

Comments on Senate Agriculture Committee's OTC Derivatives Bill
April 24, 2010

1. Section 106 should be deleted.

- a. *Lending to financial market utilities.* Section 106 would prohibit any federal assistance to swap dealers, major swap participants, swap exchanges, clearinghouses and central counterparties. This would appear to override the provision of Title VIII that would allow the Federal Reserve to provide emergency collateralized loans to systemically important financial market utilities, such as clearinghouses and central counterparties, to maintain financial stability and prevent serious adverse effects on the U.S. economy.
 - i. As systemically important post-trade "choke points" in the financial system, it is imperative that these utilities be able to settle each day as expected to avoid systemic problems and allow for a wide range of financial markets and institutions to operate. The failure of a systemically important utility to settle for its markets would not only call into question the soundness of the utility as a critical market infrastructure but could also create systemic liquidity disruptions for one or more markets and potentially other financial market utilities. The increased importance that Title VIII places on central counterparties and central clearinghouses to reduce risk in the financial system necessitates ensuring that short-term secured credit is available to these utilities in times of stress.
- b. *"Push-out" of bank swap activities.* Section 106 would in effect prohibit banks from engaging in derivative transactions as an intermediary for customers or to hedge the bank's own exposures.
 - i. Title VI, which includes the so-called Volcker rule provisions, better addresses the problem of risks from derivatives activities by prohibiting any bank, as well as any company that owns a bank, from taking speculative, proprietary derivative positions that are unrelated to customer needs.

- ii. Section 106 would impair financial stability and strong prudential regulation of derivatives; would have serious consequences for the competitiveness of U.S. financial institutions; and would be highly disruptive and costly, both for banks and their customers.
 - iii. Banks are subject to strong prudential regulation, including capital regulations that take account of a bank's exposures to derivative transactions. The Basel Committee on Banking Supervision has recently proposed tough new capital and liquidity requirements for derivatives that will further strengthen the prudential standards that apply to bank derivative activities. Titles I, III, VI, VII and VIII all add provisions further strengthening the authority of the Federal supervisory agencies to address these risks.
2. The foreign exchange swap exclusion should not be limited to non-exchange-traded non-cleared transactions.
- a. The bill permits the Treasury to exclude foreign exchange swaps and forwards from coverage as "swaps," but the exclusion applies only if the transaction is not listed or traded on an exchange or a swap execution facility and not cleared through a derivatives clearing organization. A substantial share of foreign exchange swaps and forwards are entered into using electronic trading platforms. The broad definition of swap execution facility appears to capture these platforms, thereby rendering the Treasury's exemptive authority largely meaningless.
 - b. Foreign exchange forward and swap transactions should be treated in a way comparable to other physically settled forwards for securities and nonfinancial commodities that are exempted under the bill. Foreign exchange forwards and foreign exchange swaps are delayed purchases and sales in broad and deep cash markets. Prices for foreign exchange are already readily available and transparent and that existing transparency, coupled with the breadth and depth of the foreign exchange markets, makes the foreign exchange markets not easy to manipulate.

3. Core principles for financial market utilities should not be hard-wired in the statute.

- a. The bill sets out specific core principles for derivatives clearing organizations, swap execution facilities, and swap data repositories, and would not give the CFTC or SEC leeway to adjust the core principles to reflect evolving U.S. and international standards (as does the Dodd bill).
- b. The current international standards for central counterparties are under review for needed changes in light of market developments, particularly in the OTC derivatives market, and are expected to change, thus potentially creating an immediate conflict with the bill.
- c. Providing regulatory flexibility would permit changes to the international standards and other future refinements in risk management standards to be addressed. In addition, such flexibility would facilitate the ability of the U.S. regulatory agencies to work together to adopt consistent standards across financial market utilities that perform similar functions.

4. The definition of “swap data repository” is overly broad.

- a. The definition (“any person that collects, calculates, prepares, or maintains information or records with respect to transaction or positions in or the terms and conditions of, swaps entered into by third parties”) appears to include entities whose purpose is not related to acting as a central record-keeping facility. For example, the definition may sweep in trade comparison services and news organizations that collect trading information.
- b. Given its breadth, it will be difficult to apply core principles to such disparate activities and organizations.

5. Data-sharing among regulators is unnecessarily restricted.

- a. The bill would require a swap data repository to notify the relevant Commission of any information requests from other regulators and require that those other regulators indemnify the repository and the Commission from any claims stemming from those requests. These provisions restrict access by relevant U.S. regulators to needed data.

- b. These restrictions may lead foreign regulators to demand a local repository so that they can have adequate access to the data. Splitting the market data into repositories in different countries will make it significantly more difficult for regulators to get a holistic view of the market.
 - c. The bill allows swap data to be shared with foreign central banks, but not the U.S. central bank (the Federal Reserve).
- 6. Prudential regulators should retain their safety-and-soundness enforcement authority over bank swap dealers and major swap participants.
 - a. Section 131 provides the prudential regulators with authority to enforce the prudential requirements of the Act over bank swap dealers and major swap participants and provides the CFTC with the authority to enforce non-prudential requirements.
 - b. Although section 133 preserves the prudential regulators' authority under other law, the conforming amendments in section 131 limit the prudential regulators' authority under section 8 of the Federal Deposit Insurance Act over swap dealers and major swap participants.
 - c. In order to carry out their obligations as safety-and-soundness supervisors over banks, the prudential regulators need to retain their full Federal Deposit Insurance Act enforcement authority over bank swap dealers and major swap participants.
- 7. The Act should clarify that risk management is part of prudential rules.
 - a. Section 121 provides that the prudential regulators are to prescribe prudential requirements, including capital and margin requirements, for bank swap dealers and major swap participants. Section 121 also requires swap dealers and major swap participants to establish robust and professional risk management systems.
 - b. The bill is unclear about which agency should set risk management rules. These rules should be set by the prudential regulator