new rules. It cautioned that market participants might be forced to refrain from derivatives transactions for which compliance was not possible, which could in turn cause there to be little or no liquidity in certain segments of the market. The letter noted that the Dodd-Frank Act sets only a floor for the effective date for implementing rules (*i.e.,* "not less than 60 days after publication") and, accordingly, called on the CFTC and SEC to use their discretion in order to "phase-in the application of new regulatory requirements over a reasonable period of time, determined through discussions with the market participants that the agencies expect to be directly affected by those requirements." We are pleased that Chairman Gensler recently acknowledged that Congress "gave the CFTC broad latitude in determining when final rulemakings under the Dodd-Frank Act would become effective" and that

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[1] ICI was an early supporter of Federal legislation to close this regulatory gap. *See, e.g.,* Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009), available at *http://www.ici.org/pdf/ppr_09_reg_reform.pdf*.

[2] *See, e.g.,* Letters from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated Sept. 20, 2010 and Feb. 22, 2011 (regarding the definition of key terms in the Dodd-Frank Act related to the regulation of swaps); Letters from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC, dated Jan. 18, 2011 and to David A. Stawick, Secretary, CFTC, dated Feb. 7, 2011 (regarding real-time reporting of swap transaction data); Letters from Karrie McMillan, General Counsel, ICI to David A. Stawick, Secretary, CFTC, dated Jan. 18, 2011 (regarding protection of customer collateral for cleared swaps) and Feb. 1, 2011 (regarding protection of customer collateral for uncleared swaps).

[3] *See* Letter from American Bankers Ass'n, ABA Securities Ass'n, The Clearing House Ass'n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass'n, Investment Company Institute, Managed Funds Ass'n and Securities Industry and Financial Markets Ass'n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated Dec. 6, 2010.

the agency "may give market participants more time" to comply than the 60 day floor described above.[4]

As this Committee continues to oversee the CFTC's implementation of the Dodd-Frank Act, we urge you to encourage the agency to facilitate meaningful public comment on these important rule proposals, to consider those comments fully in their rule-writing effort and, once those rules are finalized, to allow the private sector sufficient time to come into compliance.

III. CFTC Proposal To Modify or Rescind Several Exemptive and Exclusionary Rules, Including Rule 4.5

A. ICI Views on the Proposal Generally

In late January, the CFTC voted to issue a sweeping proposal to revise or rescind several of its exemptive and exclusionary rules, as well as adopt new disclosure requirements, in an effort to "more effectively oversee its market participants and manage the risks that such participants pose to the markets."[5] In particular, the proposal would rescind the exemptions from regulation as a commodity pool operator (CPO) on which sponsors of private investment funds typically rely, significantly narrow the exclusion from CPO regulation in Rule 4.5 under the Commodity Exchange Act as it relates to funds (discussed in detail below), and impose new periodic reporting requirements on all CPOs and commodity trading advisors registered with the CFTC.

Not surprisingly, a proposal of this nature and scope, if adopted, would have significant implications for many asset management firms—and this would be *in addition* to the many new obligations imposed on these firms by the Dodd-Frank Act. Because of this, ICI and other stakeholders have spent considerable time analyzing the proposal and in particular, the amendments to Rule 4.5, and have developed some recommendations for how it might be appropriately amended.

For many reasons, the timing of this proposal is most unfortunate. The proposal is not mandated by the Dodd-Frank Act, although the CFTC attempts to describe it as being "consistent with the tenor" of that Act.[6] Its publication for comment has required ICI and other stakeholders to divert attention away from analyzing and commenting on the many proposals from the CFTC, SEC and other agencies to implement the Dodd-Frank Act.[7] The proposal has likewise been a diversion for the CFTC and its staff.

It is also important to note that any adoption of the proposal in its current form would have considerable long-term implications for the CFTC. A host of new registrants would increase the agency's workload, and regulatory oversight of these new registrants would strain its limited resources, at a time when the agency acknowledges that it does not have the staffing or budget to meet new responsibilities under the Dodd-Frank Act.[8] It likewise would strain the resources of the National Futures Association (NFA), which serves as the frontline regulator for CPOs.

B. ICI Views on the Proposed Amendments to CFTC Rule 4.5

Rule 4.5 currently provides an exclusion for certain "otherwise regulated entities," including funds, from regulation as CPOs. The proposed amendments would condition eligibility for the Rule 4.5 exclusion on compliance with certain trading and marketing restrictions.[9] Funds unable to satisfy these conditions would be subject to regulation and oversight by the CFTC and the NFA. This would impose a second layer of regulation on such funds, which already must comply with comprehensive

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[4] *See* Gary Gensler, Chairman, CFTC, Remarks, *Implementing the Dodd-Frank Act,* at the Futures Industry Association's Annual International Futures Industry Conference, Boca Raton, FL (March 16, 2011).

[5] *See, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations,* 76 FED. REG. 7976 (Feb. 11, 2011) ("Release").

[6] *Id.* at 7977.

[7] The CFTC first published a petition for rulemaking from the National Futures Association on September 17, 2010. *See, Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5,* 75 FED. REG. 56997. ICI and others commented extensively on that petition. On February 11, 2011, the CFTC published the proposal in question, seemingly without taking into account the commenters' myriad concerns raised during the first comment period.

[8] *See* Testimony of Gary Gensler, Chairman, CFTC, Before the Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, United States House of Representatives, on the CFTC's budget request for FY 2012 (March 17, 2011) (stating that the Commission's current funding level is "simply not sufficient for the CFTC's expanded mission to oversee both the futures and swaps markets.").

[9] The topics covered in this section are discussed in extensive detail in ICI's comment letter on the proposal. This letter was filed with the CFTC on April 12, 2011, and we will submit a copy of this letter to the Committee for inclusion in the hearing record.

regulatory requirements under the Investment Company Act of 1940 (Investment Company Act) and other Federal securities laws.

1. The CFTC Has Not Justified the Broad Scope of the Proposed Amendments

The Release states that the amendments to Rule 4.5 are intended to "stop the practice of registered investment companies offering futures-only investment products without Commission oversight . . ."[10] The Release fails to explain, however, why the proposed amendments are troublingly broader in reach. Specifically, the sweeping language of the proposed trading and marketing conditions would implicate a large number of funds that use futures, options and swaps simply as a means to efficiently manage their portfolios, rather than as part of operating a "futures-only" fund. It is difficult to justify this result at a time when, as noted above, the CFTC Chairman has stated that current funding levels for the agency are "simply not sufficient" and is requesting substantial additional resources from Congress.[11]

2. The CFTC Has Not Demonstrated the Need for Imposing a Second Layer of Regulation on Funds

In its Release, the CFTC provides no evidence that a "futures-only" fund—not to mention a fund using futures, options or swaps for reasons *other than* providing exposure to the commodities markets—is currently subject to inadequate regulation, or that investors or the commodity markets generally have been harmed by their practices.

In fact, funds are already extensively regulated. They are the only financial institutions that are subject to all of the four major Federal securities laws. The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the public offering of shares and ongoing reporting requirements, respectively. Funds must provide comprehensive disclosure to investors in plain English, including with regard to fees and expenses, the fund's investment objectives, and the risks of investing in the fund. The Investment Company Act regulates a fund's structure and operations, and addresses fund capital structures (including limits on use of leverage), custody of assets, investment activities (particularly with respect to transactions with affiliates and other transactions involving potential conflicts of interest), and the composition and duties of fund boards. A fund's investment adviser must register with the SEC and comply with the provisions of the Investment Advisers Act of 1940. Funds and their advisers are subject to antifraud standards. Finally, the Federal securities laws provide the SEC with inspection authority over funds and their investment advisers, principal underwriters, distributing broker-dealers and transfer agents. The Financial Industry Regulatory Authority (FINRA) also has oversight authority with regard to funds' principal underwriters and distributing broker-dealers.

As a result, ICI questions why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily regulated entities.

3. Because the Regulatory Regime for Swaps Is Still Being Developed, the Fund Industry and Other Interested Parties Cannot Adequately Assess the Impact of This Proposal

It is difficult at this time to assess the full impact of, and meaningfully comment on, the proposed amendments to Rule 4.5. This is because one of the key conditions would relate to margin levels on derivative positions held by funds, and the regulators have not yet made critical determinations that relate to swap margin levels. Specifically, the CFTC and SEC have not finalized rules regarding which swaps will be subject to central clearing requirements. In addition, margin requirements have not been established for cleared or uncleared swaps (which could end up varying significantly based on the type of swap). Finally, we do not yet know whether the Department of the Treasury will exempt foreign exchange forwards and foreign exchange swaps from the definition of "swap" and, if no exemption is granted, what the margin requirements would be for these instruments.

It is our strongly held view that the new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* the Commission can propose any amendments to Rule 4.5 that implicate the use of swaps.

4. The CFTC Has Not Adequately Analyzed the Potential Costs and Benefits of Its Proposal

We believe that the CFTC's cursory analysis of the costs and benefits of the proposed amendments to Rule 4.5 is wholly inadequate to justify the costly and burdensome regulation they would impose on a large portion of the fund industry. The

[10] Release, *supra* note 5, at 7984.
[11] *See, supra* note 8.

CFTC does identify a few costs, which it does not detail or quantify, but it fails to identify many of the major costs the proposal would impose on funds, some of which would inevitably get passed on to shareholders. The CFTC's analysis of benefits is even more abstract and does not appear to be focused on the proposed amendments to Rule 4.5. Importantly, the Commission fails to acknowledge in its analysis that any benefits that fund shareholders may receive as a result of these amendments would largely duplicate many protections they currently enjoy as a result of the Investment Company Act and other Federal securities laws.

We have deep concerns whether the CFTC's cost-benefit analysis would satisfy the applicable requirements of the Commodity Exchange Act,[12] and we believe that the agency should not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis. We further question whether it is even possible for the CFTC to conduct an adequate analysis until the status and margin issues regarding swaps, mentioned above, have been resolved, as the resolution of those issues could vastly impact the number of funds that may be swept into the CFTC's jurisdiction.

ICI is not alone in its concerns. The Chairman of this Subcommittee, together with the Committee Chair, recently raised very similar concerns in requesting that the CFTC's Inspector General undertake an investigation of the adequacy of the Commission's cost-benefit analysis.[13] We particularly agree with their observations that:

> the CFTC is failing to adequately conduct cost-benefit analysis—either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . [p]articularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.

Even members of the Commission have raised concerns about the manner in which the agency conducts its cost-benefit analysis. Commissioner Sommers, for example, has observed that:

> the proposals we have voted on over the last several months [] contain very short, boilerplate 'Cost-Benefit Analysis' sections . . . . how can we appropriately consider costs and benefits if we make no attempt to quantify what the costs
> are? . . . Clearly, when it comes to cost-benefit analysis the Commission is merely complying with the absolute minimum requirements of the Commodity Exchange Act. That is not in keeping with the spirit of the President's recent Executive Order on 'Improving Regulation and Regulatory Review.' We owe the American public more than the absolute minimum.[14]

5. The CFTC's Proposal Would Impose Inconsistent and Duplicative Regulation on Funds

Finally, even if the restrictions in the proposed amendments to Rule 4.5 are appropriately scaled back, there are likely to be cases in which funds and their advisers would be unable to rely on the amended rule and thus would become subject to regulation by both the CFTC and the SEC. The Release specifically acknowledges that funds may have difficulty complying with some of the CFTC's regulations, yet it does not propose any solutions. As part of our analysis of the Commission's proposal, ICI and its outside counsel have compared the CFTC and SEC regulatory regimes under the Investment Company Act and the Commodity Exchange Act, respectively. This analysis is summarized in a detailed appendix to our April 12 comment letter.[15] As this appendix demonstrates, many of the CFTC's requirements would be duplicative of the requirements to which funds and their advisers are already subject under the Investment Company Act or other Federal securities laws.

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[12] Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.

[13] *See* Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC dated Mar. 11, 2011.

[14] *See* Jill E. Sommers, Commissioner, CFTC, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011).

[15] *See, supra* note 9.

Other of the CFTC's requirements would be fundamentally inconsistent with the requirements to which funds and their advisers are subject.

For example, the SEC significantly limits the ability of a fund to include in its prospectus performance information about other funds or accounts managed by the fund's adviser.[16] The CFTC rules, by contrast, *require* disclosure of such information in certain circumstances. A fund could not comply with the CFTC's requirements without likely violating the SEC's (and FINRA's) requirements. As another example, the CFTC rules regarding delivery and receipt of a commodity pool disclosure document are fundamentally different than the model under the Federal securities laws, and would not be practicable for funds, which generally offer their shares publicly on a daily basis though broker-dealers and other intermediaries.

The examples above illustrate why we believe it is absolutely critical that the CFTC, before imposing an *additional* regulatory requirement on funds, evaluate its regulatory purpose in doing so and consider whether a regulation to which funds and their advisers are *already* subject would be sufficient to satisfy that purpose.

More broadly, it is essential that the CFTC work closely with the SEC before amending Rule 4.5 in order to reconcile the many duplicative and conflicting regulations to which a fund and its adviser could become subject. The harmonized regulations then should be re-proposed for public comment.

IV. Conclusion

We appreciate this opportunity to testify before the Committee. The regulatory proposals discussed in our testimony have important implications for funds and the over 90 million shareholders who rely on funds to meet their retirement and investment goals. Continued Congressional oversight of the CFTC's work on these proposals is critical to ensuring that the regulatory scheme for the derivatives markets is appropriately established and that funds are not made subject to duplicative and fundamentally inconsistent regulatory requirements.

ATTACHMENT

April 12, 2011

DAVID A. STAWICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (RIN No. 3038–AD30)*

Dear Mr. Stawick:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposal by the Commodity Futures Trading Commission ("Commission" or "CFTC") to modify or rescind several of its exemptive and exclusionary rules.[2] Our comments focus on the proposed amendments to CFTC Rule 4.5 that would apply solely to registered investment companies ("Rule 4.5 Proposal").

ICI and its members strongly object to the Rule 4.5 Proposal in its current form. While we respect the Commission's authority to "reconsider the level of regulation that it believes is appropriate with respect to entities participating in the commodity futures and derivatives markets,"[3] we do not believe the Commission has demonstrated the need for a second level of regulation on registered investment companies, which are already subject to comprehensive regulation under the Federal securities laws. We further believe that the Rule 4.5 Proposal is insufficiently developed and thus it is premature to adopt it at this time. It does not appear to reflect thorough consideration by the Commission of many critical issues, including how registered investment companies participate in the commodity futures and derivatives markets, the appropriateness of including swaps in the Rule 4.5 Proposal, the exten-

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[16] FINRA, which has oversight over fund advertising, similarly prohibits funds from advertising the adviser's other fund or account performance.

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.0 trillion and serve over 90 million shareholders.

[2] *Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations,* 76 FED. REG. 7976 (Feb. 11, 2011) ("Release").

[3] *Id.* at 7977.

sive regulation to which investment companies are subject under the Investment Company Act of 1940 (the "Investment Company Act") and other Federal securities laws, the overlapping and conflicting nature of many regulatory requirements that registered investment companies would face if they were regulated by both the Securities and Exchange Commission ("SEC") and the CFTC, and the potential costs and burdens of dual regulation.

The Release states the Commission's belief that the text of the proposed amendments to Rule 4.5 is "an appropriate point at which to *begin discussions* regarding the Commission's concerns."[4] If, after reviewing the comments on the Rule 4.5 Proposal, the Commission nevertheless determines to proceed with amending Rule 4.5, we respectfully urge that the agency develop and issue a new proposal to amend the rule, taking into consideration the comments and recommendations that it receives in response to this Release. To assist the Commission in this endeavor, we have identified several critical issues that should be addressed in any proposal to amend Rule 4.5, and this letter sets forth our initial recommendations for how several of those issues might be resolved.

I. Executive Summary

Last summer, the National Futures Association ("NFA") submitted a petition for rulemaking that asked the CFTC to narrow significantly the Rule 4.5 exclusion as applied to registered investment companies, by requiring compliance with certain trading and marketing restrictions. In late January, the CFTC proposed amendments to Rule 4.5 that not only incorporate the trading and marketing restrictions suggested in the NFA petition but also extend those restrictions to a fund's positions in swaps. In the view of ICI and its members, the Rule 4.5 Proposal is overly broad in scope and would cause many registered investment companies to become subject to CFTC regulation, even though these funds do not raise the Commission's stated concerns regarding "futures-only investment products."

The CFTC has provided little rationale for its sweeping proposal, including why it is necessary to impose a second, costly layer of regulation on registered investment companies, which are already subject to comprehensive regulation under the Investment Company Act and other Federal securities laws. Moreover, the proposal is insufficiently developed and adopting it without first resolving the many critical issues it raises would be premature. As a result, ICI and its members strongly recommend that, if the CFTC nonetheless determines to move forward with the Rule 4.5 Proposal, it publish for comment a revised version of the amendments that fully addresses these issues.

Our comments, concerns, and recommendations, which we describe fully below, include the following:

- ***Including Swaps in the Rule 4.5 Proposal is Premature:*** The Commission's inclusion of swaps in the Rule 4.5 Proposal has broad implications for a wide variety of registered investment companies, which may find it difficult or impossible to meet the proposed trading and marketing restrictions. While we do not question the CFTC's jurisdiction over swaps, we nonetheless believe it has an obligation under the Administrative Procedure Act ("APA") to explain the reasoning behind its decision to require these *users* of swaps to register. We also strongly believe that application of the Rule 4.5 Proposal to swaps is premature because the CFTC and SEC have not yet adopted rules specifying which swaps will be subject to central clearing and margin requirements have not been established for cleared or uncleared swaps. It also is still unclear whether foreign exchange swaps and foreign exchange forwards will be considered "swaps" subject to CFTC oversight. As a result, commenters are unable to provide meaningful input on this very critical aspect of the proposal.
- ***Cost-Benefit Analysis:*** We believe the CFTC's cursory cost-benefit analysis of the Rule 4.5 Proposal is inadequate to justify the costly and duplicative regulation that the proposal would impose on a large portion of the investment company industry. The analysis does not take into account many of the significant costs the proposal would impose on investment companies, and does not acknowledge the many protections shareholders currently benefit from under the Investment Company Act and other Federal securities laws. We question whether the agency's analysis would satisfy applicable statutory requirements, and urge the CFTC not to adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis.
- ***Clarification Regarding Which Entity Would Register as a Commodity Pool Operator:*** The Release does not state which entity would register as a

[4] *Id.* at 7984 (emphasis added).

commodity pool operator ("CPO") if a registered investment company is unable to meet the criteria for exclusion under amended Rule 4.5. Because the investment company's investment adviser is typically responsible for establishing the company and operating it on a day-to-day basis, we request that the CFTC concur with our view that the adviser is the appropriate entity to serve as the company's CPO.

- ***Proposed Trading Restriction:*** The proposed five percent limit on positions taken for non-*bona fide* hedging purposes, especially as it would apply to swaps, futures, and options used for non-speculative purposes, would result in a large number of registered investment companies being unable to rely on the Rule 4.5 exclusion. We believe that narrowing the scope of the trading restriction would be more consistent with the CFTC's regulatory goals, and offer the following suggestions: (1) eliminating or significantly narrowing the application of the proposed rule to swaps; (2) specifically referencing risk management as an element of "*bona fide* hedging" in the context of Rule 4.5; and (3) raising the threshold for positions taken for non-*bona fide* hedging purposes. We note, however, that it is not possible to comment on what the specific threshold should be until margin levels for swaps are determined.
- ***Use of Wholly Owned Subsidiary Structure:*** The Rule 4.5 Proposal would require that any instruments held for non-hedging purposes be held directly by the fund, and not through a wholly owned subsidiary, as funds investing in commodities often do today to avoid adverse tax consequences. We emphasize that this subsidiary structure is used by funds for legitimate tax purposes and not to evade regulation under the Investment Company Act. To address any remaining concerns the Commission may have, an investment company's adviser could make representations that it would make the books and records of the subsidiary available to the CFTC and NFA staff for inspection upon request and provide transparency about fees, if any, charged by the subsidiary.
- ***Proposed Marketing Restriction:*** The proposed language seeking to restrict the ability of registered investment companies to market themselves as "otherwise seeking investment exposure to" the commodity futures and options markets is phrased broadly and could pick up a wide variety of registered investment companies that have only a modest exposure to commodity futures, commodity options, and swaps (*e.g.,* asset allocation funds). We strongly believe this additional language in the marketing restriction is unnecessary and should be eliminated. In addition, we request clarification regarding the scope of the marketing restriction and confirmation that it would not be read so broadly as to apply to risk and other required disclosures in an investment company's registration statement or marketing materials.
- ***Areas of Conflict Between SEC and CFTC Regulation:*** Advisers to those registered investment companies that would be unable to meet the criteria for exclusion under proposed Rule 4.5 would be subject to both SEC and CFTC regulation, potentially resulting in duplicative regulation in many areas, as well as conflicting requirements in others (*e.g.,* relating to disclosure documents, delivery obligations, presentation of performance data, and operational requirements). We strongly believe that investment companies should not be subject to duplicative regulation and that any conflicts between the regulatory requirements should be resolved by the CFTC and SEC before amendments to Rule 4.5 are adopted. In fact, to satisfy the requirements of the APA, the CFTC must provide affected entities with notice of how they would be expected to comply, or how conflicting regulations would be resolved, and an opportunity to provide comment before any amendments to Rule 4.5 are finalized.

