COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

IMPLEMENTATION OF TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

STATEMENT OF JOHN M. DAMGARD, PRESIDENT
FUTURES INDUSTRY ASSOCIATION

FEBRUARY 15, 2011

Chairman Conaway, Ranking Member Boswell, members of the Subcommittee, I am John Damgard, president of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today.

As the Subcommittee is aware, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) substantially rewrote the Commodity Exchange Act (CEA) to: (i) establish a comprehensive regime for swaps, including the mandatory clearing of swaps; (ii) grant important new authority to the Commodity Futures Trading Commission (Commission); and (iii) impose significant, new obligations on futures industry participants, in particular, the futures commission merchants (FCMs) that FIA represents.

Because Congress gave the regulatory agencies, including the Commission, broad discretion in adopting rules to implement provisions of the Dodd-Frank Act, it is essential that the Committee on Agriculture, as the committee of jurisdiction with respect to matters relating to the CEA, monitor carefully the Commission's implementation of the Dodd-Frank Act and provide additional guidance when appropriate. We, therefore, welcome these hearings and are pleased that Chairman Lucas and Chairman Conaway have indicated that they intend to conduct regular oversight hearings with respect to the Dodd-Frank Act.

We have had an opportunity to review the testimony presented by the Chicago Mercantile Exchange and the International Swap Dealers Association at the full Committee hearing last Thursday and share some of the concerns they expressed.

Futures Industry Association: Who We Are

Since many of the members of the Subcommittee are new, I would like to take a minute to explain who we are. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants in the United States. Among FIA's associate members are representatives from virtually all other segments of the futures industry, both national and

international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

As the principal clearing members of the U.S. derivatives clearing organizations (DCOs), our member firms play a critical role in the reduction of systemic risk in the financial markets. We commit a substantial amount of our own capital to guarantee our customers' transactions cleared through the DCO and, through contributions to the DCO's guarantee fund, guarantee the obligations of other clearing members to the DCO, in the unlikely event of a clearing member's default. As a result, our member firms, along with the DCOs of which they are members, take seriously their responsibility to manage carefully the significant financial risks that they assume on a daily basis.

We take justifiable pride that throughout the financial crisis, the futures markets operated well; no FCM failed and no customer lost money as a result of a failure of the futures regulatory system.

The FIA Principal Traders Group. This past year, we welcomed the FIA Principal Traders Group (FIA PTG) as a new division of FIA. The FIA PTG is comprised of firms that trade their own capital in exchange-traded markets. Members of the FIA PTG engage in automated, manual and hybrid methods of trading and are active in a variety of asset classes, such as futures, equities, foreign exchange, and fixed income. They are a critical source of liquidity in the exchange-traded markets, allowing those who use these markets to manage their business risks, to enter and exit the markets efficiently.

Depending on the eventual market structure of the swaps market, some of the firms that are members of the FIA PTG may choose to provide liquidity to the developing cleared swaps markets. They currently are active participants in the over-the-counter markets operated by ICE and the New York Mercantile Exchange, both of which may be required to be registered as swap execution facilities, and would expect to continue trading these products under the Dodd-Frank regulatory regime. These firms' willingness and ability to do so, however, will depend on a number of factors, including the costs associated with complying with requirements applicable to cleared swaps, as well as the absence of other barriers to entry to the swaps market.

Implementation of the Dodd-Frank Act: The Rulemaking Process

The success of the futures model understandably led Congress to require a comparable model for the swaps markets. What may have seemed like a simple solution in concept to address systemic risk in the bilateral swaps market, however, has proved to be tremendously complex in implementation. While swaps and futures may serve similar risk management purposes, the manner in which they trade and are priced and, consequently, the financial risks they pose to DCOs and clearing members when cleared, are substantially different.

As clearing member FCMs will be most directly affected by the failure of a customer or other clearing member to meet its financial obligations with respect to cleared swaps, our member firms believe it is essential that the reforms envisioned by the Dodd-Frank Act be implemented in a deliberate, measured way to assure that the risks associated with the clearing of swaps are properly identified and managed. A "Big Bang" approach threatens simply to shift systemic risk to DCOs and their clearing members, to the potential detriment of both futures market participants and swaps market participants.

We do not underestimate the challenges facing the Commission, and we recognize that the Commission and its staff are working hard to comply with the very tight timeframes set out in the Dodd-Frank Act. We also appreciate that the Commission has made an effort to solicit the views of affected parties.

In this regard, FIA member firms have committed significant time and resources to provide their views and assist the Commission in developing the rules to implement this regulatory regime. Our members have made available more than 200 professional staff with risk management and operational expertise to help FIA in this effort. Member firm representatives have participated in three roundtables conducted by Commission staff and have met with the staff on other occasions to discuss matters of particular concern. Moreover, to date, FIA has filed comment letters on 17 rule proposals.

Insufficient Time to Analyze and Comment Meaningfully

Although FIA has supported several of the Commission's proposals, as a general matter, rules have been published for comment in an order and at a pace that makes meaningful analysis and comment difficult, if not impossible.

The Commission has published for comment a myriad of proposed rulemakings that, collectively, contemplate a complete overhaul of the recordkeeping and reporting requirements to which FCMs, U.S. exchanges and clearing organizations are subject. These proposals include: (i) the advance notice of proposed rulemaking regarding the protection of cleared swaps customers before and after commodity broker bankruptcies; (ii) core principles and other requirements for designated contract markets; (iii) risk management requirements for derivatives clearing organizations; (iv) information management requirements for derivatives clearing organizations; (v) position limits for derivatives; (vi) core principles and other requirements for swap execution facilities; and (vii) swap data recordkeeping and reporting requirements.

These various rulemakings cannot be considered in isolation. All of the pending recordkeeping and reporting requirements, and the estimated costs and benefits of each, must be analyzed and evaluated collectively, not individually. In the absence of such a coordinated analysis, it is impossible to determine whether the pending rules are complementary or conflicting. Neither is it possible to calculate the aggregate financial and operational burdens these various proposals will have on the industry.

The Ownership and Control Rules. Recordkeeping and reporting requirements have real costs. The Commission's proposed rules requiring designated contract markets and other reporting entities to submit weekly ownership and control reports (OCR) to the Commission demonstrate this point. It is important to note that the OCR rules not required under the Dodd-Frank Act and are in addition to the list of rules above.

The pending OCR rules would require each reporting entity to provide the Commission detailed information, consisting of approximately 28 separate data points, with respect to each account reported in its trade register. The proposed data points include detailed information on beneficial owners and account controllers, account numbers and dates on which account numbers were assigned.

Because the OCR rules would require FCMs to collect and report a substantial amount of information that either is not collected in the manner the Commission may anticipate or is not collected at all, the proposed rules would require a complete redesign of the procedures, processes and systems pursuant to which FCMs create and maintain records with respect to their customers and customer transactions. To obtain and maintain the required information, an FCM would be required to: (i) re-negotiate all active customer agreements to require customers to provide and routinely update the necessary data points; (ii) build systems to enter the data; (iii) manually enter the data for each active account; (iv) put in place resources and processes to maintain the data; (v) provide it to the reporting entity on a weekly basis; and (vi) monitor changes daily in order to update the database.

To prepare our comment letter on the proposed OCR rules, FIA formed an OCR Working Group, comprised of individuals with significant experience in operations from (i) 16 FCMs, both large and small, with both retail and institutional customers, (ii) the several U.S. exchanges, (iii) the principal back office service providers, and (iv) other experts to analyze their potential impact.

FIA received cost estimates for building and maintaining an OCR database from 12 FIA member firms, both large and small. These firms carry more than 500,000 customer accounts and hold in excess of $83.8 billion of customer funds, or approximately 62 percent of customers' segregated funds (as of July 31, 2010, according to monthly financial reports filed with the Commission). We found that the median firm would face total costs of roughly $18.8 million per firm, including implementation costs of roughly $13.4 million, and ongoing costs of $2.6 million annually. These costs, combined with the unwarranted structural change in the conduct of business among U.S. futures markets participants the proposed rules would require, could force a number of FCMs to withdraw from the business and the barrier to entry for potential new registrants will be raised.