II. The Proposed Amendments to Rule 4.5 are Insufficiently Developed, and Adoption Would Be Premature

A. Background

The term CPO is broadly defined in the Commodity Exchange Act and generally includes, among other things, any person engaged in a business that is in the nature of an investment trust who receives funds from others "for the purpose of trading in any commodity for future delivery on or subject to the rules of a contract market or derivatives transaction execution facility."[5] CFTC Rule 4.5 recognizes the breadth of this definition, and provides an exclusion from CPO registration for certain persons operating "qualifying entities" that are subject to a different regulatory

[5] Section 1a(5) of the Commodity Exchange Act.

framework, including registered investment companies.[6] Previously, the Rule 4.5 exclusion was conditioned upon the entity satisfying certain conditions relating to its trading in commodity interests and the marketing of shares/participations in the entity. After lengthy consideration in 2002–03 (which included an advance notice of proposed rulemaking and a public roundtable on the regulation of CPOs and commodity trading advisors ("CTAs")), the CFTC determined to eliminate those conditions from the rule. In so doing, it cited, among other things, the fact that many qualifying entities avoided participation in the markets for commodity futures and commodity options because the Rule 4.5 conditions were "too restrictive for many [of them] to meet" and that facilitating participation in the commodity markets by additional collective investment vehicles and their advisers would have "the added benefit to all market participants of increased liquidity."[7]

Last summer, the NFA submitted a rulemaking petition to the CFTC to amend Rule 4.5.[8] According to the petition, the NFA had concerns about the marketing practices of three registered investment companies offering so-called "managed futures strategies." The NFA petition proposed that the Rule 4.5 exclusion should be significantly narrowed for all registered investment companies, leaving other "qualifying entities" unaffected. Specifically, the petition recommended that registered investment companies should be required to comply with trading and marketing restrictions that are based upon those in the rule prior to 2003, but are actually much broader in scope.

Following publication of the NFA petition in the fall, the CFTC received considerable feedback from individual companies and trade and bar associations, including ICI ("October Letter").[9] Many of the comment letters expressed serious concerns about the scope of the NFA's proposed language, outlined the difficulties that registered investment companies would face in trying to comply with overlapping and conflicting requirements of the CFTC and SEC, and offered possible solutions.

In late January, the CFTC voted to issue the Rule 4.5 Proposal. The agency drew the proposed rule text almost verbatim from the NFA petition, but significantly also applied the proposed trading and marketing conditions to a registered investment company's positions in swaps. The Release contains little explanation for the proposed language, except to describe it as "an appropriate point at which to begin discussions regarding the Commission's concerns."[10] The Release also does not address the considerable comments the CFTC received on the NFA petition, except to the extent it poses specific questions for further public comment based on the responses it received regarding the NFA petition.

B. The CFTC Has Not Demonstrated the Need for Imposing a Second Layer of Regulation on Registered Investment Companies

The CFTC provides little rationale in the Release for its sweeping Rule 4.5 Proposal. It is not mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), although the CFTC describes the Rule 4.5 Proposal as being "consistent with the *tenor*" of that Act.[11] According to the Release, the proposed restrictions under Rule 4.5 are intended to "stop the practice of registered investment companies offering futures-only investment products without Commission oversight" and that "such restrictions would limit the possibility of entities engaging in regulatory arbitrage whereby operators of otherwise regulated entities that have significant holdings in commodity interests would avoid registration and compliance obligations under the Commission's regulations."[12] The CFTC provides no evidence, however, that such registered investment companies are currently subject to inadequate regulation, or that investors or the commodity markets generally have been

[6] Entities seeking to rely on the Rule 4.5 exclusion must file a notice of eligibility with the National Futures Association that includes certain representations.

[7] *See, Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors,* 68 FED. REG. 12622, 12626 (March 17, 2003) ("2003 Proposing Release"); *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors: Past Performance Issues,* 68 FED. REG. 47221 (Aug. 8, 2003) ("2003 Adopting Release")

[8] *Petition of the National Futures Association, Pursuant to Rule 13.2, to the U.S. Commodity Futures Trading Commission to Amend Rule 4.5,* 75 FED. REG. 56997 (Sept. 17, 2010).

[9] Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated Oct. 18, 2010.

[10] Release, *supra* note 2 at 7984.

[11] Release, *supra* note 2 at 7977 (emphasis added). *See* Letter from Scott Garrett, Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises, to Gary Gensler, Chairman, CFTC, dated March 3, 2011 ("Garrett Letter") (Congressman Garrett recently expressed concern regarding "the CFTC in many cases . . . going even beyond what the [Dodd-Frank Act] requires.").

[12] Release, *supra* note 2, at 7984.

harmed by their practices. Nor does the agency explain why the Rule 4.5 Proposal is troublingly broader in reach than "futures-only investment products," as it potentially captures registered investment companies with relatively little exposure to the commodity markets.

As we discussed in the October Letter, investment companies are already extensively regulated under the Investment Company Act and other Federal securities laws. The protections afforded under the securities laws include, among others:

- Limits on the use of leverage
- Antifraud provisions
- Comprehensive disclosure to investors, including with regard to:
  - ➢ Fees and expenses
  - ➢ The investment objectives and strategies of the investment company
  - ➢ The risks of investing in the investment company
- Independent board oversight
  - ➢ Particular emphasis on potential conflicts of interest
- Restrictions on transactions with affiliates
- Requirements regarding custody of fund assets

Importantly, the existing regulatory scheme for registered investment companies is, first and foremost, concerned with investor protection, and is administered by the SEC, for which the protection of investors is central to its mission. In addition, investment advisers to registered investment companies must themselves be registered with the SEC and be subject to regulation under the Investment Advisers Act of 1940 and related SEC rules, which also include antifraud protections. The Financial Industry Regulatory Authority ("FINRA") also has oversight authority over an investment company's principal underwriter and distributing broker-dealers. Also, even though excluded under current Rule 4.5, registered investment companies are subject to CFTC large trader reporting requirements like any other trader, which enables the CFTC to obtain information from those entities that it can use to assess systemic risk.[13] As a result, we continue to question why the CFTC believes it is necessary to impose an additional, costly layer of regulation on these already heavily-regulated entities.

C. The CFTC Has Failed to Justify its Proposed Disparate Treatment for Registered Investment Companies

Currently, the Rule 4.5 exclusion is available to a variety of "otherwise regulated entities." The increased restrictions contemplated by the Rule 4.5 Proposal, however, would apply only to one type of entity that currently may rely on the rule—registered investment companies. Under this proposal, the full range of CFTC and NFA rules and oversight would be imposed *only* on registered investment companies that engage in commodity trading and are unable to satisfy the heightened criteria under Rule 4.5.

The Release offers no justification for imposing additional burdens on registered investment companies that, ironically, are subject to far more regulation and oversight than are other entities offered to, or operated for the benefit of, retail investors that may continue to rely on Rule 4.5 in its current form and thus be subject to only a single regulatory scheme. Such disparate treatment is an invitation to regulatory arbitrage, because there would be nothing in Rule 4.5 to preclude other qualifying entities from offering a "futures only" investment pool without CFTC oversight. The creation of this regulatory "gap" would be wholly inconsistent with the tenor of the Dodd-Frank Act. It also would be completely at odds with the Commission's stated concerns in issuing the proposal.

Should the CFTC determine to modify Rule 4.5 to treat registered investment companies differently than other regulated entities that qualify for the Rule 4.5 exclusion, it must issue a re-proposal that explain the basis for such disparate treatment as required by the APA.[14]

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[13] See Parts 15–19 and 21 of the CFTC's regulations.

[14] In *The Connecticut Light and Power Company, et al.* v. *Nuclear Regulatory Commission,* 673 F.2d 525 (D.C. Cir. 1982) ("*Connecticut Light*"), the Court of Appeals for the D.C. Circuit stated as follows:

> The purpose of the comment period [required under the Administrative Procedure Act] is to allow interested members of the public to communicate information, concerns, and criticisms to the agency during the rule-making process. If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule,

D. The Proposed Inclusion of Swaps Under Rule 4.5 is Premature

As noted above, the Release states that the language from the NFA petition is "an appropriate point at which to begin discussions," and the text of the proposed amendments to Rule 4.5 is drawn almost verbatim from the NFA petition. The text differs from the NFA's language, however, in one key respect—by including swaps within the scope of the proposed trading and marketing restrictions. While we understand that the CFTC obtained jurisdiction over swaps as a result of the Dodd-Frank Act, its expanded jurisdiction does not relieve the agency of its obligation under the APA to explain the reasoning behind its proposal, including a clear rationale as to why *users* of swaps need to be registered.[15] This includes the obligation to evaluate whether particular uses of swaps raise the concerns that Rule 4.5 is intended to address. Both analyses are entirely absent in the Release. As we cautioned in our October Letter, and as explained more fully below, the inclusion of swaps significantly expands the scope of the Rule 4.5 Proposal and would create a host of (presumably) unintended consequences. Including swaps in the proposal also would increase significantly the number of entities that would become subject to CFTC regulation at a time when the Commission has expressed concern that its resources are inadequate to meet its expanded regulatory responsibilities for swaps under the Dodd-Frank Act.[16]

As described in more detail below, the Rule 4.5 Proposal includes a condition that a registered investment company may use commodity futures, commodity options or swaps solely for "*bona fide* hedging purposes." It may, however, hold certain instruments not for *bona fide* hedging purposes, if the initial margin and premiums required to establish those positions do not exceed five percent of the fund's liquidation value.

As applied to swaps, this is a clear example of "cart before the horse" rulemaking[17] and could be subject to challenge under the APA. The CFTC and SEC have not yet finalized rules regarding which swaps will be subject to central clearing requirements. Margin requirements have not yet been established for cleared or uncleared swaps and, once they are established, could vary significantly based on the type of swap. Similarly, we do not yet know whether the Department of the Treasury will exempt foreign exchange forwards and foreign exchange swaps from the definition of "swap"[18] and, if no exemption is granted, what the margin requirements will be for these instruments. Given these uncertainties about swaps, *it is simply not possible for funds to evaluate in any meaningful way how they would fare under the proposed five percent trading restriction,* which is calculated on the basis of initial margin, or to determine whether a higher percentage threshold might be more appropriate. The new regulatory framework for swaps must be put in place and margin requirements for both centrally cleared and uncleared swaps established *before* any amendments to Rule 4.5 that implicate the use of swaps can be considered. Adopting the proposed amendments prior to that time would not provide the

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interested parties will not be able to comment meaningfully upon the agency's proposals. As a result, the agency may operate with a one-sided or mistaken picture of the issues at stake in a rulemaking. . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary. (Internal citations omitted).

[15] *See, id.* Section 553 of the APA requires that an agency provide the public with adequate notice of the substance of a proposed rule and an opportunity to provide meaningful comment. If it fails to do so, the resulting rule may be struck down by courts on the basis that it is not a "logical outgrowth" of the agency's proposal. *See, Kooritzky* v. *Reich,* 17 F.3d 1509, 1513 (D.C. Cir. 1994) (court stated that "agencies must include in their notice of proposed rulemaking 'either the terms or substance of the proposed rule or a description of the subjects and issues involved' . . . [a]nd they must give 'interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.' The Labor Department did neither." (internal citations omitted)) ("*Kooritzky*"); *Shell Oil Co.* v. *EPA,* 950 F.2d 741, 751 (D.C. Cir. 1992) ("an unexpressed intention cannot convert a final rule into a 'logical outgrowth' that the public should have anticipated. Interested parties cannot be expected to divine the [agency's] unspoken thoughts.") ("*Shell Oil*").

[16] *See* Gary Gensler, Chairman, CFTC, Remarks, *Implementing the Dodd-Frank Act,* at FIA's Annual International Futures Industry Conference, Boca Raton, Florida (March 16, 2011) ("Our current funding level of $169 million is simply not sufficient for the CFTC's expanded mission to oversee both the futures and swaps markets. Though we will work very closely with the National Futures Association, and they will take on as many responsibilities as they can, including those related to registration and examination of swap dealers, we will need significant resources to properly oversee both the futures and swaps markets.") ("Gensler Remarks").

[17] *See* Garrett Letter, *supra* note 11 (questioning the CFTC's "cart before the horse" approach to rulemaking, and whether it "depriv[es] the public of the opportunity to provide meaningful comment on the CFTC's proposals . . .").

[18] *See* Section 1a(47)(E) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

public with adequate notice of the substance of the rule the Commission intends to adopt, or an opportunity to provide meaningful comment.[19]

E. Harmonizing the Regulations That Would Apply to a Registered Investment Company Subject to CFTC Oversight Must Be Done Through Public Notice and Comment

As we explain in detail later in this letter, adoption of the Rule 4.5 Proposal could subject a large number of registered investment companies to regulation by the CFTC in addition to the SEC. As noted in our October Letter, this would make funds subject to many directly conflicting, or fundamentally inconsistent, requirements under the Investment Company Act and the Commodity Exchange Act. The Release states that dual regulation of registered investment companies "may result in operational difficulties" and seeks comment regarding "which rules and regulations are in conflict" and "how these could be best addressed by the two Commissions."[20]

While we are pleased that the CFTC recognizes the need to work cooperatively with the SEC in order to determine how their respective regulations should be harmonized for dual registrants, we are concerned that the Commission provides no guidance in the Release on how that might be accomplished. In order to meet the notice and comment requirements of the APA, we strongly believe that the agency must re-propose the rule to include a detailed proposal regarding how registered investment companies will be expected to comply with the CFTC's regulations, and how conflicting or inconsistent regulations will be reconciled.[21] To proceed otherwise would deprive registered investment companies (and the broader public) of a meaningful opportunity to comment on the new regulatory requirements that would be placed on registered investment companies.[22]

F. The CFTC Has Given Inadequate Consideration to the Potential Costs and Benefits of the Proposed Amendments to Rule 4.5

In our view, the CFTC's cursory cost-benefit analysis of the Rule 4.5 Proposal is inadequate to justify the costly and duplicative regulation that the proposal would impose on a large portion of the investment company industry.[23] In terms of costs, the agency identifies only the following as being relevant to the Rule 4.5 Proposal: (1) failing to adopt revisions to Rule 4.5 that are substantively similar to those proposed in the NFA's petition would result in disparate treatment of similarly situated collective investment schemes;[24] (2) requiring the filing of an annual notice to claim exemptive relief under Rule 4.5 enables the CFTC to better understand the universe of entities claiming relief from its regulatory scheme; and (3) the proposed changes "may result in additional costs to certain market participants due to registration and compliance obligations."[25] We strongly believe that the Rule 4.5 Proposal would impose additional, significant costs on registered investment companies. These costs—some of which would inevitably get passed on to shareholders—would include, among others:

- The cost of registering the CPO with the CFTC, and preparing for and taking additional licensing examinations (fund distributors are already subject to licensing requirements);
- The cost of preparing and distributing required disclosure documents and reports to investors (funds already provide substantial disclosures to their investors; what would be required by the CFTC's proposal would be different in form and timing, but for the most part would not provide meaningful additional information that investors currently lack);
- The cost of retaining counsel to attempt to reconcile and satisfy inconsistent regulatory requirements;
- The costs to upgrade systems to produce reports, coordinate and potentially develop new systems for vendors that currently assist in distributing investment company reports;
- The costs of training salespeople;

[19] *See, Connecticut Light, supra* note 14; *Kooritzky, supra* note 15; *Shell Oil, supra* note 15.
[20] Release, *supra* note 2, at 7984.
[21] *See, Kooritzky, supra* note 15, at 1513 ("Something is not a logical outgrowth of nothing."); *Shell Oil, supra* note 15.
[22] *Id.; Connecticut Light, supra* note 14.
[23] Release, *supra* note 2, at 7988.
[24] It is highly perplexing that the CFTC specifically lists this as a cost, given that its Rule 4.5 Proposal *fails* to include all "otherwise regulated" entities that are able to rely on the rule.
[25] Release, *supra* note 2, at 7988.

- The costs associated with the hiring and training of in-house counsel and compliance professionals, and costs associated with changes to fund compliance programs (both in terms of time spent by in-house personnel and fees paid for legal advice); and
- Even for those entities able to comply with the new Rule 4.5 restrictions on trading and marketing, the costs of having to establish the monitoring and compliance controls necessary to ensure their ongoing compliance with any trading restrictions.[26]

With regard to benefits, the CFTC's analysis is equally insufficient, appearing to focus more on benefits stemming from other aspects of the Release rather than from the Rule 4.5 Proposal. Specifically, it notes the anticipated benefits of the increased information that proposed Forms CPO–PQR and CTA–PR would provide.[27] These benefits do not make sense in the context of registered investment companies, which are already heavily regulated by the SEC and are required to provide extensive and detailed disclosure that is available both to the public and to regulators. Moreover, the CFTC fails to acknowledge in its analysis that any benefits that investment company shareholders may receive as a result of the Rule 4.5 Proposal would largely be duplicative of the many protections they currently enjoy as a result of the Investment Company Act and other Federal securities laws.

For these reasons, we have deep concerns as to whether the CFTC's analysis would satisfy the applicable requirements of the Commodity Exchange Act, and we urge that the agency not adopt any amendments to Rule 4.5 without conducting a more comprehensive analysis.[28] We further question whether it is even possible for the CFTC to conduct an adequate analysis until the status and margin issues regarding swaps, discussed above, have been resolved, as the resolution of those issues could vastly impact the number of registered investment companies that may be swept into the CFTC's jurisdiction.

III. The CFTC Must Address Many Complex and Interrelated Issues in Developing a Proposal to Amend Rule 4.5

As is clear from our foregoing comments, we strongly object to the CFTC's proceeding with the Rule 4.5 Proposal, as it has not demonstrated a sufficient need to capture a broad swath of already highly regulated entities and subject them to CFTC regulation. In the event the CFTC determines to pursue this concept, however, we offer below some suggestions for crafting the proposal to better fit the agency's stated regulatory goal of protecting investors in pools offering "futures-only investment products." Any revisions to the proposal to make it consistent with that goal would need to be significant, and we respectfully request that the Commission

[26] Based on registered investment companies' experience with Rule 4.5 prior to its amendment in 2003, these controls would likely include consultations with legal counsel to determine whether or not a particular position would come within the applicable trading restrictions.

[27] The CFTC states that "the proposed changes . . . will [provide] the Commission and other policy makers with more complete information about these registrants. . . . the Commission does not have access to this information today and has instead made use of information from other, less reliable sources." Release, *supra,* note 2, at 7988.

[28] Section 15(a) of the Commodity Exchange Act requires the CFTC to consider the costs and benefits of its actions before issuing rules, regulations or orders. Section 15(a)(2) requires the CFTC to evaluate the costs and benefits in light of the following five areas: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Both the CFTC's own Commissioners and Members of Congress have recently raised concerns regarding the inadequacies of the CFTC's cost-benefit analyses in its recent proposals. *See, e.g.,* Commissioner Jill E. Sommers, Opening Statement, Meeting on the Twelfth Series of Proposed Rulemakings under the Dodd-Frank Act (Feb. 24, 2011) (". . . the proposals we have voted on over the last several months [ ] contain very short, boilerplate 'Cost-Benefit Analysis' sections. . . . how can we appropriately consider costs and benefits if we make no attempt to quantify what the costs are? . . . Clearly, when it comes to cost-benefit analysis the Commission is merely complying with the absolute minimum requirements of the Commodity Exchange Act. That is not in keeping with the spirit of the President's recent Executive Order on 'Improving Regulation and Regulatory Review.' We owe the American public more than the absolute minimum."); Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to A. Roy Lavik, Inspector General, CFTC, dated March 11, 2011 (". . . recent public comments indicate that the CFTC is failing to adequately conduct cost-benefit analysis—either as required by the [Commodity Exchange Act] or the principles of the Executive Order [on Improving Regulation and Regulatory Review]. . . . Particularly during tough economic times, it is incumbent upon the CFTC to approach cost-benefit thoroughly and responsibly to understand the costs, and therefore the economic impact any proposed regulation will have on regulated entities and markets.").

provide the public with a meaningful opportunity to comment on such a revised proposal.

A. Clarification Regarding Which Entity Would Register as a Commodity Pool Operator

The Proposal is silent regarding which entity would register as CPO if a registered investment company is unable to meet the criteria for exclusion under amended Rule 4.5. In light of the structure and operations of registered investment companies, we request that the CFTC concur with our view that the registered investment adviser to such an investment company is the appropriate entity to serve as the company's CPO, and not the investment company itself or its directors (for a company organized as a corporation) or trustees (for a company organized as a trust) (together, "directors"). We believe having the adviser register as CPO under these circumstances will satisfy the CFTC's regulatory interest in ensuring that investors receive appropriate disclosure and reports, and that adequate records are maintained and available for regulatory inspection.[29]

The CFTC has indicated that the following factors may be relevant to determining who is acting as a CPO of a pool:

- Who is promoting the pool by soliciting, accepting or receiving from others, funds or property for the purpose of commodity interest trading;
- Who has the authority to hire (and to fire) the pool's CTA; and
- Who has the authority to select (and to change) the futures commission merchant ("FCM") that will carry the pool's commodity interest trading account.[30]

In applying these factors in the registered investment company context, it is apparent that an investment company's adviser is the primary force in establishing and operating the company and the most logical person to serve as its CPO. A registered investment company has no employees and relies on its adviser for the day-to-day management of, and decisions regarding, the company. For example, it is typically the adviser that makes the decision to establish the investment company and, as the investment company's initial shareholder, typically selects its initial board of directors. The adviser also selects and recommends, for the board's approval, the investment company's service providers, which may include sub-advisers, a principal underwriter, custodians, a transfer agent, and an audit firm. It is the adviser that has the authority to select and change the investment company's FCM. Although employees of the adviser cannot, in their capacity as advisory employees, solicit investors to invest in the investment company, this function is typically served by the investment company's principal underwriter, often an affiliate of the adviser.[31] The adviser has a fiduciary duty to the registered investment company, and is required to act in the best interests of the company and its shareholders.[32]

By contrast, an investment company's directors do not perform functions that should require them to register or be subject to regulation as CPOs.[33] They serve an oversight role and are not responsible for the day-to-day management or operation of the investment company. The CFTC and its staff have recognized that registration of directors as CPOs may not be practicable or necessary.[34] The directors

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[29] We note that while a registered investment adviser serving as CPO for a registered investment company would also be the investment company's CTA, regulations under the Commodity Exchange Act specifically acknowledge that an investment pool's CPO and CTA can be the same entity. *See* Rule 4.14(a)(4) under the Commodity Exchange Act (exemption from registration as a CTA for a person that is registered under the Commodity Exchange Act as a CPO, where the person's commodity trading advice is directed solely to, and for the sole use of, the pool or pools for which it is so registered).

[30] *See, Commodity Pool Operators; Exclusion for Certain Otherwise Regulated Persons From the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements,* 50 FED. REG. 15868 (Apr. 23, 1985) ("1985 Adopting Release").

[31] The principal underwriter is a registered broker-dealer. Its employees that engage in solicitation activities are registered representatives and hold appropriate licenses. As a result, an employee of the adviser that is also a registered representative of the principal underwriter can only engage in solicitation activities in his or her capacity as a registered representative, and not an advisory employee.

[32] *See* Sections 36(a) and 36(b) of the Investment Company Act.

[33] *See* Letter from Dorothy A. Berry, Chair, IDC Governing Council, to David A. Stawick, Secretary, CFTC (Apr. 12, 2011).

[34] *See, e.g., Commodity Pool Operators: Relief From Compliance With Certain Disclosure, Reporting and Recordkeeping Requirements for Registered CPOs of Commodity Pools Listed for Trading on a National Securities Exchange; CPO Registration Exemption for Certain Independent Directors or Trustees of These Commodity Pools,* 75 FED. REG. 54794 (Sept. 9, 2010) (proposing exemptive relief from CPO registration for directors of exchange traded commodity

do not solicit investors for the investment company. The board's role is to oversee the performance of the investment company's adviser and other service providers under their respective contracts and monitor potential conflicts of interest. Under the Investment Company Act, an investment company's board of directors must generally be comprised of a majority of "independent" directors. In order to be considered "independent" under the Investment Company Act, these directors generally may not have a significant business relationship with the fund's adviser, principal underwriter, or affiliates.[35] As the Supreme Court has recognized, these independent directors are responsible for looking after the interests of the fund's shareholders and serve as "independent watchdogs" who "furnish an independent check" upon the management of the fund.[36] While the directors have the authority to approve and terminate the investment company's agreement with its adviser, termination is a drastic step. Such an action is not only costly and disruptive, but also contrary to the investment company shareholders' express intention to invest with a particular manager. Requiring registration of directors would be fundamentally inconsistent with their oversight role; subjecting them to the requirements applicable to CPOs when they do not perform the functions of a CPO would be unnecessary and would not further investor protection.

We also believe that it is not appropriate for the registered investment company to register as CPO. The CFTC generally takes the position that a CPO and its pool must be separate legal entities.[37] As noted above, a registered investment company has no employees and relies on its adviser for the day-to-day management of, and decisions regarding, the company. It is the registered investment adviser, not the investment company, which performs the functions that are key to being deemed a CPO and is responsible for the investment company's operations. It is appropriate, therefore, that the fund's adviser should register solely with respect to the funds it manages. This approach would be consistent with the CPO/pool model, in which it is the pool's operator that registers with the CFTC, not the pool itself.

If you concur with our view that the adviser to a registered investment company is the entity that should register as CPO, only those registered investment companies or other pools managed by the adviser that are not eligible for exclusion under Rule 4.5 would become subject to CFTC regulation.[38] In addition, if the CFTC deemed it appropriate, it could require an investment company adviser that must register as a CPO to amend its advisory agreement at its next annual contract renewal to state that the adviser will serve as the investment company's CPO and to notify investment company shareholders of this change in the investment company's next annual prospectus update.

The CPO registration process would provide the CFTC with additional information about the adviser, its principals, including any principals of the adviser that also serve as directors of investment companies managed by the adviser, and any associated person(s). An adviser registering as a CPO would include Form 8–Rs for its natural person principals and associated persons, including those investment company directors who are principals and/or associated persons of the adviser. The adviser also would submit, on behalf of those persons, a fingerprint card. We note that, under the Investment Company Act, all of the investment company's directors, including the independent directors, are subject to statutory disqualification provisions, which are similar to those under the Commodity Exchange Act.[39]

One of the adviser's executive officers would serve as the associated person of the CPO. We believe it is appropriate for an adviser CPO to have only one associated person for purposes of its CPO registration because, as discussed above, the adviser cannot solicit investors for the registered investment company. Instead, that function is performed by registered representatives of the registered investment company's principal underwriter, who hold Series 7 licenses.[40] Rule 3.12(a) under the

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funds that were not registered investment companies) ("Commodity ETF Release"); CFTC Staff Letter No. 10–06 (March 29, 2010).

[35] An independent director also cannot own any stock of the investment adviser or certain related entities, such as parent companies or subsidiaries. *See* Section 2(a)(19) of the Investment Company Act.

[36] *Burks* v. *Lasker,* 441 U.S. 471, 484 (1979).

[37] *See* Rule 4.20(a) under the Commodity Exchange Act.

[38] We note that the CFTC has recognized that separate funds should be treated separately for purposes of determining whether the criteria for exclusion under the rule have been met. *See, e.g.,* 1985 Adopting Release, *supra* note 30, at II.B.

[39] *See* Section 9 of the Investment Company Act.

[40] A Series 7 license is designed to ensure that the holder has an understanding of the concepts relating to solicitation, purchase, and/or sale of all securities products, including corporate

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Commodity Exchange Act generally requires that any person associated with a CPO be registered under the Commodity Exchange Act as an associated person, which typically requires passing the Series 3 examination. Rule 3.12(h)(1)(ii), however, provides that if the pool is offered by registered representatives that are associated with broker-dealers that are registered under the Securities Exchange Act of 1934, the registered representatives are exempt from the Series 3 licensing requirement. The registered representatives of the fund's principal underwriter would rely on this exemption to sell the fund's shares. Because it is the fund's principal underwriter, and not the adviser, that offers and sells the fund's shares, we believe it would be appropriate for the associated person of the adviser to satisfy his or her licensing requirement by passing the Series 31 examination rather than the Series 3 examination, and plan to request such relief from the NFA.[41]

B. Scope of the Trading Restrictions in the Rule 4.5 Proposal

As indicated above, the overly broad nature of the Rule 4.5 Proposal in its current form would implicate many registered investment companies beyond the "futures-only" funds referred to in the Release. This point is illustrated by preliminary data from several ICI member complexes, discussed below. In particular, the data suggest that many types of registered investment companies use swaps, futures, and options as a means to efficiently manage their portfolios, rather than as part of operating a commodity fund. As a result, we believe that the CFTC should revise the scope of the Rule 4.5 Proposal in a manner that acknowledges that registered investment companies' use of these instruments for non-speculative purposes does not raise the concerns that the Rule 4.5 Proposal is designed to address.

We begin with a brief discussion of how registered investment companies use futures, options and swaps. Next, we present the member data described above. Finally, we offer several suggestions for how the CFTC might appropriately narrow the scope of the trading restrictions in the Rule 4.5 Proposal, including by: (1) eliminating or significantly narrowing the application of the proposed rule to swaps; (2) specifically referencing risk management as an element of "*bona fide* hedging" in the context of Rule 4.5; and (3) raising the threshold for the Non-Hedging Restriction.

1. Use of Commodity Futures, Commodity Options and Swaps by Registered Investment Companies

Registered investment companies use commodity futures, commodity options and swaps in a variety of ways to manage their investment portfolios, and many of these uses are unrelated to speculation[42] or providing exposure to the commodity markets. Uses of these instruments include, for example, hedging positions, equitizing cash that cannot be immediately invested in direct equity holdings (such as if the stock market has already closed for the day), managing cash positions more generally, adjusting portfolio duration (*e.g.,* seeking to maintain a stated duration of 7 years as a fund's fixed income securities age or mature), managing bond positions in general (*e.g.,* in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objective stated in the fund's prospectus (*e.g.,* an S&P 500 index fund that tracks the S&P 500 using a "sampling algorithm" that relies in part on S&P 500 or other futures).

Swaps are a particularly useful portfolio management tool because they offer registered investment companies considerable flexibility in structuring their investment portfolios. We offer two examples to illustrate how a registered investment company might use swaps:

- Total return swaps provide an efficient means to gain exposure (*e.g.,* to particular indices, to foreign markets for which there is no appropriate or liquid futures contract, to foreign markets where local settlement of securities transactions may be difficult and costly). A registered investment company might use a total return swap based on a broad market index in order to gain market exposure on cash flows to the investment company until such cash flow is fully

securities, municipal securities, municipal fund securities, options, direct participation programs, investment company products, and variable contracts.

[41] We believe the Series 31 examination is better tailored to the adviser's limited activities in this regard than the Series 3 examination, which requires knowledge of general commodity-related topics.

[42] We use the term "speculation" to be consistent with the commodity industry's common understanding of the term. Registered investment companies, however, do not consider their investment strategies to be "speculative;" the substantive provisions of the Investment Company Act preclude their ability to engage in "speculative" behavior (*see, e.g.,* Section 18 of the Investment Company Act).

invested. It is important that registered investment companies be able to put cash flows "to work" immediately, for the benefit of their shareholders.

- Interest rate swaps are commonly used by registered investment companies that follow fixed income strategies. This type of swap allows the investment company to adjust the interest rate and yield curve exposures of the investment company or to replicate a broadly diversified fixed income strategy (which may be difficult to do solely through direct purchases of bonds). For example, inflation protected funds are now relatively common. To protect against inflation, these strategies use Treasury inflation-protected securities ("TIPS") or an efficient substitute. Since the market for TIPS is not especially deep, registered investment companies may find it more efficient to achieve inflation protection through interest rate swaps linked to the return on TIPS.

The Commission has failed to justify its broad inclusion of all non-security based swaps in its proposal, despite the variety of ways investment companies may use these instruments, many of which are far afield of running a futures-only investment product. As previously discussed, a far more nuanced analysis of swaps usage by registered investment companies is necessary before this rule can proceed.

2. ICI Member Data Illustrates the Overly Broad Nature of the Rule 4.5 Proposal

As indicated above, the broad language of the proposed conditions, together with the inclusion of swaps, would significantly expand the scope of the Commission's Rule 4.5 Proposal to an extent the CFTC may not have contemplated and well beyond the Commission's stated objective, which is to preclude the offering of "futures-only investment products" without CFTC oversight. The preliminary data outlined below serve to illustrate these points.

Information provided by thirteen ICI member firms, which in total advise 2,111 registered investment companies (including SEC-registered open-end funds, closed-end funds ("CEFs"), and ETFs) whose assets total $2.9 trillion indicates that these member firms have 1,154 separate funds that use or may use derivatives, of which an estimated 485 funds potentially would be unable to meet the criteria for exclusion under proposed Rule 4.5 for various reasons (see *Table 1*).

Table 1: Use of Derivatives by Investment Companies Managed by Selected ICI Member Firms [1]

Number of fund complexes providing information	13
Total assets of open-end funds, CEFs, and ETFs managed by these complexes ($ millions)	$2,899
Number of open-end funds, CEFs, and ETFs managed by these complexes	2,111
of which: [2]	
Funds that use or invest in derivatives	1,154
of which:	
Funds that may be unable to rely on proposed Rule 4.5	485
of which, funds that primarily: [1]	
Pursue managed futures strategy	23
Seek exposure to physical commodities or other commodity-related strategies	6
Are broad-based diversified funds	190
Are fixed-income funds or other funds using derivatives to meet investment objectives	160
Use other strategies that could be implicated by proposed Rule 4.5	102

Source: ICI compilation of information provided by thirteen ICI member firms.

[1] *Includes registered investment companies that are open-end mutual funds, CEFs, and ETFs. All figures in the table refer exclusively to long-term funds. Funds of funds are included in the number of funds but are excluded from asset totals to avoid double counting total assets in these funds.*

[2] *Total does not add to 485 because certain fund complexes felt that categorization was too uncertain in light of current lack of specificity in Proposed Rule 4.5.*

As *Table 1* illustrates, of the 485 investment companies that may be unable to meet the criteria for exclusion under the Rule 4.5 Proposal for various reasons, only 29 investment companies seek returns primarily based on a managed futures strategy or by providing exposure to physical commodities or other commodity-related strategies. By contrast, 190 investment companies are broad-based diversified funds, such as index funds, asset allocation funds, target date funds, inflation-protected funds, or other funds that have exposure to physical commodities as a non-primary component in a broad-based investment strategy. Another 160 of the 485 investment companies are fixed-income or other funds that use financial futures or swaps to help achieve their investment objectives. The remaining 102 investment companies follow other strategies that could be implicated by the proposed rule.

Our members' estimate of 485 investment companies in these 13 complexes that could potentially be implicated by the proposed rule is based on a fair degree of uncertainty. As noted, the proposed rule at present lacks critical details, such as pre-

cisely how swaps will be treated, whether foreign exchange forwards and foreign exchange swaps will be included, and others. Our member firms have thus made a good-faith effort to interpret how the proposed rule may affect the investment companies they advise. The total number of affected investment companies, however, could be either considerably higher or lower depending on the rule's final provisions. In addition, these estimates are *only* for the thirteen member firms that provided information. There are an additional 248 member complexes that either were not asked to provide information or were unable to provide information given the uncertainty inherent in the Rule 4.5 Proposal, including a few of the very largest complexes. Thus, the estimates in *Table 1* should not be taken as an upper bound on the likely number of investment companies that could be affected by the Rule 4.5 Proposal, and likely *understate* the number of entities that could be subject to dual registration and regulation by the SEC and CFTC under the Rule 4.5 Proposal. Nonetheless, the data clearly suggest that the rule, at least as proposed, would likely affect a large number and variety of investment companies, the vast majority of which pursue strategies outside the CFTC's intended reach, as stated in the Release.

3. Suggestions for Narrowing the Scope of the Trading Restrictions in the Rule 4.5 Proposal

The Rule 4.5 Proposal incorporates the trading restrictions from the NFA petition with the addition, as discussed above, of swaps. Specifically, a registered investment company would be required to represent, in its notice of eligibility for the exclusion, that it will use commodity futures, commodity options or swaps solely for "*bona fide* hedging purposes." It may, however, represent that it will hold certain instruments not for *bona fide* hedging purposes, generally subject to representations that the aggregate initial margin and premiums required to establish those positions will not exceed five percent of the liquidation value of the fund's portfolio (the "Non-Hedging Restriction"). We are concerned that the Non-Hedging Restriction, especially as it would apply to swaps, futures, and options used for non-speculative purposes, would result in a large number of registered investment companies being unable to rely on amended Rule 4.5 and becoming subject to registration with, and regulation by, all of the SEC, the CFTC and NFA. We thus offer several suggestions for how the CFTC might appropriately narrow the scope of these proposed restrictions.

(a) The Non-Hedging Restriction Should Not Apply to Swaps, or Its Application Should be Significantly Narrowed

Based on data and other information obtained from many of our member firms, we have concluded that a wholesale inclusion of swaps in the Rule 4.5 Proposal could result in advisers to a large number of registered investment companies being unable to rely on the rule's exclusion, burdening the CFTC and NFA with a large number of additional registrants—entities already subject to comprehensive SEC regulation—at a time when CFTC resources are severely constrained.[43] Advisers to these investment companies would become subject to CFTC and NFA regulation, even if the investment company's uses of swaps would not raise the concerns that CPO regulation is designed to address.

The Commission also has not provided any analysis that would establish a basis for a wholesale inclusion of swaps in the Rule 4.5 Proposal, and the Proposal's consequent broad reach. While we acknowledge the CFTC's jurisdiction over swaps as a result of the Dodd-Frank Act, we believe its expanded jurisdiction does not relieve the agency of the obligation to provide a clear rationale as to why *users* of swaps need to be registered and to examine whether particular uses of swaps raise the concerns that the Rule 4.5 Proposal is intended to address. If the Commission does not eliminate or narrow the application of the Rule 4.5 Proposal to swaps, as we suggest below, we are concerned that some registered investment companies may choose to limit their use of swaps in order to avoid this second layer of regulation, with potential adverse effects on liquidity of the swaps markets.[44]

[43] *See, e.g.,* Gensler Remarks, *supra* note 16.

[44] *See, e.g.,* Garrett Letter, supra note 11 (". . . in none of the relevant notices of proposed rulemakings is there any discussion of the impact on liquidity."); October Letter at n. 5 (stating that "should the CFTC decide to move forward with a rulemaking to amend Rule 4.5, we would urge the agency to consider carefully the effect that its proposed changes would have on market liquidity."). The Commission's lack of discussion in the Release regarding the potential effects of the Rule 4.5 Proposal on liquidity contrasts with its focus on this issue in 2003 when it amended the rule to eliminate the trading restrictions, in significant part because of concerns about the effects they could have on market liquidity. *See* 2003 Adopting Release, *supra* note 7.

For these reasons, we respectfully urge the Commission to eliminate, or at least narrow significantly, the application of the Non-Hedging Restriction to swaps.[45] We believe such a result would be consistent with the fact that many registered investment companies use swaps for a variety of purposes in connection with the efficient management of their investment portfolios. Further, the use of swaps for these purposes is unrelated to the Commission's stated objective, which is to preclude the offering of "futures-only investment products" without CFTC oversight.

(b) The Commission Should Specifically Reference Risk Management as an Element of "*Bona Fide* Hedging" in the Context of Rule 4.5

We recommend that the Commission specifically reference, in any amendments to Rule 4.5 that include a "*bona fide* hedging" test, risk management transactions that would encompass contemporary uses of swaps, futures, and options by investment company advisers, on behalf of their funds, for non-speculative purposes. The CFTC has explicitly recognized that hedging includes the concept of risk management and distinguished it from speculative trading. Specifically, in a 1987 agency interpretation ("1987 Interpretation"), the Commission provided for risk management exemptions for commodity exchanges from speculative position limit rules.[46] In the 1987 Interpretation, the CFTC discussed different non-speculative derivatives trading strategies, many of which are used by investment companies.[47] More recently, the CFTC has applied the concept of risk management in proposing an exception from the mandatory clearing requirement for swaps subject to conditions including, among others, that the entity be using the swap to hedge or mitigate against commercial risk.[48]

We therefore request that the Commission state specifically that risk management will be considered as part of the *bona fide* hedging test (or as an additional category) in connection with any amendments to Rule 4.5. This would include transactions or positions taken by a registered investment company in futures contracts, options contracts, or swaps if used for the following purposes:

- As alternatives or temporary substitutes for "cash market" positions;
- To mitigate or offset changes in the value of "cash market" positions owned by the investment company or non-derivative liabilities of the investment company;
- To facilitate the investment company's management of its cash and/or reserves;
- To adjust an investment company's duration; or
- To efficiently adjust a fund's exposure to one or more asset allocation categories.

Such a Commission statement would be consistent with current and prior positions of the CFTC.[49] Use of futures, options, or swaps in these and other ways that allow investment company advisers to manage the risks in their investment portfolios does not present the higher risks to commodity markets and investors that may be raised by speculation, and should not be subject to the Non-Hedging Restriction.

(c) The Threshold for the Non-Hedging Restriction Should be Raised

The threshold for the Non-Hedging Restriction is proposed to be five percent, the same threshold that was included in Rule 4.5 prior to its amendment in 2003. We

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[45] The CFTC could do so, for example, by excluding swaps that provide exposure to the securities markets—markets over which the CFTC has no jurisdiction—or interest rate swaps.

[46] *See, Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61,* 52 FED. REG. 34633 (Sept. 14, 1987) (agency interpretation providing for risk-management exemptions, in addition to current exemptions for hedging, from speculative position limit rules of exchanges); *see also* Report of the Financial Products Advisory Committee of the Commodity Futures Trading Commission, *The Hedging Definition and the Use of Financial Futures and Options: Problems and Recommendations for Reform* (June 15, 1987) ("Committee Report") (Committee's recommendations included, among others, revising Rule 1.61 and issuing guidelines that permit exchanges to exempt from speculative position limits transactions or positions taken for risk-management purposes, revising Rule 1.3 to include a definition of risk management, and revising Rule 4.5 to provide an exclusion from CPO regulation for otherwise-regulated entities that use futures and options for risk-management purposes).

[47] While the 1987 Interpretation specifically did not address Rule 4.5, it appears that may have been because the Committee Report included separate, specific recommendations related to Rule 4.5 and Rule 1.3(z). *See* 1987 Interpretation, *supra* note 46 at n. 3; Committee Report, *supra* note 46 (recommending revising Rule 1.3(z) to include a definition of risk management and revising Rule 4.5 to provide an exclusion from CPO regulation for otherwise-regulated entities which use futures and options for risk-management purposes).

[48] *See, End-User Exception to Mandatory Clearing of Swaps,* 75 FED. REG. 246 (Dec. 23, 2010) (CFTC proposal for elective exception from mandatory clearing requirement for swaps subject to conditions including, among others, that the entity be using the swap to hedge or mitigate against commercial risk) ("Swaps Proposal").

[49] *See, e.g., id.;* 1987 Interpretation, *supra* note 46; Committee Report, *supra* note 46.

note, however, that current margin levels for a number of derivative instruments in which registered investment companies invest now exceed five percent of contract value. Almost a decade ago, the CFTC acknowledged that margin levels for certain stock index futures significantly exceeded five percent of contract value and that margin levels for security futures contracts were 20 percent of contract value, which had the effect of limiting their use for non-hedging purposes as compared to instruments subject to lower margin requirements.[50] These concerns remain valid today, and would be exacerbated by applying the Non-Hedging Restriction to swaps, as contemplated by the Rule 4.5 Proposal.