In its comment letter, FIA presented an alternative OCR proposal which we believe would achieve the essential regulatory purposes of the Commission's proposed rules. The cost of the alternative OCR was considerably less than the estimated cost of implementing the OCR rules, but they are substantial nonetheless. We must emphasize that this alternative was not developed within the 60-day comment period originally proposed by the

Commission. It took several months of detailed analysis by industry representatives who otherwise perform critical operational and risk management responsibilities in their firms.

Rules Go Beyond Congressional Intent

The Commission has also proposed rules (or published an advance notice of proposed rulemaking) that we believe go well beyond congressional intent in the Dodd-Frank Act. In doing so, the Commission has moved away from the principles-based regulation, which has facilitated growth and innovation in the exchange-traded markets over the past decade, and has proposed a far more prescriptive regulatory regime.

Conflicts of Interest. The rules regarding conflicts of interest for FCMs, swap dealers and major swap participants provide one example where we believe the Commission has gone beyond the requirements of the Dodd-Frank Act. Among other things, these provisions, found in 4s(j)(5) and 4d(c) of the CEA, require firms to establish informational barriers among the different business units within the firm to assure that the research and analysis unit and the unit responsible for clearing are not subject to pressure from the swap dealer unit that might bias their judgment or supervision.

The Commission's proposed rules go far beyond the principles established in these provisions of the CEA and require absolute bans on communications in many instances. They would prohibit any employee of a swap dealer or major swap participant business unit from participating in any way with the provision of clearing services and related activities by the FCM. The rules would restrict routine contacts between trading and clearing personnel, which we believe would work to the detriment of customers, and call into question other forms of completely benign and beneficial conduct. Moreover, these proposed rules could impair a firm's ability to follow established risk management best practices. We believe the Commission needs to revise or even reissue these rules for comment.

Governance and Ownership. Proposed rules on governance and ownership of clearing organizations, contract markets and swap execution facilities is another example of the Commission's decision to propose rules that go beyond the Dodd-Frank Act and, in this case, would impose restrictions that Congress specifically rejected. Although the House version of the financial reform legislation contained provisions that set specific ownership limits for these entities, they were rejected in the Dodd-Frank Act, which simply authorizes the Commission to adopt rules with respect to ownership and governance, but only after completing a review, and only if it first determines "that such rules are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest." Although the Commission conducted no review and did not make the required determination, the Commission nonetheless proposed rules that would effectively implement provisions that were removed by the Conference Committee.

Chief Compliance Officer. The proposed rules relating to chief compliance officers provide another. The Dodd-Frank Act sets out specific responsibilities that chief compliance officers of swap dealers and major swap participants must meet, but simply requires chief compliance officers of FCMs to "perform such duties and responsibilities as shall be set forth in regulations to be adopted by the Commission or rules to be adopted by a futures association."

Notwithstanding these differences, the Commission elected to propose that FCMs be subject to the same rules as swap dealers and major swap participants. Although there may be advantages in creating uniform rules for entities under its jurisdiction, we are concerned that, in so doing, the Commission has ignored the model for compliance that FCMs have long followed.

In a detailed comment letter that FIA filed jointly with the Securities Industry and Financial Markets Association, we explained that the proposed rules would establish a compliance framework that is significantly different from that currently in place in the financial services industry under the regulations promulgated by other federal regulators, including the Securities and Exchange Commission (SEC) and the several banking regulators, as well as the compliance model adopted by the Commission itself as recently as September 2010.

Among other things, the proposed rules would fundamentally change the role of chief compliance officers by requiring them to perform supervisory duties. Traditionally, the chief compliance officer acts as an independent advisor to the firm's business-line supervisors, who have the authority to supervise the firm's business activities and are ultimately responsible for the firm's compliance with applicable law. By eliminating the separation between supervision and compliance, the proposed rules would eliminate the independence necessary to perform the chief compliance officer function effectively and would undermine the long-standing regulatory principle that the supervisory responsibility in the firm rests with the business managers, not the chief compliance officer.