In the Release, the CFTC requests comment on whether a higher threshold is appropriate. We believe it is, although due to the current high level of uncertainty regarding the regulatory treatment of swaps and the margin levels to which they will be subject, we are unable to recommend what that higher threshold should be. If the threshold for the Non-Hedging Restriction is not raised to reflect the realities of the financial markets in which registered investment companies invest, the result could be that investment companies may alter their investment strategies specifically to avoid exceeding the Non-Hedging Restriction, which would not be in the best interests of investors. We stress that a full analysis of the correct threshold for the Non-Hedging Restriction should be undertaken only after further opportunity for public comment, following resolution of the regulatory issues regarding the status of swaps, foreign exchange swaps, and foreign exchange forwards.

C. Registered Investment Companies Should Continue To Be Permitted To Use a Wholly Owned Subsidiary Structure

The Rule 4.5 Proposal would require that any positions in swaps, commodity futures or commodity option contracts for non-hedging purposes would need to be held "by a qualifying entity only." This language was added by the NFA Petition and was not included in Rule 4.5 as it existed prior to 2003. The language is apparently directed at investment companies' use of wholly-owned subsidiaries to engage in a limited amount of swaps, commodity futures, and commodity options trading (*i.e.,* no more than 25% of an investment company's investment portfolio, as disclosed in its registration statement and as specifically permitted by the Internal Revenue Service ("IRS")) and would effectively preclude a registered investment company from using the subsidiary structure.

We emphasize, as we did in the October Letter, that this subsidiary structure is used by registered investment companies for tax purposes and not to evade regulation under the Investment Company Act, which is focused on protecting investors. Under Subchapter M of the Internal Revenue Code of 1986, as amended, each registered investment company is required to realize at least 90 percent of its annual gross income from investment-related sources, which is referred to as "qualifying income."[51] Direct investments by a registered investment company in commodity-related instruments generally do not, under IRS published rulings, produce qualifying income. As a result, certain registered investment companies sought and received private letter rulings from the IRS that income from a wholly owned subsidiary that invests in commodity and financial futures and options contracts, swaps on commodities or commodity indexes and commodity-linked notes, fixed-income securities serving as collateral for the contracts and potentially cash-settled non-deliverable forward contracts constitutes qualifying income.

If the CFTC has any remaining regulatory concerns about the operations of these subsidiaries, we believe these concerns could be addressed effectively through representations made by the investment company's adviser that it would make the books and records of the fund's subsidiary available to the CFTC and NFA staff for inspection upon request and provide transparency about fees, if any, charged by the subsidiary. We strongly recommend that the CFTC make explicit in any re-proposal that use of the subsidiary structure as described above would continue to be permitted.

D. Restriction on Marketing

In addition to the Non-Hedging Restriction, the Rule 4.5 Proposal would require that an investment company seeking to rely on the Rule 4.5 exclusion represent that

[50] *See* 2003 Proposing Release, *supra* note 7. These concerns were made moot by the CFTC's adoption of amendments to Rule 4.5 that eliminated the Non-Hedging Restriction. *See* 2003 Adopting Release, *supra* note 7.

[51] Income from investment-related sources includes income specifically from dividends, interest, proceeds from securities lending, gains from the sales of stocks, securities and foreign currencies, or from other income (including, but not limited to, gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, or income from certain types of publicly traded partnerships.

it will not be, and has not been, marketing participations in the fund to the public as or in a commodity pool or otherwise as or in a vehicle for trading in *(or otherwise seeking investment exposure to)* the commodity futures, commodity options, or swaps markets (the "Marketing Restriction") (emphasis added). The italicized language was not part of the Marketing Restriction in Rule 4.5 prior to 2003 but was introduced in the NFA petition. The CFTC fails to explain why it believes this language is necessary or to give any indication as to its intended scope, despite concerns raised by ICI and other commenters in response to the CFTC's earlier publication of the NFA's rulemaking petition. The NFA petition similarly failed to address these issues.

As discussed in our October Letter, ICI and its members are very concerned that this new language could be interpreted broadly, even applying to registered investment companies whose investment portfolios (whether directly or indirectly through a so-called "fund-of-funds" structure) have only a modest exposure to commodity futures, commodity options, and swaps.[52] The proposed language is also broad enough that it could apply to an investment company's use of commodity futures, options, or swaps for *bona fide* hedging purposes or within the Non-Hedging Restriction, thereby rendering the trading exceptions within the Rule 4.5 Proposal effectively moot. The language even appears broad enough to capture registered investment companies that invest only in securities and not commodities—entities clearly outside the CFTC's jurisdiction—such as sector investment companies that invest in securities of oil or mining companies, or other registered investment companies that obtain commodity exposure through investments in securities. Clearly, investments in these securities products cannot result in CFTC registration. Finally, as drafted, the Marketing Restriction could be triggered by basic disclosures in prospectuses and marketing materials concerning the range of investments the investment company may be entitled to make. We outline below several recommendations intended to address these concerns.

1. The Reference to "Otherwise Seeking Investment Exposure" Should Be Deleted

We strongly recommend that the CFTC eliminate from the Marketing Restriction the "otherwise seeking investment exposure" language. We believe that this change would appropriately capture those registered investment companies about which the CFTC may have concerns—funds that are effectively holding themselves out as commodity pools. Adding the investment exposure language only creates ambiguity and would result in a significant number of registered investment companies that do not provide meaningful commodity exposure being unable to satisfy the exclusion and becoming subject to CFTC and NFA regulation, which neither serves the interests of the regulators nor those of investors.

2. Two Tier Registration System

We recommend that advisers to registered investment companies that do not market themselves as commodity pools, according to the revised criteria we suggest above, but hold positions in commodity interests that exceed the threshold under the Non-Hedging Restriction (as we suggest it be amended) be, at most, required to register as CPOs, but not otherwise be subject to the requirements applicable to CPOs under Part 4 of the CFTC's rules. These investment companies, which may include, among others, fixed-income funds, index funds, inflation-protected funds, asset allocation funds and balanced funds, do not raise the concerns the CFTC seeks to address in its Proposal. Registration of the investment adviser as a CPO would require membership with the NFA, and subject the adviser to examination by the NFA.[53] We do not believe it is appropriate to additionally subject the advisers to these registered investment companies, which are already subject to comprehensive regulation under the Federal securities laws and rules, to the CFTC's Part 4 requirements, which are designed for CPOs that market their commingled vehicles as commodity pools or provide significant commodity interest exposure.

Because registered investment companies are subject to extensive public disclosure and reporting requirements, the CFTC would have access to comprehensive and detailed information about, among other things, an investment company's risks, holdings, fees, performance information, financial information, and service pro-

[52] Many investment company complexes sponsor funds-of-funds for retail investors. These funds-of-funds are in many cases intended to provide retail investors with broad asset class diversification in a single investment vehicle. As part of that diversification goal, funds-of-funds often invest a portion of their assets in other investment companies whose portfolios may include investments in non-traditional asset classes such as commodities and commodity-related products.

[53] Please see our analysis above, at Section III.A., regarding CPO registration of the investment adviser.

viders, as well as detailed information about the investment company's adviser, all without applying the CFTC's Part 4 requirements.[54] Furthermore, the SEC has proposed amendments to Form ADV that would expand even further the information that is required by the form, including disclosure about whether an adviser provides advice with respect to futures contracts, forward contracts, or various types of swaps.[55] We also note that the CFTC would have antifraud and inspection authority over an adviser that is deemed to be a CPO even without registration. Imposing additional regulatory requirements on the advisers to these registered investment companies would not provide meaningful additional information to investors and, because of the inconsistent and duplicative information requirements of the two regulatory regimes, could instead cause confusion.

3. Need for Clear Guidance

We are aware that others are exploring approaches to the Marketing Restriction that would require registered investment companies to consider a variety of factors, such as how the investment company holds itself out to the public/its representations in materials provided to investors; the composition of the investment company's assets; the activities of its officers and employees; its historical development; and perhaps other factors, to determine whether the investment company's adviser should register as a CPO. If the CFTC determines to adopt this or a similar test, we believe it is absolutely critical that the agency provide clear guidance articulating what the relevant factors are, how they will be weighted, and how the agency expects industry participants to apply them. Certainty will be essential to the usefulness of any such test, both to the industry and to regulators.[56] It is also critical that the public has an opportunity to comment on any test that the CFTC determines to propose.[57]

4. Other Clarifications

Finally, we respectfully request that the CFTC clarify certain aspects of the Marketing Restriction. We specifically request clarification that the Marketing Restriction would not preclude registered investment companies from including in their registration statements (including prospectuses and statements of additional information), as well as in marketing materials, basic disclosure concerning the range of investments the investment company may be entitled to make as well as risk disclosures that may mention investment in commodity futures, commodity options, and swaps. Our requested clarification is consistent with the CFTC's past interpretations of the marketing restriction.[58] We further request clarification that the Marketing Restriction would not preclude disclosures concerning the range of investments or risks of a fund of funds relating to its investments in underlying funds which may include limited commodity exposure, when those investments are made as part of an Investment Company Act-registered investment product, such as a target date or asset allocation fund.

IV. Registered Investment Companies Should Not Be Subject to Overlapping and Conflicting Regulatory Requirements

As noted above, investment companies are already extensively regulated under the Investment Company Act and other Federal securities laws. The protections afforded under the securities laws include, among others: limits on the use of leverage; antifraud provisions; comprehensive disclosure to investors, including with regard to fees and expenses, the investment objectives and strategies of the investment company, and the risks of investing in the investment company; oversight by

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[54] Please see the examples of fund disclosure and reporting requirements described in *Appendix A* to this letter. In addition, Part 1A of Form ADV, the registration form for investment advisers, provides detailed information about the investment adviser and its business, including information about the types of clients it has, its advisory services, potential conflicts of interest, custody of client assets, any disciplinary history, its owners and executive officers, and information about certain service providers.

[55] *See, Rules Implementing Amendments to the Investment Advisers Act of 1940,* Investment Advisers Act Release No. 3110 (Nov. 19. 2010).

[56] We also note that, to the extent applicability of the test is unclear, advisers that do not register as CPOs based on a good faith application of the enumerated factors nevertheless could be subject to the hindsight analysis used in some private lawsuits claiming that, in fact, the adviser should have registered.

[57] *See, Kooritzky, supra* note 15, at 1513; *Shell Oil, supra* note 15, at 751.

[58] The CFTC has previously stated that it will allow, within the Marketing Restriction, "any promotional material required by and consistent with the policies of a qualifying entity's other Federal or state regulator," as well as permit "a [registered investment company] to describe accurately in its sales literature the limited use of its commodity interest trading and how it believes that use will be beneficial." *See* 1985 Adopting Release, *supra* note 30, at C.3.

an independent board of directors, particularly with regard to potential conflicts of interest; restrictions on transactions with affiliates; and requirements regarding custody of the investment company's assets. As we discuss above, we believe strongly that the Rule 4.5 Proposal is overbroad and would subject registered investment company advisers to CPO regulation in cases where a second layer of regulation is not necessary.

Even if the trading and marketing restrictions in the Rule 4.5 Proposal are appropriately scaled back, there are likely to be cases in which advisers to registered investment companies would be unable to rely on the amended rule and may have to comply with Part 4 of the CFTC's rules. For this reason, we believe it is critical that the CFTC work closely with the SEC *before* amending Rule 4.5 in order to reconcile the many conflicting and duplicative CFTC and SEC regulations to which these investment companies and their advisers would be subject. The harmonized regulations then should be re-proposed for public comment.

A. Reconciliation of Duplicative or Conflicting Regulatory Requirements

Registered investment companies are subject to extensive disclosure and reporting requirements. Many of these are very similar to the requirements to which CPOs are subject, including the requirement to deliver disclosure documents to shareholders/participants in connection with offers and sales to investors, and requirements to provide periodic reports to shareholders/ participants, as well as reports to regulators. We believe that, in those areas where SEC and CFTC requirements are similar, requiring registered investment companies to comply with both sets of regulatory requirements would be burdensome and costly, as well as potentially confusing to investors; these largely duplicative requirements also would not provide meaningful improvement in the regulatory protections provided. Therefore, we recommend that, as to those matters, the relevant SEC provisions should apply. It is more efficient for registered investment companies to comply with provisions to which they are currently subject, and to which the other registered investment companies in their complexes would be subject. Those provisions, based on the similarities to the CFTC's requirements, would appear to satisfy the CFTC's regulatory interest.

In other areas, the requirements under the Investment Company Act and the Commodity Exchange Act are wholly inconsistent and would require reconciliation or further guidance from the SEC and CFTC before an adviser to a registered investment company could comply. While the Commission requests comment in the Release regarding "how these [conflicts] could be addressed by the two Commissions,"[59] it provides no guidance on how that might be accomplished. In order to meet the notice and comment requirements of the APA, we strongly believe the agency must re-propose the rule to include a detailed proposal for how conflicting or inconsistent requirements will be reconciled, or detailed discussion regarding the guidance it proposes to provide.[60]

We have compared the SEC and CFTC requirements that would be applicable to CPOs of registered investment companies subject to Part 4 of the CFTC's regulations in *Appendix A* to this letter. In addition, we discuss below several areas in which we specifically request relief from the CFTC.

B. Areas in Which CFTC Relief is Necessary

1. Disclosure Document Delivery and Acknowledgment

The disclosure document delivery and acknowledgment requirements applicable to commodity pools differ from the prospectus delivery requirements applicable to registered investment companies. Specifically, Rule 4.21(a) under the Commodity Exchange Act requires that a CPO deliver a disclosure document to a prospective pool participant "by no later than the time it delivers to the prospective participant a subscription agreement for the pool," and Rule 4.21(b) states that the CPO may not accept money from a prospective pool participant unless the CPO first receives from the prospective participant a signed and dated acknowledgement stating that the participant received the disclosure document describing the pool that is required under the Commodity Exchange Act (the "Disclosure Document").[61] Registered investment companies are required to deliver a prospectus to prospective investors no later than when a transaction confirmation is delivered.[62] Delivery or use of a sub-

[59] *See* Release, *supra* note 2, at 7984.
[60] *See, Kooritzky, supra* note 15; *Shell Oil, supra* note 15.
[61] *See* Rules 4.21 and 4.24 under the Commodity Exchange Act.
[62] *See* Section 5 of the Securities Act of 1933 ("1933 Act") and Rule 10b–10 under the Securities Exchange Act of 1934.

scription agreement is not required for a registered investment company, nor is receipt of a signed and dated acknowledgement.

The CFTC has recognized that the prospectus delivery requirements under the Federal securities laws differ from CFTC regulations "with respect to timing and other aspects." [63] The CFTC has proposed, and its staff has granted, relief from the disclosure document delivery and acknowledgement requirement of Rule 4.21 for commodity exchange traded funds ("commodity ETFs"). As the CFTC has acknowledged for CPOs of commodity ETFs, "simultaneous compliance with both sets of requirements [is] unnecessarily cumbersome, and would needlessly interfere with the established procedures for conducting a registered public offering of shares . . ." [64] The same would be true for registered investment companies and their advisers. The compliance difficulties are equally challenging regardless of whether a pool is listing its shares on an exchange or otherwise offering them publicly. We therefore request relief, on behalf of our members that could be subject to the Part 4 regulations, from the Disclosure Document delivery requirement of Rule 4.21(a) and from the signed acknowledgement requirement of Rule 4.21(b) similar to that which the CFTC recently proposed for commodity ETFs.[65] In addition, we request relief from the requirements in Rule 4.26(d)(1) and (2) under the Commodity Exchange Act, which require a CPO to file the Disclosure Document and amendments with the NFA prior to use. In particular, the registered investment company's CPO would satisfy conditions analogous to those proposed for CPOs of commodity ETFs, including: [66]

- Causing the investment company's prospectus and statement of information ("SAI") to be readily accessible on an Internet website maintained by the adviser;
- Causing the investment company's prospectus and SAI to be kept current; [67]
- Informing prospective investment company investors of the Internet address of the website and directing any broker, dealer or other selling agent to whom the investment company's principal underwriter sells shares of the investment company to so inform prospective investors;
- Complying with all other requirements applicable to pool Disclosure Documents under Part 4 of the CFTC's regulations except (1) those with which the investment company should be deemed to already satisfy (as described in *Appendix A*), and (2) those with which the investment company would be unable to comply (absent the CFTC's reconciliation of conflicting CFTC and SEC regulations or obtaining relief as requested in this letter).

2. Updating of Prospectus and SAI

CPOs are required by the rules under the Commodity Exchange Act to update a commodity pool's Disclosure Document every 9 months.[68] Registered investment companies, however, are permitted under the Federal securities laws to update their registration statements (including their prospectuses and SAIs) annually.[69] Requiring registered investment companies to update their prospectuses every 9 months would increase costs for registered investment companies whose advisers do not qualify for exclusion under Rule 4.5. Because the registered investment company's audited financial statements would not be completed when the 9 month update was due, the fund would be required to file supplemental/post-effective amendments with the SEC to add the audited financial statements. Such a requirement would also place those investment companies managed by an adviser subject to Part 4 of the CFTC regulations on a different updating cycle than other investment companies managed by the adviser, which would be costly and inefficient. We therefore request that investment companies be permitted to satisfy the Federal securities

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[63] *See* Commodity ETF Release, *supra* note 34.

[64] *Id.* at 54795.

[65] Because we are requesting relief based on conditions that the CFTC has proposed but not yet adopted, we request the opportunity here and below to revisit the conditions to the relief if the CFTC subsequently adopts different conditions for commodity ETFs.

[66] Proposed Rule 4.12(c)(2)(i)(A)–(D). Commodity ETF Release, *supra* note 34, at 54800.

[67] We would cause the investment company's prospectus and SAI to be kept current in accordance with the requirements of the Federal securities laws, rather than the rules under the Commodity Exchange Act. Please see our request for relief below.

[68] Rule 4.26(a)(2) under the Commodity Exchange Act provides that "[n]o commodity pool operator may use a Disclosure Document . . . dated more than 9 months prior to the date of its use."

[69] Section 10(a)(3) of the 1933 Act states that "when a Prospectus is used more than 9 months after the effective date of its registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use . . ."

law standard for updating, rather than being required to update every 9 months.[70] We do not believe that requiring that prospectuses be updated more frequently would materially increase protections for investors, but would increase costs to them.

3. Shareholder/Participant Reporting Requirements

The rules under the Commodity Exchange Act and the Investment Company Act impose similar obligations as regards periodic reports to be delivered to participants and shareholders, respectively. Both the SEC and the CFTC require the delivery of annual reports to shareholders containing audited financial statements.[71] The SEC also requires the delivery of semi-annual reports to shareholders containing unaudited financial statements.[72] The CFTC, however, requires that CPOs of pools with net assets of more than $500,000 at the beginning of the pool's fiscal year deliver to pool participants a *monthly* Account Statement that includes an unaudited Statement of Operations and a Statement of Net Assets.[73] Complying with the monthly reporting requirement would be unduly burdensome and costly for the CPO to a registered investment company because registered investment companies are not currently required to create monthly reports, most registered investment companies redeem their shares on a daily basis, and shares are often held in book-entry form.[74]

Accordingly, we request that investment companies that satisfy the periodic reporting requirements under the Investment Company Act be granted relief from the monthly Account Statement requirements under the Commodity Exchange Act.[75] Requiring registered investment companies to create monthly reports only for those funds that would be subject to Part 4 of the CFTC's regulations would be very costly and burdensome. We believe that the semi-annual reporting requirements under the Investment Company Act provide comparable protections to investment company shareholders. We further note that rules under the Investment Company Act require a registered investment company to file a quarterly report 60 days after the close of the first and third quarters that contains a schedule of investments and other disclosures.[76] This report is publicly available to investors.

We agree that the relief would be subject to conditions analogous to those proposed for CPOs of commodity ETFs, including:[77]

- Keeping the annual and semi-annual reports sent to shareholders readily accessible on the adviser's website for a period of 30 days following the date they are first posted on the website;
- Indicating in the investment company's prospectus or SAI that the company's annual and semi-annual reports will be readily accessible on the adviser's website; and
- Including in the prospectus or SAI the Internet address where the investment company's annual and semi-annual reports are available.

4. Books and Records

CFTC rules require that a CPO maintain required pool books and records at its main business address.[78] Rules under the Investment Company Act, by contrast, generally require that the books and records of a registered investment company be preserved for specified periods of time, with more recent books and records typically preserved in an "easily accessible place."[79] These rules also permit a registered investment company to have a third party maintain the books and records on its behalf, if the investment company and the third party enter into a written agreement specifying that the records are the property of the registered investment company

[70] *See, Appendix A.* In addition, we request relief, above, from the requirement in Rule 4.26(d)(2) under the Commodity Exchange Act to file amendments to the Disclosure Document with the NFA.

[71] *See* Rule 30e–1 under the Investment Company Act and Rule 4.21(c) under the Commodity Exchange Act.

[72] *See* Rule 30e–1 under the Investment Company Act.

[73] *See* Rule 4.22(a) under the Commodity Exchange Act. Also see *Appendix A* for a detailed comparison of the reporting requirements.

[74] Most registered investment companies would meet the rule's $500,000 threshold.

[75] We note that the CFTC has proposed, and its staff has granted, relief from the Account Statement delivery requirement for commodity ETFs. *See* Commodity ETF Release, *supra* note 34.

[76] *See* Rule 30b1–5 under the Investment Company Act.

[77] *See* Rule 4.23 under the Commodity Exchange Act.

[78] *See* Rule 4.23 under the Commodity Exchange Act.

[79] *See* Rule 31a–2 under the Investment Company Act.

and stating that such records will be surrendered promptly on request.[80] An investment adviser is also required to specify on its Form ADV each entity that maintains its books and records, including the location of the entity, and a description of the books and records maintained at that location.[81] It would be burdensome and inefficient for CPOs to registered investment companies to develop different procedures and systems to maintain solely those books and records relating to their commodity trading.

We therefore request relief from Rule 4.23 on behalf of our members to permit a registered investment company's CPO to maintain the CPO's books and records required by the Commodity Exchange Act with professional service providers as permitted by the Investment Company Act. We note that the CFTC has proposed, and its staff has granted, similar exemptive relief permitting CPOs to commodity ETFs to keep books and records with certain professional service providers, rather than at the CPO's main business address.[82] We believe compliance with the SEC books and records requirements would be fully consistent with investor protection, and would provide the CFTC with any information it may want about entities that maintain an investment adviser CPO's books and records, as those entities will be identified (and the books and records they maintain described) on the adviser's Form ADV.

5. Adviser CPOs Should Be Able to Provide SEC-Required Risk Disclosures to Satisfy the CFTC's Proposed Swap Risk Disclosure Requirement

In the Release, the CFTC also proposes to amend the mandatory risk disclosure statements under the Commodity Exchange Act for CPOs and CTAs to require disclosure about certain risks specific to swaps transactions.[83] While we fully support strong risk disclosure to investors, we also believe such disclosure must be accurate in order to be effective.

We are concerned that the CFTC's proposed language fails to capture the variety of ways in which registered investment company advisers that are CPOs and CTAs may use swaps, which we describe above, and that, as a result, the disclosure may provide investors with a misleading impression of the risks presented by an investment company's use of such instruments. We therefore recommend, in lieu of the proposed language, that if an adviser is a CPO or CTA to a registered investment company that engages in swaps transactions, the CFTC's proposed risk disclosure requirement would be satisfied by the risk disclosures that the SEC currently requires of registered investment companies, which are comparable and allow an investment company to tailor its disclosure to convey the particular risks presented by its use of swaps.[84]

Alternatively, we recommend that the CFTC require an adviser that is a CPO or CTA to such a registered investment company to omit the second paragraph of the proposed risk disclosure language. The second paragraph provides that:

> Highly customized swaps transactions in particular may increase liquidity risk, which may result in a suspension of redemptions. Highly leveraged transactions may experience substantial gains or losses in value as a result of relatively small changes in the value or level of an underlying or related market factor.[85]

This disclosure is inapposite to registered investment companies. First, most registered investment companies issue redeemable securities and are not permitted, under the Investment Company Act, to suspend redemptions without obtaining an SEC order.[86] Second, the Investment Company Act does not permit registered in-

[80] *See* Rule 31a–3 under the Investment Company Act.

[81] *See* Item 1(K) of Form ADV and Section 1.K. of Schedule D of Form ADV.

[82] *See* Commodity ETF Release, *supra* note 34, at 54796. We note that professional services providers commonly used by registered investment companies are not limited to those the CFTC has included in its proposed exemptive relief (*i.e.,* the pool's administrator, its distributor, or a bank or registered broker or dealer that is providing services to the CPO or the pool similar to those provided by an administrator or distributor), and may also include professional records maintenance and storage companies.

[83] *See* Rules 4.24(b) and 4.34(b) under the Commodity Exchange Act.

[84] *See* Items 4 and 9 of Form N–1A under the Investment Company Act, which require a registered investment company to disclose the principal risks associated with investing in the company, as well as Item 16 of the SAI, which requires additional information about the risks of investing in the company.

[85] *See* Release at 7990–91.

[86] *See* Section 22(e) of the Investment Company Act and Rule 22c–1 under the Act. On rare occasions, the SEC has granted relief, either under Section 22(e) or Rule 22c–1, to investment companies experiencing "emergency situations" that make it difficult to calculate their net asset values in order to meet purchase or redemption requests. Snowstorms, power outages, and similar events fall into this category.

vestment companies to engage in "highly leveraged transactions," as investment companies are subject to strict capital and asset coverage requirements.[87] Requiring registered investment companies to make the disclosures quoted above would be tantamount to requiring them to make materially misleading statements.

C. Request for Clarification Regarding Series Investment Companies

We request clarification from the CFTC regarding the treatment of series investment companies. For reasons of efficiency, a registered investment company is frequently organized as a single corporation or statutory trust that has multiple "series," each of which represents an interest in a separate pool of securities with separate assets, liabilities, and shareholders. While the corporation or trust is the entity that registers with the SEC, the registrant is required to amend its registration statement each time it creates a new investment company by issuing a new series. It is common practice for registered investment companies to use the series form, and there are mutual fund families that have single registered investment companies with over 100 series. The courts have treated series investment companies as separate corporate entities for purposes of inter-series liability.[88]

The CFTC, both historically and recently, has recognized pools organized in series form as separate investment pools. The CFTC explicitly recognizes series companies in its rules, and acknowledges that each series should be treated as a separate pool if it has limited liability.[89] In addition, when the CFTC adopted the Rule 4.5 exclusion, it specifically stated that it would treat each separate series of an investment company separately for purposes of determining whether the series satisfied the criteria for exclusion from the rule. In doing so, it noted approvingly its staff's statement from an interpretive letter that:

> . . . in light of the separate ownership in and identities of the Fund's Portfolios—*e.g.,* separate investment objectives, net asset valuation and dividend policies—we believe it consistent with the intent of proposed Rule 4.5 to treat as separate entities each of the two Portfolios that intend to engage in commodity interest trading for purposes of determining whether the criteria of the proposal have been met. Conversely, where such separate ownership and identities are not present, we might find it more consistent with proposed Rule 4.5 to aggregate all of the portfolios of a series investment fund in determining whether the criteria have been met.[90]

More recently, the CFTC has recognized series companies in its final rules for periodic account statements and annual financial reports, taking the position that series with limits on inter-series liability should be treated as separate pools for account statement disclosure purposes.[91]

We are aware, however, that the CFTC staff has recently taken the position that CPOs seeking to register new funds that are organized in series form may not use standalone prospectuses for each separate series but must instead include all the series in a trust in a single prospectus. We believe such a result is inconsistent with treatment of series investment companies both by the SEC, as discussed above, as well as the CFTC's own rules and prior positions, and request that the CFTC clarify that series investment companies should be treated the same as investment companies that are not organized in series form. This clarification would be fully consistent with CFTC positions, SEC treatment of series investment companies, and the decisions of courts that have considered the issue.[92]

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[87] *See* Section 18 of the Investment Company Act.

[88] *See, Seidl* v. *American Century Companies, Inc.,* 713 F.Supp.2d 249, 257 (S.D.N.Y. 2010) (stating that "[t]he individual series of a registered investment company are, for all practical purposes, treated as separate investment companies . . . and therefore any recovery in a derivative suit would go to the shareholders of the [affected fund], not to the shareholders of [the investment company's] other funds"); and *In re Mutual Funds Inv. Litig.,* 519 F.Supp.2d 580, 588–89 (D.Md. 2007) (stating that the practice of establishing individual series of a registered investment company "is entirely in accord with applicable rules of the SEC, which has expressly pronounced that under such circumstances each series is to be treated as a separate investment company"); *see also Stegall* v. *Ladner,* 394 F.Supp.2d 358, 362–363 (D.Mass. 2005).

[89] *See* Rule 4.7(b)(2)(iv) and 4.7(b)(3)(i)(D) under the Commodity Exchange Act (exemption for CPOs that offer or sell commodity pool participations only to qualified eligible persons includes periodic reporting relief and annual report relief that provides that, in the case of a pool that is a series fund with limited liability, the account statement or financial statements required are not required to include consolidated information for all series of the pool).

[90] 1985 Adopting Release, *supra* note 30.

[91] *See, Commodity Pool Operator Periodic Account Statements and Annual Financial Reports,* 74 FED. REG. 75785, 75786 (Nov. 9, 2009).

[92] *See, id.;* 1985 Adopting Release, *supra,* note 30; *Seidl, supra* note 88.

V. Request for Adequate Transition Period and Grandfathering

If the CFTC nonetheless determines to proceed with amendments to Rule 4.5, we believe that, once any such amendments are adopted, it will be critical for investment advisers and investment companies to have adequate time to make the changes to their operations and policies and procedures necessary to comply with the amended rule. Given the many uncertainties about the rule at this time and the many changes that could be required if it is adopted, especially if rules of the SEC and CFTC are reconciled, we believe it will be essential for the Commission to provide a substantial transition period for compliance with any amended rule, although it is difficult at this time to estimate what that period should be. The length of such a transition period should be a specific request for comment in any re-proposal. As a matter of fairness, we also request that those registered investment companies that have previously claimed reliance upon current Rule 4.5 be exempted from compliance with any amendments to the rule, as these funds are structured to rely on the exclusion in its current form.

* * * * *

As outlined above, we believe the Rule 4.5 Proposal is deeply flawed and requires significant additional modification before adoption is appropriate. We thus respectfully request that the CFTC fully and carefully consider all of the concerns raised in our letter and by other commenters and, if it continues to believe that amendments to Rule 4.5 are necessary, to re-propose those amendments, taking into consideration the views of commenters.

ICI and its members stand ready to assist the Commission in this important and challenging effort. If you have questions or require further information, please contact me at [**Redacted**], Sarah A. Bessin at [**Redacted**], or Rachel H. Graham at [**Redacted**].

Sincerely,

KARRIE MCMILLAN,
General Counsel.

CC:

Hon. GARY GENSLER, *Chairman;*
Hon. MICHAEL V. DUNN, *Commissioner;*
Hon. JILL E. SOMMERS, *Commissioner;*
Hon. BART CHILTON, *Commissioner;*
Hon. SCOTT D. O'MALIA, *Commissioner;*
KEVIN P. WALEK, *Assistant Director;*
AMANDA LESHER OLEAR, *Special Counsel;*
DANIEL S. KONAR II, *Attorney-Adviser,* Division of Clearing and Intermediary Oversight;
Hon. MARY L. SCHAPIRO, *Chairman,* SEC;
Hon. KATHLEEN L. CASEY, *Commissioner,* SEC;
Hon. ELISSE B. WALTER, *Commissioner,* SEC;
Hon. LUIS A. AGUILAR, *Commissioner,* SEC;
Hon. TROY A. PAREDES, *Commissioner,* SEC;
EILEEN ROMINGER, *Director,* Division of Investment Management, SEC.

APPENDIX A

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators

SEC Requirement	CFTC Requirement	Recommended Result
Disclosure Requirements		
Disclosure Document—Form N–1A sets forth the disclosure that a registered investment company must include in its registration statement and is divided into three parts—the Prospectus, the SAI and the Wrapper/Part C. While the Prospectus is generally the only document that a registered investment company must deliver to prospective investors, the SAI, which includes additional includes certain additional information describing the registered investment company, is available to investors upon request at no charge. These documents are subject to SEC pre-effective review.	Rules 4.21 and 4.24 together require a CPO to provide a single Disclosure Document to prospective participants that includes certain information describing the pool.	Registered investment companies should be deemed to have met CFTC requirements if they satisfy SEC requirements and pre-clearance by the NFA should not be required.
Investment Program—Items 2, 4 and 9 of Form N–1A require a registered investment company to state its investment objective and to disclose the principal investment strategies that will be used to seek to accomplish that objective. The SAI requires additional information about the investment company's investment program.	Rule 4.24(h)(1) and (2) require a CPO to provide a description of "the trading and investment programs and policies that will be followed by the offered pool." and "the types of commodity interests and other invests which the pool will trade."	Registered investment companies should be deemed to have met CFTC requirements if they satisfy SEC requirements.
Principal Risks—Items 4 and 9 of Form N–1A require a registered investment company to disclose the principal risks associated with investing in the registered investment company. The SAI requires additional information about the risks of investing in the investment company.	Rule 4.24(g) requires a CPO to disclose "the principal risk factors of participation in the offered pool."	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators—Continued

SEC Requirement	CFTC Requirement	Recommended Result
Fee Disclosure—Item 3 of Form N–1A requires a registered investment company to include in its Prospectus a fee table and expense example disclosing its fees and expenses. The fee table generally discloses shareholder fees (maximum sales charge imposed on purchases, maximum deferred sales charge, maximum sales charge imposed on reinvested dividends, redemption fee, exchange fee and maximum account fee) and annual operating fund expenses (management fees, distribution and/or service fees, other expenses) on a percentage basis. Items 10 and 12 require additional disclosure regarding management fees and sales expenses. Detailed narrative and historical expense disclosure is required in the SAI, including total dollar amounts of advisory fees for each of the last 3 fiscal years, fees paid to other service providers for management-related services for each of the last 3 years, distribution-related fees paid during the last fiscal year and the purposes for which such payments were made, aggregate brokerage commissions for each of the last 3 fiscal years, brokerage commissions paid to affiliates for each of the last 3 fiscal years, compensation paid to the investment company's principal underwriter and director/trustee compensation. Item 27(d)(1) of Form N–1A also requires an example of the effect of expenses on a shareholder account, and must appear in every annual and semi-annual shareholder report.	Rule 4.24(i) requires a CPO to include in the Disclosure Document for its pool "a complete description of each fee, commission and other expense which the commodity pool operator knows or should know has been incurred by the pool for its preceding fiscal year and is expected to be incurred by the pool in its current fiscal year, including fees or other expenses incurred in connection with the pool's participation in investee pools and funds." The rule includes a non-exhaustive list of fees that must be described in the Disclosure Document, including management fees, brokerage fees and commissions, fees paid in connection with trading advice provided to the pool, incentive fees, commissions that may accrue in connection with the solicitation of participants in the pool, professional and general administrative fees and expenses, organizational and offering expenses, clearance fees and any other direct or indirect cost. The disclosure must also include a break-even analysis that reflects all fees, commissions and other expenses of the pool.	These requirements are in many respects duplicative and, in others, inconsistent. The formats for disclosing fees are different. Requiring registered investment companies to comply with both sets of requirements would be redundant and confusing to shareholders. We therefore believe registered investment companies should be deemed to have met CFTC requirements if they satisfy SEC requirements.

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators—Continued

SEC Requirement	CFTC Requirement	Recommended Result
Performance Disclosure—Item 4 of Form N–1A generally requires a registered investment company to include a bar chart showing the investment company's annual total returns for each of the last 10 calendar years, but only for periods subsequent to the effective date of the registration statement. Following the chart, the investment company must disclose the highest and lowest quarterly return during the 10 years covered by the chart (or since inception if less than 10 years). Form N–1A also requires an investment company to disclose its average annual total returns for the last 1, 5 and 10 years (or since inception if less than 10 years) and to compare its returns to a broad-based securities market index. An investment company is permitted to include in its registration statement performance data for other accounts only in circumstances where the other account is managed in a substantially similar manner, among other requirements.	Rule 4.24(n) requires a pool to include past performance of the pool and in some cases of the CPO's other pools, as set forth in Rule 4.25, which requires a significant amount of performance data that is different from that required or permitted under Form N–1A. In addition to performance data for the pool, the CPO must disclose information for the performance of each other pool it operates (and by the trading manager if the offered pool has a trading manager) if the applicable pool has less than 3 years of actual performance. Further, if the CPO (or the trading manager) has not operated for at least 3 years any pool in which 75% or more of the contributions to the pool were made by persons unaffiliated with the pool operator, the trading manager, the pool's CTAs or their respective principals, the CPO also must disclose the performance of each pool operated by and account traded by the trading principals of the CPO. The performance of any accounts (including pools) directed by a major commodity trading adviser must also be disclosed. The CPO also must disclose the performance of any major investee pool.	These requirements directly conflict and will need to be reconciled. Registered investment companies should be permitted to show only the information required by Form N–1A and related SEC and SEC staff interpretations, including with respect to performance of other pools and accounts. A registered investment company is permitted to include in its registration statement performance data for other accounts only in circumstances where the other account is managed in a substantially similar manner, among other requirements. In addition, FINRA rules generally prohibit broker-dealers from using sales literature for a registered investment company that includes the performance of other accounts. This approach is different than that taken under Rule 4.25, which in certain cases requires performance of all pools (including privately offered pools) and accounts of the CPO or CTA, whether or not they are managed in a substantially similar manner. Moreover, the inclusion of performance information for a private fund in a prospectus for a publicly offered registered investment company, as may be required under the CFTC's performance disclosure requirements, could jeopardize the ability of the private fund to rely on the private offering exemption from registration that is provided pursuant to Regulation D under the 1933 Act.
Management—Items 5 and 10 require a registered investment company to disclose the name and experience of each investment adviser and portfolio manager for the investment company. The SAI requires additional disclosure about investment advisers and portfolio managers.	Paragraphs (e) and (f) of Rule 4.24 require the Disclosure Document to include, among other things, the name and business background of each CPO, the pool's trading manager, and each major commodity trading adviser.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators—Continued

SEC Requirement	CFTC Requirement	Recommended Result
Disclosure Document Delivery and Updating Requirements		
Disclosure Document Delivery— Section 5 under the 1933 Act, the primary provision governing the receipt and timing of Prospectus delivery, does not necessarily require delivery of a Prospectus prior to investment and also does not require delivery or use of a subscription agreement. Rule 10b–10 requires broker-dealers to deliver confirmations of securities transactions, and the Prospectus delivery requirements would ensure that a Prospectus is delivered no later than with the transaction confirmation.	Rule 4.21(a)(1) provides that "each commodity pool operator . . . must deliver or cause to be delivered to a prospective participant in a pool that it operates or intends to operate a Disclosure Document for the pool prepared in accordance with [Rule] 4.24 *by no later than the time it delivers to the prospective participant a subscription agreement for the pool.*" (Emphasis added.) The Disclosure Document also must be filed with and pre-cleared by the NFA under Rule 426(d)(1).	We request that the CFTC grant exemptive relief to adviser CPOs subject to Part 4 (similar to the relief that has been granted to CPOs of commodity ETFs) to permit advisers to make available fund prospectuses and SAIs on their websites. We believe that filing with, and pre-clearance by, the NFA should not be required.
Disclosure Document Updating—Section 10(a) of the 1933 Act effectively permits an investment company to update its registration statement annually. In particular, Section 10(a)(3) states that "when a Prospectus is used more than 9 months after the effective date of its registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use . . ."	Rule 4.26(a)(2) provides that "[n]o commodity pool operator may use a Disclosure Document . . . dated more than 9 months prior to the date of its use." The updated Disclosure Document also must be filed with and precleared by the NFA under Rule 426(d)(2).	We request exemptive relief so that registered investment companies may update based on the SEC requirements. We believe that filing with, and preclearance by, the NFA should not be required.
Registered investment companies must supplement their Prospectuses and SAIs to correct material inaccuracies and omissions, but, to the extent supplements are mailed to existing shareholders, the mailings typically are timed to coincide with other regular mailings to manage costs. Some changes are so material that the investment company may mail supplements to shareholders immediately. In certain cases, an investment company may not deliver supplements to existing shareholders absent an additional investment.	Rule 4.26(c)(1) requires a CPO to update its Disclosure Document to correct any material inaccuracies or omissions, and to deliver the updated information to existing pool participants within 21 calendar days of the date upon which the CPO first knows or has reason to know of the defect.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.
Disclosure Document Acknowledgment—There is no requirement under the Federal securities laws that investment company investors acknowledge receipt of a Prospectus.	Rule 4.21(b) provides that "[t]he commodity pool operator may not accept or receive funds, securities or other property from a prospective participant *unless the pool operator first receives from the prospective participant an acknowledgement* signed and dated by the prospective participant stating that the prospective participant received a Disclosure Document for the pool." (Emphasis added.)	We request that the CFTC grant exemptive relief to adviser CPOs similar to the relief that has been granted to CPOs of commodity ETFs. Requiring an acknowledgment is fundamentally inconsistent with the registered investment company distribution model.