Particularly troublesome is the Commission's statement that chief compliance officers may be subject to criminal liability as a result of carrying out their duties, although there is no indication that Congress intended that chief compliance officers would be subject to criminal liability under the applicable sections of the Dodd-Frank Act. Criminal liability is not specifically a part of the existing financial services compliance model, and potential criminal liability will make it much more difficult, if not impossible, for firms to hire competent employees who will be willing to serve as chief compliance officers. Moreover, imposition of criminal liability on chief compliance officers would create a duplicative, inconsistent, burdensome and unpredictable regulatory environment in many registrants that are subject to and have implemented the existing financial services compliance model.

In lieu of these proposed rules, we believe the Commission should exercise the authority that Congress specifically provided in the Dodd-Frank Act and delegate to the National Futures Association (NFA) the responsibility to adopt rules for chief compliance officers.

NFA has considerable experience in this area and such delegation would be consistent with the policy followed by the SEC, which has delegated this responsibility to FINRA.

The Potential Costs Are Not Well-Understood

The Commission has acknowledged that its proposed rules will increase the costs of effecting transactions in swaps, but believes that the benefits outweigh any additional costs that may be imposed on customers. We believe the Commission may well have underestimated certain costs. Again, however, we simply have not had the time, and in certain cases lack the information necessary, to make a meaningful analysis in the time provided.

Moreover, these additional costs will not be imposed solely on swap participants. They are certain to affect participants in the exchange-traded markets as well. In this regard, we are concerned by Chairman Gensler's announcement in his testimony last week that the Commission has established a rulemaking team to develop "conforming rules" to update the Commission's existing rules to take into account the provisions of the CEA. To the extent this rulemaking team recommends imposing the proposed rules for swaps on the exchange market, costs are certain to rise. As a result, as discussed earlier, a number of FCMs could be compelled to withdraw from registration and the barrier to entry for potential new registrants will be raised which will negatively affect competition. In any event, FCMs will have little choice but to pass these costs on to their customers.

Essential Decisions Have Been Deferred

As important, the Commission has not yet made decisions on critical issues that will determine the Commission's view of the full scope of its jurisdiction. The basic definitions of a "swap dealer", "major swap participant" and "swap" have not been adopted. Similarly, rules relating to capital and margin requirements have not been proposed. As a result, many swap market participants may not be aware, or may be uncertain, whether they will be required to be registered with the Commission in some capacity or otherwise be affected by the proposed rules. Therefore, they may not have had an opportunity to, or reason to believe that they should, comment on the proposed rules.

The Commission has also offered no guidance on the extent to which it may seek to assert its jurisdiction over entities located, or transactions that take place, outside of the United States, but which touch the U.S. in some way. Because swaps have not previously been entered into on organized exchanges or other trading facilities, the swaps market is truly international in scope. For example, the U.K. branch of a U.S. bank and a French bank may enter into an interest rate swap, which is governed by New York law.

The Dodd-Frank Act provides that its provisions should not apply to activities that take place outside of the United States, unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States." Further, the Commission is authorized to exempt from regulation foreign derivatives clearing organizations and swap execution facilities that are subject to comparable, comprehensive

supervision and regulation in their home country. As the members of the Subcommittee may be aware, the European Union (EU) is developing a comprehensive regulatory regime for swaps, including clearing through EU clearing organizations. The Commission should be encouraged to use its exemptive authority to assure that transactions and participants that do not have a "direct and significant connection with activities in, or effect on, commerce of the United States" are not subject to duplicative, and perhaps conflicting, regulatory requirements.