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators—Continued

SEC Requirement	CFTC Requirement	Recommended Result
Additional Documents—The Federal securities laws do not require an investment company to distribute its shareholder reports with the investment company Prospectus, but require registered investment companies to disclose in the Prospectus how shareholders can obtain such documents at no charge.	Rule 4.26(b) generally requires a CPO to attach to its Disclosure Document the applicable pool's most current Account Statement (discussed below) and Annual Report.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirements.
Participant/Shareholder Reporting Requirements		
Rule 30e–1 under the Investment Company Act requires a registered investment company to send to its shareholders at least semiannually a report containing financial statements and other required disclosures. The annual report must contain audited financial statements. Rule 30b2–1 requires that the reports to shareholders, along with certain additional information, be filed with the SEC on Form N–CSR.	Rule 4.21(c) requires each CPO to "distribute an Annual Report to each participant in each pool that it operates . . . ." The Annual Report must include, among other things, audited financial statements.	We request that the CFTC grant exemptive relief to adviser CPOs (similar to the relief that has been granted to CPOs of commodity ETFs) to permit advisers to make available annual and semi-annual shareholder reports required by Rule 30e–1 on their websites.
While the Federal securities laws do not require a registered investment company to distribute a monthly report or account statement to shareholders, they require certain interim reports in addition to the annual report noted above. For example, Rule 30e–1 and Rule 30b2–1 cited above require filing and delivery to shareholders of a semi-annual report, in addition to the filing and delivery of the annual report. In addition, Rule 30b1–5 under the Investment Company Act requires a registered investment company to file a quarterly report on Form N–Q within 60 days after the close of the first and third quarters containing a schedule of investments and other disclosures.	Rule 4.22(a) generally requires "each commodity pool operator . . . [to] distribute to each participant in each pool that it operates, within 30 calendar days after the last date of the reporting period . . . an Account Statement, which shall be presented in the form of a Statement of Operations and a Statement of Changes in Net Assets, for the prescribed period." Rule 4.22(b) states that the Account Statement must be distributed at least monthly in the case of pools with net assets of more than $500,000 at the beginning of the pool's fiscal year, and otherwise at least quarterly.	We request that the CFTC grant exemptive relief to adviser CPOs (similar to the relief that has been granted to CPOs of commodity ETFs) to permit advisers to make available annual and semi-annual shareholder reports required by Rule 30e–1 on their websites.
Regulatory Reporting Requirements		
Form N–SAR—Items 1–6 require information regarding the name of the investment company, its SEC file numbers and address, among other things. Item 75 requires information regarding assets under management.	Form CPO–PQR Schedule A, Part 1—Part 1 requests information that is comparable to that requested in Form NSAR, Items 1–6 and 75. Part 1 requires CPOs to report basic identifying information about the CPO, including its name, NFA identification number and assets under management.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators—Continued

SEC Requirement	CFTC Requirement	Recommended Result
Form N–SAR requires the name of each series of the registrant (Item 7); the identification of key service providers (Items 8–15); information regarding portfolio investments and positions (Items 67–70); and information regarding subscription and redemption activity (Item 28). Performance information is not specifically required by the form, but performance information is available in other reports and registration statements filed with the SEC.	Form CPO–PQR Schedule A, Part 2—Part 2 would require a CPO to report information regarding each of its commodity pools, including the names and NFA identification numbers, position information for positions comprising 5% or more of each pool's net asset value, and the identification of the pool's key relationships with brokers, other advisers, administrators, custodians, auditors and marketers. Part 2 also would require disclosure regarding each pool's quarterly and monthly performance information and information regarding participant subscriptions and redemptions.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement. While there are some differences between the requirements of Form N–SAR and proposed Form CPO–PQR, these differences generally reflect the fact that Form CPO–PQR is intended to obtain information relating to systemic risk, a concern that in our strongly held view is not raised by the activities of registered investment companies that are the subject of this letter. SEC proposed Form PF, which the CFTC has stated solicits information that is generally identical to that sought by Form CPO–PQR, is specifically designed to address the potential systemic risk raised by activities of advisers to private funds, not registered investment companies. However, registered investment companies are subject to CFTC large trader reporting requirements like any other trader, which enables the CFTC to obtain information from those entities that it can use to assess systemic risk.
Investment companies must complete the entire Form NSAR regardless of assets under management. In addition, the form must be completed on a series by series basis. In general, Form N–SAR requires the name of each series (Item 7); information regarding each series' investment strategies and positions (Items 62–70); liabilities from borrowings and other portfolio management techniques (Item 74); and information regarding brokerage transactions (Items 20–26).	CPOs that have assets under management equal to or exceeding $150 million would be required to file Schedule B, which would require the CPO to report detailed information for each pool. The required information is comparable to that required by the corresponding provisions of Form N–SAR for funds and includes information regarding each pool's investment strategy, borrowings by geographic area and the identities of significant creditors, credit counterparty disclosure, and entities through which the pool trades and clears its positions.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement.

Comparison of Requirements Applicable to Registered Investment Companies and Commodity Pool Operators—Continued

SEC Requirement	CFTC Requirement	Recommended Result
Form N–SAR generally requires a registered investment company to report investment and exposure information on a series by series basis in all cases. It generally does not require an investment company to report investment and exposure information on an aggregate basis or certain more detailed information required by Schedule C of Form CPO–PQR.	Form CPO–PQR Schedule C, Parts 1 and 2—CPOs that have assets under management equal to $1 billion or more would be required to file Schedule C. Part 1 would require certain aggregate information about the commodity pools advised by large CPOs, such as the market value of assets invested, on both a long and short basis, in different types of securities and derivatives, turnover in these categories of financial instruments, and the tenor of fixed income portfolio holdings. Part 2 would require CPOs to report detailed information regarding individual pools with at least $500 million in assets under management, including liquidity, concentration, material investment positions, collateral practices with significant counterparties and clearing relationships.	Registered investment companies should be deemed to have met CFTC requirement if they satisfy SEC requirement. Registered investment companies are subject to CFTC large trader reporting requirements like any other trader, which enables the CFTC to obtain information from those entities that it can use to assess systemic risk. Accordingly, the more detailed information requested by Form CPO–PQR, Schedule C should not be necessary for registered investment companies.
Books and Records		
Rule 31a–2 requires a registered investment company to preserve its books and records for specified periods of time, with more recent books and records typically preserved in an "easily accessible place." Rule 31a–3 permits a registered investment company to use a third party to prepare and maintain required records. Reliance on the rule is conditioned upon having a written agreement to the effect that the records are the property of the person required to maintain and preserve them, and that such records will be surrendered promptly on request. In addition, Item 1(K) of Form ADV requires a registered investment adviser to indicate whether it maintains its required books and records at a location other than its principal office and place of business, and Section 1.K. of Schedule D of Form ADV requires the adviser to specify each entity that maintains its books and records, including the location of the entity, and a description of the books and records maintained at that location.	Rule 4.23 requires a CPO to maintain required pool books and records at its main business office.	We request that the CFTC grant exemptive relief to adviser CPOs from Rule 4.23 if they satisfy the requirements of the Investment Company Act rules and Form ADV.

The CHAIRMAN. Thank you, Ms. McMillan.

Mr. Greenberger, 5 minutes.

STATEMENT OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD

Mr. GREENBERGER. Thank you very much, Chairman Conaway and Ranking Member Boswell. I am deeply appreciative to have the opportunity to talk to you today.

I think I come at this from a slightly different context, and I may be so bold as to say a context that may be one of your typical constituents.

We seem to, in this entire discussion, forget what we have just been through. We have been through a process where we deregulated a $100 trillion—over a $100 trillion industry, and it collapsed. And that led to the meltdown.

The very reason this Committee so energetically and thoughtfully put its weight behind the derivatives section of Dodd-Frank was, everybody who is objective and honest said the failure of the swaps market—failure in the sense that people were placing bets, the casino never put money aside; when the bets were called, the casino, like AIG and others, didn't have money, the taxpayer had to make up the difference.

In betting, there is usually a winner and loser. In these bets, there were two winners: the people who won the bets; the people who lost the bets got money from the American taxpayer. The American taxpayer, who wasn't part of the bets, ended up paying everything. We paid trillions of dollars to rescue the too-big-to-fail banks that are now reporting billions of dollars of profits.

When you say, what is the cost-benefit analysis, talk to your constituents. Do they think they paid a cost for what happened back in September of 2008? They are either jobless, they have job insecurity, their pensions are down, their houses have lost value, they can't get loans from these banks even though the banks are very profitable. There was a terrific cost paid by the American taxpayer.

The purpose of Dodd-Frank is to make sure that never happens again. And so, when you do your cost-benefit analysis, remember your constituent whose kid is sitting on a couch with a college degree and can't find a job with loans that can't be repaid. That has to be part of the cost.

And, by the way, when the CFTC rules go into effect, it is only the swaps that succeed those rules that become regulated. The hundreds of trillions of dollars of swaps that are out there now that are being entered into today are not going to be regulated.

The reason there is a July 21st deadline for these rules is, if we don't put some discipline into this system, history is going to repeat itself. Why will history repeat itself? European countries are facing sovereign defaults. Jamie Dimon just advised a group of investors, "Don't worry about the municipalities. I only think about a hundred or so will default on their bonds." That is going to cause systemic risk if that happens. There is oil shock right now. We are talking about the possible default of the United States Government.

That is going to trigger all the unregulated swaps out there. People are going to say, "Oh, I won my bet," to the counterparty. "Where is my money?" And the money isn't going to be there. And you know who is going to be asked to pay that burden? The American taxpayer.

So we can—all of this stuff about cost-benefit analysis, let's get all the rules out and have a new comment period—this is what used to be called the four-corners offense to prevent the agency from complying with its statutory mandate: to put protections in, to ensure capital adequacy, provide transparency, give pricing to the system to prevent the next default, the next meltdown.

If any of these bad events take place—European default, municipal default, oil price shock—there is going to be a second dip recession, and people are going to say to you, "How come there are no rules?" And we are going to say, well, we wanted to have the Office of Management and Budget chief economists bring in new data and everything else.

This is a bipartisan issue. Republicans and Democrats are laying flat on their back today because regulation failed. The CFTC should not only not be criticized—the people who work there have been there in the Reagan Administration, H.W. Bush, Clinton, W. Bush. These are career employees; they don't have an agenda. They are killing themselves to comply and save the American people from lack of capital that the taxpayer has to make up and lack of transparency.

I just ask that the Committee please stand back and say, what is going to happen if we are analyzing this like our navels while the American public goes down for a second time and there are no bullets left? There is no money for stimulus, no money for TARP. And what did they say in September of 2008? If we don't have stimulus, we are going to go into the Great Depression. Well, if we have a second dip, there will be no stimulus.

Thank you.

[The prepared statement of Mr. Greenberger follows:]

PREPARED STATEMENT OF MICHAEL GREENBERGER, J.D., PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MD

The Relationship of Unregulated OTC Derivatives to the Meltdown. It is now accepted wisdom that it was the non-transparent, poorly capitalized, and almost wholly unregulated over-the-counter ("OTC") derivatives market that lit the fuse that exploded the highly vulnerable worldwide economy in the fall of 2008.[1] Because tens of trillions of dollars of these financial products were pegged to the economic performance of an overheated and highly inflated housing market, the sudden collapse of that market triggered under-capitalized or non-capitalized OTC derivative guarantees of the subprime housing investments. Moreover, the many undercapitalized insurers of that collapsing market had other multi-trillion dollar OTC derivatives

[1] *See* Ben Moshinsky, *Stiglitz says Banks Should Be Banned From CDS Trading,* *BLOOMBERG.COM* (Oct. 12, 2009), *http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=a65VXsI.90hs;* Paul Krugman, Op-Ed, *Looters in Loafers,* N.Y. TIMES, Apr. 18, 2010, available at *http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk. See, generally* Alan S. Blinder, *The Two Issues to Watch on Financial Reform—We Need an Independent Consumer Watchdog and Strong Derivatives Regulation. Industry Lobbyists are Trying to Water Them Down,* WALL ST. J., Apr. 22, 2010, available at *http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html;* Henry T. C. Hu, *Empty Creditors and the Crisis,* WALL ST. J., Apr. 10, 2009, at A13; Michael Lewis, *The Big Short: Inside the Doomsday Machine* (2010) [hereinafter *The Big Short*]; Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (2011) [hereinafter *13 Bankers*]; Michael Hirsh, *Capital Offense: How Washington's Wise Men Turned America's Future Over to Wall Street* (2010) [hereinafter *Capital Offense*]; Bethany McLean & Joe Nocera, *All The Devils Are Here: The Hidden History of the Financial Crisis* (2010) [hereinafter *All The Devils Are Here*]; *Inside Job* (Sony Pictures Classics & Representational Pictures 2010); FRONTLINE: *The Warning* (PBS television broadcast Oct. 20, 2009) [hereinafter *The Warning*]; Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* xxiv (Jan. 2011), available at *http://www.fcic.gov/report* [hereinafter *FCIC Report*].

obligations with thousands of financial counterparties (through unregulated interest rate, currency, foreign exchange, and energy derivatives). If a financial institution failed because it could not pay off some of these obligations, trillions of dollars of interconnected transactions would have also failed, causing a cascade of collapsing banks throughout the world. It was this potential of systemic failure that required the United States taxpayer to plug the huge capital hole that a daisy chain of nonpayments by the world's largest financial institutions would have caused, thereby heading off the cratering of the world's economy.[2]

An Example of the Multi-Trillion Dollar Derivative "Bets" That Had to Be Paid by the U.S. Taxpayer. The then perfectly lawful "bets" that hedge fund manager John Paulson placed through this unregulated OTC derivatives market provide but a single example of how that market collectively misfired and—but for taxpayer bailouts—nearly imploded the world economy.[3] From 2006 to 2007, Mr. Paulson with, *inter alia,* the assistance of swaps dealers, purchased synthetic collateralized debt obligations ("CDOs"), which were nothing more than the purchase of insurance on his selection of weak tranches of subprime residential mortgage-backed securities that Mr. Paulson himself did not own.[4] In other words, through so-called "naked credit default swaps ('CDS')," Mr. Paulson effectively bought insurance on his own selection of subprime investments in which he had no ownership and for which he had no risk, but which he believed would fail. Since the dawn of the 19th century, it has not been legal to buy insurance on someone else's risk. However, because these "bets" were categorized as OTC derivatives, they were expressly deregulated as "swaps" by Congressional enactment, and insurance laws were not applied.

When subprime mortgage borrowers (*i.e.,* those with various degrees of non-creditworthiness) defaulted and could not, as common sense would have suggested, sustain their mortgages, the tranches that Mr. Paulson insured (but did not own) failed, thereby triggering highly lucrative payment obligations to Mr. Paulson pursuant to his synthetic CDOs and naked CDS. Paulson ultimately made about $15 billion on these bets.[5]

Even though the purchasers of synthetic CDOs, such as Mr. Paulson, "profited spectacularly from the housing crisis . . . they were not purchasing insurance against anything they owned. Instead, they merely made side bets on the risks undertaken by others."[6] In fact, because synthetic CDOs mimicked insurance, those who were "insured" through synthetic CDOs were only required to sustain their multi-trillion dollar bets with insurance-like "premiums," *i.e.,* they were only required to pay about two percent of the total amount insured.[7]

Moreover, as has been widely demonstrated, investors "creating" their synthetic bets that the subprime market would fail often repeatedly insured against the *same* weak subprime tranches, *i.e.,* many weak subprime tranches were "bet" to fail multiple times.[8] In essence, therefore, once a borrower defaulted on a mortgage, the loss in the real economy was exponentially multiplied by the many side bets placed on whether that borrower would default.

Mr. Paulson's investments are reflective of trillions of dollars bet on the subprime market, and the astronomical amounts owed to the holders of this unregulated "insurance" of the subprime market serve as a microcosm of the worldwide financial crisis.[9]

Most importantly, the "insurers" of the subprime market (some of the most prominent financial institutions in the world) were not required to have capital to sustain

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[2] *See* Moshinsky, *supra* note 1; Krugman, *supra* note 1; Blinder, *supra* note 1; Hu, *supra* note 1; *The Big Short, supra* note 1.

[3] Complaint at 2, *Securities and Exchange Commission* v. *Goldman Sachs & Co. and Fabrice Tourre,* 2010 U.S. Dist. Ct. 3229 (S.D.N.Y. Apr. 16, 2010) ("Undisclosed in the marketing materials and unbeknownst to investors, a large hedge fund, Paulson & Co. Inc. ('Paulson'), with economic interests directly adverse to investors in the ABACUS 2007–AC1 CDO, played a significant role in the portfolio selection process. After participating in the selection of the reference portfolio, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps ('CDS') with [Goldman] to buy protection on specific layers of the ABACUS 2007–AC1 capital structure. Given its financial short interest, Paulson had an economic incentive to choose RMBS that it expected to experience credit events in the near future.") (On July 15, 2010, Goldman Sachs entered into a settlement without admitting or denying the SEC's allegations for the amount of $550 million.)

[4] *Id.*

[5] Svea Herbst-Bayliss and Kevin Lim, *Paulson reassures on Goldman role,* REUTERS (April 21, 2010), available at *http://www.reuters.com/article/2010/04/21/us-goldman-paulson-redemptions-idUSTRE63K0C620100421?pageNumber=1.*

[6] *FCIC Report, supra* note 1, at 195.

[7] *See,* ***The Big Short,*** *supra* note 1, at 51.

[8] *See, id.*

[9] *See, generally,* ***The Big Short,*** *supra* note 1; *see also* ***Inside Job,*** *supra* note 1.

their insurance or to post collateral to ensure their payments. (Had these investments been governed by insurance or gaming laws, those betting that subprime mortgages would be paid would have been required to have adequate capital to ensure payments if the bet were lost.) And, when the "insurers" were "surprised" to find that those without creditworthiness could not pay their mortgages, they did not have the ability to pay off their indebtedness to the holders of synthetic CDOs. However, what should have been a zero-sum game was converted from a lose-lose game into a win-win situation, *i.e.,* the Mr. Paulsons of this world only got paid because "insurers" were subsidized by the taxpayer so that the "casinos" could make payment on the bets. Unlike regular gambling, no gambler lost—except the perfectly innocent bystanders: the U.S. taxpayer.[10]

As it now stands, the world is attempting to dig itself out of the worst financial crisis since the Great Depression of the 1930's—a task now aggravated, *inter alia,* by the burden of escalating energy and food commodity prices. Dozens of studies suggest that even those escalating commodity prices may very well be aided by betting on the upward direction of those prices through passive investments originated by U.S. financial institutions using unregulated OTC derivatives.[11]

Dodd-Frank Provides the Tools to Protect the U.S. Taxpayer. Title VII of the Dodd-Frank Act[12] would make it very difficult to repeat the kind of undercapitalized, non-transparent, and economy-busting "betting" mentioned above. That statute, *if properly implemented,* (1) requires all major players to have adequate capital to enter the market to sustain their potentially huge obligations; (2) requires that *almost* all of these kinds of investments be collateralized by counterparties; (3) requires *almost* all of these investments to be guaranteed and properly margined by clearing facilities, which, in turn, are subject to strict Federal regulation and oversight; (4) requires all of these transactions to be publicly recorded and, in many instances, traded on public exchanges or exchange-like environments; and (5) collectively places the CFTC, the SEC, and the members of the Financial Stability Oversight Council in a position to have full transparency of these kinds of investments with an eye to preventing the kind of systemic risk that threatened the world economy in the fall of 2008.

It must be emphasized that Title VII exempts from the clearing requirement commercial end-users.[13] Moreover, the CFTC and SEC have repeatedly said that uncleared swaps used by commercial end-users will be exempt from margin requirements both for the commercial end-user *and* for the swap dealer selling the hedging vehicle.[14]

Moreover, the statute expressly exempts from regulation all swaps in existence before the statute passed, as well as swaps executed before final rules are put in

[10] *See,* ***The Big Short,*** *supra* note at 1, at 256.

[11] *See,* Commodity Markets Oversight Coalition, *Evidence of the Impact of Commodity Speculation by Academics, Analysts and Public Institutions* (2011), available at *http://www.nefiactioncenter.com/PDF/evidenceonimpactofcommodityspeculation.pdf; see also,* Kenneth J. Singleton, Graduate School of Business Professor, Stanford University, *Investor Flows and the 2008 Boom/Bust in Oil Prices* (March 23, 2011), available at *http://www.stanford.edu/~kenneths/.*

[12] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203 (2010).

[13] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 723(a)(3) (2010) ("Clearing Transition Rules—(A) Swaps entered into before the date of the enactment of this subsection are exempt from the clearing requirements of this subsection if reported pursuant to paragraph (5)(A); (B) Swaps entered into before application of the clearing requirement pursuant to this subsection are exempt from the clearing requirements of this subsection if reported pursuant to paragraph (5)(B).").

[14] Written Testimony of Gary Gensler, Chairman, Commodity Futures Trading Commission, *Hearing Before the U.S. House Committee on Agricultural to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Acton,* February 10, 2011, available at *http://www.cftc.gov/pressroom/speechestestimony/opagensler-68.html* ("Transactions involving non-financial entities do not present the same risk to the financial system as those solely between financial entities. Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve non-financial end-users.") [hereinafter "Gensler Testimony"]; Written Testimony of Mary Schapiro, Chairman, Securities and Exchange Commission, *Hearing Before the U.S. House Financial Services Committee on Implementation of Titles VII and VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act by the U.S. Securities and Exchange Commission,* February 15, 2011, available at *http://www.sec.gov/news/testimony/2011/ts021511mls.htm* ("in proposing margin rules, we will be mindful both of the importance of security-based swaps as hedging tools for commercial end-users and also of the need to set prudent risk rules for dealers in these instruments.") [hereinafter "Schapiro Testimony"].

place.[15] That means until the CFTC acts, hundreds of millions of dollars of swaps will continue to be unregulated with no provision for capital adequacy or transparency. This latter factor, in and of itself, justifies the timetable established in Dodd-Frank for implementation of the statute, which the CFTC is diligently attempting to follow. Until final rules are adopted, the American taxpayer, consumer and retiree are exposed to the same regulatory inadequacies that caused the fall 2008 credit crisis to begin with.

One of the most important sections in Title VII of Dodd-Frank is Section 737 on Position Limits.[16] It is designed to ban excessive speculation from the derivatives market, *i.e.,* ban that speculation which exceeds the need for liquidity by commercial hedgers in the commodity markets. The CFTC, as Congressionally mandated, is currently in the process of implementing Section 737 through the rulemaking process and proposed rules on position limits on January 26, 2011.[17]

However, in attempting to properly implement Section 737, the CFTC has faced massive opposition. Opponents have argued that Section 737 is not necessary to prevent volatility in commodity prices. First, as I have stated in my comment letter in response to the proposed position limits rules,[18] Section 737 does not afford the CFTC discretion regarding the implementation of position limits. Rather, it imposes the statutory obligation to set position limits with the goal of limiting excessive speculation. In drafting this section, Congress purposefully replace the word "may" in the House version of the Dodd-Frank Act[19] with "shall,"[20] to "strengthen confidence in trader position limits on physically deliverable commodities as a way to prevent excessive speculative trading."[21]

Those who oppose position limits argue that there is a lack of empirical data demonstrating that excessive speculation has unnecessarily and dramatically increased the price of energy and agricultural commodities. For example, Terry Duffy of the CME Group stated during the March 3, 2011 hearing before the Senate Committee on Agriculture, Nutrition and Forestry that "there's been absolutely no evidence that [speculators] have anything to do with the effect of price whether it comes from an academic, whether it comes from a government study or anything else. So just want to put that clear."[22] This is simply incorrect. Even if, for argument's sake, the imposition of position limits is discretionary, many company/commercial end-users, including, *inter alia,* Starbucks, Hershey, Lindt & Spruengli, and Delta Airlines, have now come forward demonstrating that the futures market is in complete disarray because of excessive speculation.[23] The Commodity Markets Oversight Coali-

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[15] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 739 (2010) ("Unless specifically reserved in the applicable swap, neither the enactment of the Wall Street Transparency and Accountability Act of 2010, nor any requirement under that Act or an amendment made by that Act, shall constitute a termination event, *force majeure,* illegality, increased costs, regulatory change, or similar event under a swap (including any related credit support arrangement) that would permit a party to terminate, renegotiate, modify, amend, or supplement one or more transactions under the swap.").

[16] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 737 (2010).

[17] *Position Limits for Derivatives,* 76 FED. REG. 4752 (January 26, 2011).

[18] *See* Comment Letter by Michael Greenberger, Professor, University of Maryland School of Law, Director, Center for Health and Homeland Security, to David Stawick, Secretary, Commodity Futures Trading Commission, *Position Limits for Derivatives* (March 28, 2011), available at *http://www.michaelgreenberger.com/files/Greenberger_PL_comment_letter.pdf*.

[19] The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

[20] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 737 (2010).

[21] Official website of House Committee on Agriculture, *House Passes Peterson-Frank Amendment to Strengthen Regulation of Over-the-Counter Derivatives,* December 10, 2009, available at *http://democrats.agriculture.house.gov/press/PRArticle.aspx?NewsID=207*.

[22] *See, Transcript of Implementation of Title VII of the Wall Street Reform and Consumer Protection Act,* Hearing Before the Senate Committee on Agriculture, Nutrition & Forestry, 112th Cong. (March 3, 2011) (Statement of Terry Duffy, Executive Chairman, CME Group); *see also e.g.,* in the comment letter submitted by SIFMA Asset Management Group, which is comprised primarily of Chief Operating Officers and other senior executives at asset management firms, argued: "The CFTC should delay adoption of position limits until an 'appropriateness' determination can be made. *Currently, there lacks insufficient evidence to suggest that speculation is affecting commodities markets.*" Comment Letter by Timothy W. Cameron, Esq., Managing Director, Asset Management Group of Securities Industry and Financial Markets Association (SIFMA) to David Stawick, Secretary, Commodity Futures Trading Commission, Notice of Proposed Rulemaking—Position Limits for Derivatives, March 28, 2011, available at *http://www.sifma.org/issues/item.aspx?id=24137* (emphasis added).

[23] *See, e.g.,* Howard Schultz, Chief Executive Officer of Starbucks, Inc., recently stated: "I've been in this business for 30 years. I can tell you unequivocally with every coffee farmer and resource that we talk to in which we have decades of relationships, we cannot identify a supply

tion, an independent, non-partisan and nonprofit alliance of groups that represents commodity-dependent industries, businesses and end-users, has also adopted the position that commodity prices defy market fundamentals due to excessive speculation.

Notably, during the March 31, 2011 hearing before the House Committee on Natural Resources, three out of the four panelists (Bill Graves, CEO and President of American Trucking Association and former Republican Governor of Kansas, Don Shawcroft, President of Colorado Farm Bureau, and Michael J. Fox, Executive Director of Gasoline & Automotive Service Dealers of America, Inc.) supported the need to regulate excessive speculation with strict aggregate position limits as required by Section 737 across all derivatives markets and to provide necessary funding to the CFTC to implement that strict anti-speculative regime.[24] In particular, Mr. Fox told the Committee: "The fastest way to $6 retail gasoline price is to not fully fund the CFTC and not impose the Dodd-Frank regulations. That's the fastest way to get to $6 gasoline."[25]

Overbroad exemptions from speculative position limits are wholly unjustified, as it has been repeatedly proven that the swap dealer exemptions have allowed those Too Big to Fail banks to enter into excessive speculative transactions in the commodities market. Specifically, the bipartisan Senate Permanent Subcommittee on Investigations Report on Excessive Speculation in the Wheat Market, which was released on July 24, 2009, found that "four swap dealers selling index-related swaps currently operate with hedge exemptions that allow them to hold much larger positions on the Chicago wheat futures market than would otherwise apply under the CFTC's speculative position limits."[26] Allowing these kinds of exemptions to continue would drive excessive speculation in all commodity markets, which is why we are in an inflationary food and energy bubble at this time.

We Are Not Home Free Yet. There is now a substantial question whether Title VII of Dodd-Frank will be properly implemented because of resistance by big banks and other financial institutions. According to the Comptroller of the Currency, five big Wall Street banks have controlled 98% of the existing (pre-Dodd-Frank) OTC derivatives market, thereby necessitating, for example, the Antitrust Division of the Department of Justice to intervene in one of the critically important CFTC and SEC proposed rulemakings concerning ownership of the major new financial institutions created by Dodd-Frank. The big banks want to keep these institutions within their control. Needless to say, if properly implemented, the huge profits of these and other banks will be diminished by the competition that a transparent market brings, in the words of Dodd-Frank, "free and open access" to what would be highly competitive derivatives markets.

While each argument advanced by swaps dealers must be analyzed on its own merits, there can be no mistake that a unifying rationale for minimizing the impact of Dodd-Frank, either implicitly or explicitly, is that we are now out of the financial crisis and there is no need for change. Therefore, it is suggested that as much of the status quo ante as can be preserved should now be left in place.

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problem in the world where we're buying coffee. So one question is, 'why are coffee prices going up?' and in addition to that, 'why is every commodity price going up at the same time?' Why is cotton, corn, wheat, why? And I think what's going on is financial engineering; that financial speculators have come into the commodity markets and drove these prices up to historic levels and as a result of that the consumer is suffering." Josh Garrett, *Starbucks CEO Points to Speculation as Cause of Rising Commodity Prices, HEATINGOIL.COM* (April 6, 2011), available at *http://www.heatingoil.com/blog/starbucks-ceo-points-to-speculation-as-cause-of-rising-commodity-prices0406/; see also e.g.,* The world's largest chocolate maker, Hershey Co. have announced that they have increased the price to "offset the higher costs of ingredients such as cocoa and sugar which has doubled in cost over the last year." Moreover, Lindt & Spruengli, the Swiss chocolate maker, said that "they may well increase their prices to consumers in the second half of the year to offset the higher costs of Cocoa prices that the company have incurred *after Cocoa costs rose following financial speculation* and post-election violence in the Ivory Coast." Edward Buckley, *Hershey's Raise Their Prices By Nearly 10% To Offset Rising Costs, NEWSDAILYBRIEF.COM* (April 1, 2011), available at *http://newsdailybrief.com/hersheys-raise-their-prices-by-nearly-10-percent-to-offset-rising-costs/353628/* (emphasis added); Jim Spencer and Dee DePass, *As we pay more at the pump, oil trading curbs still on hold,* STAR TRIBUNE (March 20, 2011) (quoting Ben Hirst, Chief Counsel, Delta Air Lines: "[S]peculators try to anticipate what other speculators are going to do, and the market overreacts. It's not as though there's a shortage of product that caused the price to move up. It's a casino process with financial players betting on where the price is going to go. But it has an effect on [current] prices.").

[24] *See, Harnessing American Resources to Create Job and Addressing Gasoline Prices: Impacts on Business and Families,* Hearing Before the H. Comm. on Natural Resources, 112th Cong. (March 31, 2011).

[25] *Id.*

[26] Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, *Excessive Speculation In The Wheat Market* 37 (June 24, 2009) [hereinafter "*Wheat Report*"].

A subsidiary argument is that if Dodd-Frank is fully enforced, it will be a job killer. However, as shown above, the undercapitalized casino that unregulated derivatives fostered in the subprime housing market was the ultimate job and pension killer. The misery created by that unregulated market often gets lost in Wall Street talking points. Moreover, the economic gambling infrastructure built before Dodd-Frank around subprime mortgages exists, *e.g.,* for prime mortgages, commercial mortgages, student loans, auto and credit card debt.

We are presently in a jobless "recovery." Moreover, the shock of rapidly escalating energy and food prices, as well as threatened defaults by municipalities and European Union sovereign states, can either individually or collectively create economic dislocations akin to that experienced in the fall of 2008. For example, there is almost certainly an untold number of grossly undercapitalized naked CDS on municipal and sovereign obligations. If there are widespread defaults in those areas, an untold number of undercapitalized "insurance" guarantees will be triggered.

The loss of profits of "Too Big to Fail" financial institutions, which have fully recovered and may be stronger and bigger now than before the meltdown, must be balanced against the well being of the American consumer, worker and taxpayer.[27] Rejecting Dodd-Frank on the assumption that all is now well is a dangerous strategy to follow legislatively or at the regulatory level.

There is another concern that the implementation of Dodd-Frank would add significant operation costs to commercial end-users. However, as shown above, the Act contains a statutory "end-user" exception to ease the burden on businesses using swaps to mitigate risk associated with their commercial activities.[28] The legislative intent shows that the drafters of the Act unequivocally share this goal as well.[29] Furthermore Chairman Gensler and Chairwoman Schapiro have said repeatedly that end-users will not have to post margin for uncleared swaps and that the swaps dealer counterparty will not have to post margin.[30] Simply, this is a case of commercial end-users not taking "yes" for an answer to their worries about having to post collateral for uncleared swaps.

Whatever new costs Dodd-Frank imposes (and those costs are greatly exaggerated by those seeking to deflate regulation) are minimal compared to the dire economic havoc that might be caused by under-regulation, especially when Congress is now almost devoid of "stimulus bullets" to repair future economic ills.

Funding for the CFTC and SEC. Severely hampering the CFTC's and SEC's ability to implement Title VII of Dodd-Frank are their challenging financial and staffing conditions. With regard to the CFTC, that agency's gross under-funding makes performing its new and complex functions under Dodd-Frank "a Herculean task."[31] Under the new regulations, the CFTC must examine a voluminous amount of data and information encompassing transactions that number in the millions.[32] An $11 million slash in the technology budget has forced the agency to cease developing a new program that would scan the overwhelming number of trades to detect suspicious trading. Moreover, the potential long-term effects of insufficient funding is severe; operating under its current budget will mean that applications, findings, and enforcement required by the new law would languish.[33] As Commissioner Bart Chilton aptly warns, "Without the funding, we could once again risk another calami-

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[27] Karen Weise, Banks *'Too Big to Fail' Could Get Bigger: Federal agencies putting mortgage and derivative reforms into force are writing rules that seem to have a big-bank bias,* BLOOMBERG BUSINESSWEEK (April 7, 2011), available at *http://www.businessweek.com/magazine/content/11_16/b4224025246331.htm*.

[28] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 723 (2010).

[29] *See,* Letter from Christopher Dodd, Chairman, Senate Committee on Banking, Housing, and Urban Affairs & Blanche Lincoln, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, to Barney Frank, Chairman, Financial Services Committee & Colin Peterson, Chairman, Committee on Agriculture, (June 30, 2010), available at *http://www.wilmerhale.com/files/upload/June%2030%202010%20Dodd_Lincoln_Letter.pdf* (explaining that the end-user exception is "for those entities that are using the swaps market to hedge or mitigate commercial risk.").

[30] *See,* Gensler Testimony, *supra* note 14; *see also* Schapiro Testimony, *supra* note 14.

[31] Ben Protess, *Regulators Decry Proposed Cuts in C.F.T.C. Budget,* N.Y. TIMES (February 24, 2011) (quoting CFTC Commissioner Michael Dunn), available at *http://dealbook.nytimes.com/2011/02/24/regulators-decry-proposed-c-f-t-c-budget-cuts/?ref=todayspaper*.

[32] Jean Eaglesham and Victoria McGrane, *Budget Rift Hinders CFTC,* WALL ST. J. (Feb. 25, 2011).

[33] *See,* Transcript of the Congressional Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act before the H. Comm. on Agriculture (Feb. 15, 2011) (statement of Terry Duffy, Executive Chairman, CEM Group).

tous disintegration."[34] Lack of funds not only shortchanges the Commission, but it also risks another widespread financial crisis.

In this regard, the CFTC lacks an adequate number of personnel to perform its increased regulatory duties. From 1999 to 2007, the agency shrunk from 567 full-time equivalents ("FTEs") to 437. By 2010, the number of FTEs had risen to 650, only a 30% increase in the number of personnel since the agency's establishment in 1975. Chairman Gary Gensler estimates that he needs an additional 400 people to meet the challenges of regulating the multi-trillion dollar derivatives markets.[35] As Barbara Roper of the Consumer Federation of America has noted, for example, the "Draconian cuts" of the House of Representatives' proposed budget would "decimate that tiny agency without making any meaningful inroads in the Federal deficit."[36] Even the relatively fiscally conservative *Financial Times* has recently editorialized that the SEC and CFTC deserve the funding levels that were promised to prevent a future meltdown through proper implementation of Dodd-Frank.

It is one thing to attack Dodd-Frank frontally by seeking deregulatory action either through legislation or weakened rules. There can be little doubt, however, that starving financial regulatory agencies dependent upon appropriations is a *de facto* rescission of Dodd-Frank. It asks Americans to face yet another crisis under the guise of budget cuts—a crisis that may "the next time" drag the United States and the world into the next Great Depression.

In making this point, I also want to commend the CFTC for its heroic work in meeting the necessarily rigorous deadlines imposed by Dodd-Frank for well over 60 new rules. I spent 25 years in a private law practice heavily devoted to rulemaking advocacy, and then involvement in the judicial review of those rules in virtually every Federal circuit court of appeals in the country and in the United States Supreme Court. I was also very proud of the many rules that were promulgated by the CFTC while I was the Director of the Division of Trading and Markets. However, the hard and productive work performed by the CFTC in implementing Dodd-Frank, especially with its small staff, is extraordinary. The quality of that work also meets the highest standards of public service. This Subcommittee as one of the key oversight bodies for the CFTC should be very proud of this effort. The agency has more than demonstrated that it will be a vigilant protector of the important markets it now oversees if it receives the financial support it needs from this Congress.

This testimony is further supported in detail by my March 3, 2011 written testimony before the Senate Committee on Agriculture, Nutrition and Forestry at pp. 6 to 25;[37] my March 28, 2011 comment letter to the CFTC on Position Limits for Derivatives;[38] my published article in the University of Maryland School of Law's *Journal of Business and Technology Law;*[39] and a series of my previously published articles and testimony delivered to Congress and to the Financial Crisis Inquiry Commission.[40] Links to those documents may be found in the margin.

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[34] *See,* Statement of Bart Chilton, Commissioner, Commodity Futures Trading Commission, Risky Business (February 24, 2011), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement022411.html*.

[35] Ben Protess and Mac William Bishop, *At Center of Derivatives Debate, a Gung-Ho Regulator,* N.Y. TIMES (Feb. 10, 2011), available at *http://dealbook.nytimes.com/2011/02/10/at-center-of-debate-over-derivatives-a-gung-ho-regulator/*.

[36] *See,* Statement of Barbara Roper, Director of Investment Protection, Consumer Federation of America, Feb. 14, 2011.

[37] Written Testimony of Michael Greenberger, *Hearing Before the U.S. Senate Committee on Agriculture, Nutrition and Forestry Regarding the Implementation of Title VII of the Wall Street Reform and Consumer Protection Act* (March 3, 2011), available at *http://www.michaelgreenberger.com/files/110303-Greenberger__Senate__Ag__Testimony2.pdf*.

[38] Comment Letter by Michael Greenberger, Professor, University of Maryland School of Law, Director, Center for Health and Homeland Security, to David Stawick, Secretary, Commodity Futures Trading Commission, Position Limits for Derivatives (March 28, 2011), available at *http://www.michaelgreenberger.com/files/Greenberger__PL__comment__letter.pdf*.

[39] *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by An Unregulated Multi-Trillion Dollar Derivatives Market,* 6 J. BUS. & TECH. L. 127 (April 2011), available at *http://works.bepress.com/michael__greenberger/41/*.

[40] *Derivatives in the Crisis and Financial Reform*, in THE POLITICAL ECONOMY OF FINANCIAL CRISES, Oxford University Press Handbook (Gerald Epstein & Martin Wolfson eds., forthcoming 2012); *Is Our Economy Safe? A Proposal for Assessing the Success of Swaps Regulation under the Dodd-Frank Act,* in THE FUTURE OF FINANCIAL REFORM: WILL IT WORK? HOW WILL WE KNOW? (Roosevelt Institute 2010), available at *http://works.bepress.com/michael__greenberger/34; Out of the Black Hole: Regulatory Reform of the Over-the-Counter Derivatives Market,* in MAKE MARKETS BE MARKETS 99 (Roosevelt Institute 2010), available at *http://works.bepress.com/michael__greenberger/35/; Out of the Black Hole: Reining in the Reckless Market in Over-the-Counter Derivatives,* AMERICAN PROSPECT (2010), available at *http://*

Continued

The CHAIRMAN. Well, I thank the witnesses for your comments. We will now go into the question period.

In spite of those comments, I do think that cost-benefit analysis is an appropriate tool to use to make sure that we get the regulations right.

So, Mr. Scott, Dr. Overdahl, do we need, looking forward—I know we don't have it in place right now, but looking forward with respect to the CFTC, do you recommend any specific legislative changes to 15(a), or whatever it might be, to require broader economic analysis of impact regulations would have for the good or for the bad on the folks who have to comply with those regulations?

Dr. Overdahl, do you want to start?

Dr. OVERDAHL. Sure.

I think the obligation under 15(a) to consider is one that is pretty easily satisfied, and I can envision language that would go beyond that. I guess my preference would be that it would be a direction to the Commission to develop their own internal procedures on how to analyze rules, how to implement effective cost-benefit analysis.

I think if they are doing that, with help, perhaps, from the OIRA at the OMB—the reason I mention them is because they have a lot of experience dealing with Federal agencies that have this very same type of requirement, that that could improve the process.

And, if there was anything additional, it would be that somehow their analysis be reviewed by somebody. I don't think it really matters by whom, because just by the fact that somebody is looking, I think, will improve that process.

The CHAIRMAN. Mr. Scott?

Mr. SCOTT. I agree with what Dr. Overdahl just said. I think we need to impose a more demanding standard of cost-benefit analysis on the CFTC—and, by the way, the SEC, as well.

And I also agree that somebody should be looking at this analysis to check it out. So my proposal is that OIRA, within OMB, review the cost-benefit analysis of these independent financial agencies and make comments. Unlike with the non-independent agencies, their comments would not be binding. Actually and technically, they are not even binding on the non-independent agencies. But, practically speaking, since they are part of the Administration, they are.

I think we need to respect the independent agencies and their independence. So I would not make the Office of Management and Budget's review binding on these agencies. But, it would add a lot to the process if they reviewed the cost-benefit analysis and articulated what their opinion was. This would put pressure, obviously, on these agencies to do a better job.

Dr. OVERDAHL. And could I just add one thing?

I think there needs to be some distinction between major rules and minor rules. I don't think you would want to have the same level of scrutiny for every possible rule. But, certainly, for major rules I think it is a reasonable requirement.

Mr. SCOTT. Major *versus* others, is that the issue? I am not sure.

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works.bepress.com/michael_greenberger/37; and Written Testimony of Michael Greenberger, *Hearing Before the Financial Crisis Inquiry Commission Regarding The Role of Derivatives in the Financial Crisis* (June 30, 2010), available at *http://www.fcic.gov/hearings/pdfs/2010-0630-Greenberger.pdf.*

Dr. OVERDAHL. Yes.

Mr. SCOTT. Well, of course, then we get into what is major and what is not, so it is difficult.

But the spirit of your question is that the more important the rule and the more potential economic impact that it has on the country, the more stringent the analysis should be, because it matters more.

So, in the operation of a cost-benefit analysis regime, what you are suggesting will happen, but I wouldn't, kind of, say major, yes, non-major, no——

The CHAIRMAN. I guess that the struggle here is to write a principles-based requirement that is not so prescriptive that—whatever. But that is the struggle we all run.

Mr. Duffy, on the position limits, a lot has been said about that. We have a recent report from the Financial Services—something—that they don't think position limits work. I got folks on both sides of this.

Is it your sense, from an international standpoint—Mr. Scott, you may want to pitch in on this, as well—that all these international folks are just waiting with bated breath for us to do position limits so they can flood in and do them themselves? I mean, they are really wanting to do this, but they are just waiting on the U.S. to lead in that regard?

Mr. DUFFY. I don't believe that the position-limits issue in Europe will take hold. They have basically said—I know that the French want more strict limits, the U.K. wanted no limits, so they came out with a compromise saying that if, in fact, they find an issue where they need to impose certain limits, they have the ability to do so. The study you are referring to, I believe, was the Chairman of the U.K. FSA and two other academics that came out and said they saw no correlation between speculation and the price of any particular product.

And I do believe that they would love to see the United States of America act, put on prescriptive position limits on certain products and watch that business migrate over to London and other parts of Europe. This is something that is very attractive, very appealing.

And you have to also—and I know you know this, Mr. Chairman. London is very much focused on financial services, and it is a big part of their economic fabric. And if they lose any market share, that puts them in a very difficult situation. So, without a doubt, they will not make a move until the United States of America does first.

The CHAIRMAN. Thank you.

Mr. Boswell for 5 minutes.

Mr. BOSWELL. Well, thank you.

Interesting points you have all made. Stimulating, for sure. Let's see where we can go here.

But, Mr. Greenberger, you have heard your fellow panelists and others advocate for delaying implementation of the derivatives title of Dodd-Frank. Who do you think benefits the most from delay?

Mr. GREENBERGER. There is no doubt that the big banks, who now have to face regulation that they didn't have before, want to see this delayed. Their profits are going to be cut. Does that mean

the financial services industry, which now makes 33 percent of all the profits of the United States, is going to be cut? No. It means the big banks will have to share those profits with banks in your jurisdiction. They won't hold an oligopoly anymore.