The Commission has a successful model for the regulation of international transactions that could serve as an starting point for exempting participants and transactions from its jurisdiction. Under the Commission's Part 30 rules, governing the offer and sale of futures and options traded on foreign exchanges, the Commission has granted exemptions from registration to non-U.S. firms that deal with U.S. customers and that the Commission determines are subject to comparable regulation in their home country. On the same basis, the Commission has also authorized certain foreign boards of trade to permit direct access from the U.S. In each case, the exemption is made subject to appropriate information sharing agreements and all affected participants must consent to the jurisdiction of the Commission and Department of Justice to be certain that the Commission and the Department of Justice are able to obtain information when necessary.

Delay in Adopting Final Rules

It has been suggested that the Commission should move forward with adopting final rules within the Dodd-Frank Act timeframes, but set effective dates that will afford participants sufficient time to come into compliance. Although this is certainly one alternative, we believe the better choice is to delay adopting final rules until all affected participants have a reasonable opportunity to analyze fully and understand the scope of the regulatory regime the Commission has proposed.

Responsibilities Should Be Delegated to the National Futures Association

In closing, I want to note that we were pleased that Chairman Gensler has indicated that he intends to rely more heavily on the National Futures Association. Self-regulation has worked extremely well in the futures markets, and we see no reason why the success of these programs cannot be transferred to the swaps markets.

When Congress amended the CEA in 1974 to establish the Commission, it included a provision for an industry-wide self-regulatory organization such as NFA. Since NFA began operations in 1982, Congress has demonstrated its confidence in NFA by amending the CEA three times to provide it with additional responsibilities.

As a self-regulatory organization, NFA is subject to the ongoing oversight of the Commission. Our experience is that NFA and the Commission have a very close and cooperative working relationship. The Subcommittee can be confident, therefore, that NFA will use its broad authority to achieve the regulatory goals that Congress sought in

enacting the Dodd-Frank Act. Importantly, NFA is funded entirely by futures market participants, thereby relieving additional strain on the federal budget.

We urge the Subcommittee to take whatever action it deems appropriate to encourage the Commission shift many of the regulatory obligations that it has assumed for itself under the proposed rules to NFA and, through NFA, to the other industry self-regulatory organizations. As discussed above, for example, the Commission could delegate to NFA the responsibility to adopt rules for chief compliance officers.

Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you may have.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2008.

Name: John M. Damgard

Organization you represent (if any): Futures Industry Association

1. Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2008, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:

Source: _____ Amount: _____

Source: _____ Amount: _____

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2008, as well as the source and the amount of each grant or contract:

Source: _____ Amount: _____

Source: _____ Amount: _____

Please check here if this form is NOT applicable to you: XX

Signature: Brian Kirzynski general counsel FIA

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.

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John M. Damgard is President of the Futures Industry Association (FIA) and founder, past president and a member of the board of the Institute for Financial Markets (IFM). FIA is the non-profit trade association that represents the commodity futures and options industry. The FIA membership is composed of the 40 largest brokerage firms and over 130 law firms, accounting firms, banks, insurance companies, pension funds, commodity pool operators, commodity trading advisors, domestic and international exchanges, international firms and other market users. We estimate that FIA members are responsible for over 90% of the customer business transacted on U.S. futures markets. Incorporated in 1989, the IFM's mission is to be the preeminent non-profit educational resource for the financial services industry.

Prior to joining the FIA in 1982, Mr. Damgard directed the Washington office of ACLI International, a leading commodity merchant firm active in cash and futures markets worldwide. He served as Deputy Assistant and Acting Assistant Secretary of Agriculture and was responsible for the major marketing and regulatory functions at the USDA. Prior to his service at the Department of Agriculture, Mr. Damgard served on the White House staff as Assistant to the Vice President during the Nixon/Ford Administrations and previously was active in banking, farming and manufacturing in Illinois.

Mr. Damgard was born and raised in Ottawa, Illinois. He was educated at Deerfield Academy in Massachusetts, Knox College in Illinois and University of Virginia. Mr. Damgard is active in community and political affairs. He currently serves as a special advisor to the Managed Funds Association. He has appeared on numerous radio and television programs to discuss public policy issues related to the domestic and international financial markets. Also, he has been a frequent witness before Congress regarding a variety of legislative issues and before the Commodity Futures Trading Commission regarding regulatory policies.