They are desperate to, through budget cuts, procedural delays, slow this thing down. And you run the risk that while you are slowed down you are bareback; the protections are not there. If there is another crisis—and, believe me, if you had to bet whether there was or wasn't, from your instinct you got to worry about it—your constituents are going to want to know, where were you? This was your Subcommittee; why weren't the rules put in place?

Mr. BOSWELL. I don't know about you, Mr. Chairman. My local banks, I hear a lot of complaints—and I have some great local banks, community banks, so don't misinterpret what I am saying. But I have producers out there, been at it a long time, pretty stable, that are having a hard time putting resources together.

Do you think that because of what this whole picture of what we are talking about is what is running downhill, water and other things run downhill, is that why they are being so difficult to satisfy on any process of operational loans?

Mr. GREENBERGER. Look, credit is tight out there. Jamie Dimon just got a $23 million bonus and a $600,000 payment for moving expenses. Your constituents cannot borrow money. The too-big-to-fail banks are too big to worry about loaning money to the average American, the average student, the average homeowner.

And what do they want to do? They want to do proprietary trading. They want to deal with these swaps. They want to enter into the AIG transactions where they bet that something is going to happen. And when they lose and don't have the money, they will turn around to you and say, "Hey, if we go down, everybody goes down. You had better rescue us."

Lord Turner has been mentioned here. Lord Turner has made the very famous statement that these big banks are societally useless. They don't help your constituents. To the extent you delay this rule, you are helping Jamie Dimon get a bigger bonus next year, more than $23 million. You are not supporting the average citizen in your constituency.

Mr. BOSWELL. I still have a few moments.

Mr. Scott, your testimony advocates consistency in coordination among the regulators with regard to Dodd-Frank, except when required by real differences. It appears the prudential regulators believe end-users should be required to post margin to better protect the banks overseen by their prudential regulators. Do you believe this difference is merited?

Mr. SCOTT. I am a little hard of hearing, Congressman, and I didn't catch your question.

Mr. BOSWELL. Okay. Your testimony advocates consistency in coordination among regulators with regard to Dodd-Frank except when required by real differences. It appears prudential regulators believe end-users should be required to post margins to better protect the banks overseen by the regulators. Do you believe this difference is merited?

Mr. SCOTT. Sorry, Congressman. It is my fault, not yours.

I guess the question is, when should there be differences between the CFTC and the Fed in particular. I don't think there should be differences. I think whatever the CFTC does should be consistent with preventing systemic risk.

Mr. Greenberger talked about the crisis. A large part of the losses in that crisis were due to systemic risk. And it is the Fed's job, principally, under Dodd-Frank, to worry about that.

So, there should be consistency, okay, not only between the CFTC and the SEC, but also with the Fed.

Mr. BOSWELL. Thank you.

I yield back.

The CHAIRMAN. The gentleman yields back.

Mr. Neugebauer from Texas for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

And I was pleased to hear—what we are hearing is a common theme. I had a hearing last week in Financial Services Oversight Committee, and we heard a lot about people saying that there wasn't appropriate cost-benefit analysis going on. And when you look at Dodd-Frank, for example, 240 rulemaking opportunities here, compared to Sarbanes-Oxley, which I think had 16 or 17. And the volume and the speed about which a lot of these were coming out is very concerning.

In fact, Commissioner Sommers was one of the witnesses. And she said, "we are voting on rules that contain very short, boilerplate cost-benefit analysis. And I think when you look at the size and the scope of the impact of a lot of these proposals, a boilerplate, short analysis doesn't seem to correspond with what the potential conflicts or potential outcomes of some of these changes are." So I concur with many on the panel that I think that process needs to take place.

I think the other thing, Mr. Scott, you mentioned, and this is something else that I have actually said to Mr. Gensler, is that after all of these regulations are promulgated that, really, we need to then take a big-picture look at what—not only just being able to execute those from an infrastructure standpoint, but also the consequences of all of those regulations and how they not only impact the marketplace but also competitiveness, the cost, and, in fact, how much incrementally did we improve the system.

A lot of people disagree that Dodd-Frank is the bill that is going to save the world. What I would say is we are not quite sure of that, because we didn't do the proper investigation and oversight in going in and looking at what did happen in the system before we implemented this very broad piece of legislation. In many cases, we had regulators that just weren't doing their job, not that they needed more regulation.

Mr. Duffy, you talked a little bit about London. And, certainly, that is one—in a global marketplace, that is one of the places that we—but you didn't—and I apologize, I didn't get to hear all of your testimony—but there are other places, Asian markets, as well.

Can you elaborate, when you look at the landscape that is going on now, European, because what I am beginning to hear is that the infrastructure is building up in the Asian markets to be very competitive.

Mr. DUFFY. There is absolutely no question about it. One of the largest competitors for CME's agricultural business is in Dalian, China, today under the Dalian Exchange. They are trading enormous amounts of grain products throughout—they are discovering price throughout Asia under a different regulatory regime.

Hong Kong has become more and more focused on financial services. And, Singapore has become the haven for Asian institutions to do their business. And they do it completely different than we do here in the U.S.

We are competing with the world, Congressman, as you know. I mean, our world has gotten so small, and it has no borders. So if we get—and I will say it again—a regulatory arbitrage, people will migrate to where they can do business in the most cost-effective way. And the way you do that is to have liquidity generate there in certain jurisdictions, and that is how you move the business.

We are seeing a tremendous amount of liquidity throughout Asia. We don't talk about it as much here in Washington; we normally talk more about Europe. Asia is just, if not a bigger, threat to the U.S. financial services, because liquidity is building by the second over there. So we are very concerned with our Asian competitors, but we do work and compete globally over there also.

Mr. NEUGEBAUER. Thank you.

Any other panelists want to comment on that issue?

Mr. SCOTT. Well, I agree again with Mr. Duffy. But I articulated concern in my testimony that we could take measures actually that makes this worse. If the CFTC took the attitude, for instance, that European or Asian clearinghouses were not adequately regulated in its view—maybe their membership requirements were too high compared to Mr. Gensler's—then I think the CFTC actually has the power under Dodd-Frank to restrict use of those clearinghouses by U.S. firms, which would be a terrible result, because the E.U. would, possibly, retaliate, and then we would get into a conflict.

So, as I said, regulatory arbitrage would be a better outcome than that kind of a stalemate. All to say that we should be doing a lot more than we are doing. It is not enough to go over to London and make a speech, okay? What you have to do is sit down with the E.U., the staffs, and work out these differences.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back.

The gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you, all of you, for being here.

Just a couple of questions. Mr. Duffy, I wondered if you could just comment briefly on Chairman Gensler's proposal to phase in the clearing requirements either according to the parties to the swap or by asset class.

Mr. DUFFY. Well, fading in the implementation, one of the things that we think is critically important—and I hope I am answering your question properly, sir—is there is a requirement to bring dealer-to-dealer and dealer-to-client on clearing of these products. What we feel is very important under the Dodd-Frank law, it said, give the customer the choice on where they want to clear their product. And if we just go ahead and lead with just dealer-to-dealer, the cli-

ent will have no other alternative but to go to a particular clearinghouse.

So we would like to see the implementation of the clearing coincide together, which we think makes the most amount of sense, to be with the spirit of the law, and also let the client make that choice.

I hope I am answering your question properly.

Mr. HULTGREN. Yes, I think you are. Do you get the sense that they are open to that, from comments of Chairman Gensler and others? Are they——

Mr. DUFFY. I don't have any indication that they are not open to it, sir. I have been working with Chairman Gensler and other Commissioners to make sure they understand that point. It is a competitive issue amongst many different clearing entities. And, of course, the law would suggest that the customer has that right.

And so, yes, I do believe we are making some headway, but I am concerned because of other things we have seen coming out of the agency.

Mr. HULTGREN. Yes.

Switching gears just a little bit, also, Mr. Duffy, an area that hasn't been discussed at great length in the Committee are the rules proposed—the proposals aimed at market manipulation and anti-disruptive trading practices.

While we certainly want to ensure bad actors cannot engage in manipulative or disruptive practices, we have heard concerns that vague terms of the rules may have a freezing effect on the market.

I wonder about your view on that, if these rules do go too far. And, if so, how can the regulators strike that right balance of protecting from bad actors while at the same time protecting our markets?

Mr. DUFFY. First of all, market manipulation is something, obviously, we are very focused on. We are a publicly traded company. We are a 156 year old institution. We have never had a customer lose a penny due to a clearing member default, so we have all these great things that we have to make sure we keep ourselves at the highest standard. And if we don't have credible markets, we don't have a credible company. So market manipulation is something we spend a lot of time focusing and watching, and we feel very comfortable there.

Anti-disruptive trading practices is something that, when you create a law as it relates to what is considered anti-disruptive trading practices—I traded for 23 years of my life, sir, and the markets go up and they go down and they go fast and they go furious. In the day of "electronification", they go in milliseconds, not in 10 second time periods.

So these are laws or rules that are being promulgated, putting forward, that could be so broad and vast that it would actually take a transaction that is absolutely, 100 percent legitimate that is done on the close of a trading session and deem that to be anti-disruptive. Many participants like to enter their orders on the close of business or the opening of business because that gives them a mark for the next day and they know where the market closed.

So if you were to enter into that and that order actually moved the market, whether because of an illiquid time of the trading, you

could be deemed as anti-disruptive trading practices. This is just too wide, too vast, and could absolutely kill liquidity, move it more to the over-the-counter market, move it to block, take it away from the central marketplace. And all the things that Mr. Greenberger doesn't want to see happen will happen if this rule goes into place.

Mr. HULTGREN. And that is my fear, and I think many of our fears, is that these broad responses here really could do exactly the opposite of what our hope was with so much of this.

Last week, Chairman Gensler was asked about a letter he received from the UK's Financial Services Authority expressing concern about a CFTC proposal to cap the amount a capital clearinghouse can require of potential clearing members at $50 million. FSA expressed concerns that the proposal may actually inject more risk into the system.

I wonder if you could, Mr. Duffy, just respond quickly on that idea of would that potentially inject more risk into the system. And are there other CFTC proposals that you think might result in more instead of less risk to the system?

Mr. DUFFY. And I appreciate the question, sir.

On the clearing requirement minimums, there are clearinghouses, as you know—how they work, they are capitalized by the members of the firms. And when there is a potential default or something goes wrong within one of the clearing members, they all participate in assuming that default.

So if you are trading 4,000 to 5,000 transactions a day with a high notional value of over-the-counter swaps transactions and you have people that are involved in your clearinghouse for $50 million while the others are capitalized at $1 billion and one of them defaults, how are you going to get the $50 million participant to help in the default process? They absolutely cannot.

Because what the Chairman is suggesting is, whatever you trade, then you can put a small amount of money just up to that limit, which would make sense from a perspective if the world was perfect, but if there are defaults, like we saw Lehman, like we saw Bear, like we saw all these other institutions, people have to participate to come together to help make up the difference. And if you have $50 million, I assure you will be out of money before the first transaction happens. You won't be able to help out in there.

So I understand what the dealers are talking about, and I understand what the Chairman is talking about. I don't know if there is a good mix. But you have to have everybody be able to participate in the default process. That is what keeps the system sound and safe.

Mr. HULTGREN. Thank you.

Thank you all for being here. I do have other questions. I am out of time, but hopefully we can present those to you. I also felt bad that I missed the first part of the hearing. We had some votes in another committee that I am on that I had to be at. But I do appreciate the work that you are doing. This is important right now for us to be discussing this.

So I yield back my time. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

We will go another round.

I wanted to ask Ms. McMillan, you and I had a conversation yesterday about the impact that some of these rules would have on some disclosure requirements: the CFTC would force you to disclose, and the SEC would prevent you from disclosing.

So can you talk to us a little bit more about this loss of the exemption of Rule 4.5, what it does to your industry and member companies? And what is your opinion that this proposed action by the CFTC will do?

Ms. MCMILLAN. Certainly. Thank you.

The proposed removal of the exemption of Rule 4.5 by the CFTC would essentially require funds that are already regulated by the SEC to have a second layer of regulation by the CFTC if they trip over two different tests, which, the way that they are drafted very, very broadly, they are likely to do.

One of the main reasons for that is that swaps are now part of the CFTC's jurisdiction and are included in this proposal. We don't think that the CFTC took adequate time to understand how registered investment companies use swaps. They are more for hedging, for risk management, not for what is typically viewed in this Committee as being speculative purposes.

The other is that there is a marketing restriction that could prohibit investment companies from putting in the prospectus disclosure that they are required to put in by the SEC or risk management or risk disclosure that they are also required to put in if they engage even to a small extent in future options or swaps.

The problem, then, is that if these companies then also have to be regulated by the CFTC, these are largely disclosure issues, and both agencies have different philosophies about how that disclosure should be done. Some are similar and could be reconciled fairly easily, but some are absolutely contradictory and kind of go to the fundamental nature of how these agencies think investors should get information.

One good example is that the SEC absolutely prohibits registered investment companies from putting in performance of the advisor with respect to other pools that it manages, on the theory that that could mislead investors because the other pools may be very different from the one that they are investing in. The CFTC takes the opposite approach and says, well, that is valuable information for an investor because they should know how the advisors perform, particularly if the advisor doesn't have a long track record.

If a company is required to comply with both rules, it is going to violate one of them; it simply cannot go forward. And while the CFTC in its proposal recognized that there are these contradictions, they did not offer up any solution to that, so the public doesn't have any opportunity of knowing what regime it may have to live under and to provide comments. And we do think that disclosure to investors of this and other issues are very important and we should have the opportunity to comment on it.

The CHAIRMAN. All right. Thank you, Ms. McMillan.

I yield back.

The gentleman from Iowa, Mr. Boswell, for another 5 minutes.

Mr. BOSWELL. Thank you, Mr. Chairman. I don't think I will need that.

I think I owe an apology to Mr. Scott. Am I speaking clearly? Can you hear me? No, I thank you very much for being here. And I want to make sure I am clear in our discussion.

But prudential regulators, the Feds, say end-users should post margin. The CFTC says no. I think you say Fed views should trump CFTC views. Question: Do you agree with prudential regulators that end-users should post margin to better protect the banks?

Mr. GREENBERGER. If I can answer that question, I think there has been a lot of misunderstanding about that. The FDIC published a rule yesterday. In fact, Commissioner O'Malia said, "Oh, the two Commissions couldn't be further apart." If you read what the FDIC said, it says that commercial end-users who have good credit do not have to post margin. And, as they said, even before we had Dodd-Frank, under the old thing, in a self-regulatory sense, banks will not extend counterparty credit if the counterparty doesn't have good credit.

If you read these carefully, the FDIC, representing the prudential regulators, and the CFTC both say they will not require end-users with good credit ratings to post margin. There is no difference between the two agencies. I can brief you on that. In the FDIC, page 7–8 of their summary says, we agree with Chairman Gensler and the CFTC staff; we want to do what they are doing.

The end-user here is protected by statute, if it is a commercial end-user. The agencies have said they will not collect margin. There has been no issue that has been more carefully drilled into and more reassurances offered that end-users don't have to clear and they don't have to post margin. And, as I keep saying, people don't want to take "yes" for an answer. They are out from under.

Mr. BOSWELL. Well, thank you for that comment.

Mr. Scott, would you like to—I pose the question to you.

Mr. SCOTT. Well, maybe from Chairman Gensler's point of view, they are out. But the bank regulators have a concern, which I think was articulated in their proposal yesterday, that a bank could get overexposed to a counterparty. And so they want to set some limit on the unsecured exposure as net of the collateral protection that their counterparty has, whether that counterparty is financial or commercial.

I think, in practice, this isn't going to be a big deal because the threshold will be set high. But to say that the regulators of banks would be totally unconcerned with the counterparty risk of commercial counterparties seems to me not the right solution.

What the right solution is, is to recognize that commercial counterparties are different, they pose different risks, and we should have a very high risk limit; it shouldn't be infinite. And I think that is basically what the bank regulators are saying.

Mr. BOSWELL. Thanks for the comment.

Mr. Greenberger, do you have any response?

Mr. GREENBERGER. Yes, the only thing I am going to say is, Mr. Scott said the Federal Reserve should be more involved in this, and the statute requires both the SEC and the CFTC to consult with the Federal Reserve. What we are beginning to see is the Federal Reserve and the prudential regulators saying they are going to be tougher than the CFTC.

So if we criticize the CFTC, if we put them down, “They aren’t doing their job right,” “They aren’t taking this seriously,” “They are using boilerplate explanations,” you are going to so diminish them that two people are going to lose in this battle. This Committee is going to end up seeing these guys go over to prudential regulators, and they are going to lose the protection of this Committee. If you beat the CFTC down like this, you are just asking for someone to take them over. As you well know, that has been up in the air.

I think the CFTC—they have not used boilerplate. They have busted their rear ends on this. They are not ideological. Some of those people were hired in the Reagan Administration, served under Wendy Gramm. They are trying to do their best. We hear, “They could do this. They could do that. They might do this.” Let’s see what they do.

Then we are told on judicial review they are going to get killed. Judicial review is where this should all work out. If they are not doing their job right, we are being told the courts will reverse them. I have every confidence, because I have handled many judicial reviews, all the way up to the Supreme Court, that the CFTC will survive judicial review. They are doing this carefully, thoughtfully.

And if their economic analysis is bad, as Mr. Scott has said, they will be reversed in the D.C. Circuit. I don’t think they will be reversed; I think they can justify it.

You have to ask yourself, do you want to take the place of a reviewing cost and unwind the 2,400 page statute or, as normally happens, let this work its way out in the normal process?

Mr. BOSWELL. Thank you.

I guess I should yield back.

The CHAIRMAN. The gentleman from Illinois for a second round.

Mr. HULTGREN. Thank you. A couple quick questions.

Dr. Overdahl, just a quick question. Do economists at the CFTC write the cost-benefit sections of the rules?

Dr. OVERDAHL. When I was there, it certainly was not the case. It was the drafters of the rule who are in the rulemaking divisions, typically, the attorneys in those divisions that wrote the cost-benefit analysis.

Mr. HULTGREN. A quick question for Ms. McMillan. The CFTC’s proposal says that Rule 4.5 proposals are intended to stop the practice of registered investment companies offering futures-only investment products without Commission oversight.

I wonder if you can tell us what the problems have been with those funds.

Ms. MCMILLAN. To be perfectly honest with you, I am puzzled as well. We have not seen those kinds of problems. They actually were not alleged in the rule proposal.

We do understand that the CFTC has the right to take a look at practices that it feels may come within its jurisdiction, but the proposal that it has drafted goes well beyond even what its stated intent was.

Mr. HULTGREN. Thanks.

Last question. Mr. Scott, you have done quite a bit of research and writing in the past as it relates to our financial regulatory structure and the competitiveness of U.S. capital markets. Many of

your recommendations were focused on modernizing the regulatory structure to better reflect today's markets.

In your view, has Dodd-Frank modernized the regulatory structure?

Mr. SCOTT. The short answer is "no." We needed much more than FSOC to rationalize our regulatory structure.

You always talk about CFTC and SEC. As you know, at some point, the discussion of those agencies were up for merger through the Paulson blueprint. That never occurred.

I think the fragmentation of our regulatory structure has made it dysfunctional. I am depressed by the fact that the biggest crisis since the Depression couldn't change it. It actually made it more complicated. You have FSOC, Office of Financial Research, Consumer Financial Protection Bureau. So I am about to give up hope for serious reform, Congressman.

Mr. HULTGREN. Just to wrap up, Mr. Duffy, I wonder, just from your thoughts and your view, has Dodd-Frank modernized the regulatory structure?

Mr. DUFFY. You know, the jury is still out on that, sir. I think we have to wait until all the rules get written, comments are in, and the implementation happens. I think that is even more reason to take pause and make sure we get it right. I think, in order to answer that question, only time will tell.

So, hopefully everybody gets an opportunity to comment. I am hearing the amount of comments that are coming into the CFTC, the letters are staggering, in the thousands. And this is something that needs to be completely worked out.

There are parts of Dodd-Frank that we are very, very supportive of, and there are other parts that we are not. And I am hopeful that Dodd-Frank can do what the CEA Modernization Act of 2000 did for our industry. So I am very hopeful that can happen, but, again, we have our concerns. But only time will tell.

Mr. HULTGREN. Yes. We do, as well.

Well, thank you very much. I appreciate it.

I yield back my time.

The CHAIRMAN. The gentleman yields back.

Before we adjourn, I will ask the Ranking Member if he has any closing remarks.

Mr. Boswell?

Mr. BOSWELL. No.

The CHAIRMAN. Well, I want to thank our panel. Some diverse views. We appreciate that.

I do think it is the role of this Committee, Subcommittee, to continue to watch what is going on. And an attitude that we are simply players in a Greek tragedy, that we can't affect our fate, is inaccurate. The fact that we question what is going on, we ask for things—that we are trying to get this thing done correctly, I think is the appropriate role of this Committee and this Subcommittee. It is one that we will continue to explore vigorously as we work with Chairman Gensler, with Dan Berkovitz, who testified earlier, to try to get the best regulatory scheme we can that allows these markets to continue to function in America, that allow American end-users and producers across this country to get at the tools they need to mitigate their risks and deal with those risks in ways that

make sense, and that allows the providers a scheme that they can comply with that is cost-effective and it gets done what we all want to have done.

So, with that, we will adjourn the hearing. Thank you very much.

Under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material, supplemental or written responses from the witnesses to any questions proposed by a Member.

This meeting of the Subcommittee on General Farm Commodities and Risk Management is adjourned.

[Whereupon, at 12:00 p.m., the Subcommittee was adjourned.]