Hearing before the Committee on Agriculture, Nutrition & Forestry

United States Senate

106 Dirksen Senate Office Building

"Regulatory Issues Impacting End-Users and Market Liquidity"

Testimony of Michael D. Bopp
Partner, Gibson, Dunn & Crutcher LLP on behalf of the Coalition for Derivatives End-Users
May 14, 2015

Chairman Roberts, Ranking Member Stabenow, other members of the Committee,
I am Michael Bopp, a Partner at the law firm Gibson, Dunn & Crutcher LLP and Counsel to the Coalition for Derivatives End-Users. I want to thank you for inviting the Coalition for Derivatives End-Users to be represented at this important hearing. The Coalition includes roughly 300 end-user companies and trade associations and, collectively, we represent thousands of end-users from across the economy that employ derivatives to manage everyday business risks. The Coalition supports regulation that promotes economic stability and transparency without imposing undue burdens on derivatives end-users. We believe that imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, restricts job growth, decreases productive investment, and hampers U.S. competitiveness in the global economy.

The Coalition appreciates the bipartisan efforts by the Members of the Committee on behalf of American companies who use derivatives to manage many of the risks they face in running their businesses. In particular, end-users applaud Congress' passage, earlier this year, of legislation providing them relief from the mandatory initial and variation margin requirements. Seventeen members of this committee opposed an amendment that would have stripped the end-user margin bill from the Terrorism Risk Insurance Act legislation to which it was attached. We are very grateful for your support of main street businesses.

The Coalition also appreciates and supports the Chairman's introduction of the centralized treasury unit (CTU) bill, S.876, which would prevent end-user companies from being denied use of the clearing exemption in Dodd-Frank drafted specifically for them.

The Coalition concurs with the broad consensus that end-users should not be subject to regulations designed to reduce the risk of those who maintain derivatives positions that could pose risk to the financial system. End-users employ derivatives to mitigate the risks that arise from business operations and do not engage in the type of trading that cause risk to our financial system.

As the implementation of derivatives regulation continues in both the U.S. and abroad, and other aspects of the financial crisis are addressed, end-users are facing uncertainty and costly regulatory burdens on a number of fronts. The result of this uncertainty and expense is that end-users are being forced to consider foregoing hedging transactions, entering into less efficient transactions or placing themselves at a competitive disadvantage to other market participants. In particular, the three areas where we believe congressional attention would help address inefficiencies and unnecessary expense are as follows:

- CTUs engaging in inter-affiliate and external-facing derivatives transactions;
- Capital and liquidity requirements applicable to derivatives transactions;
- Cross-border, market fragmentation and liquidity concerns.

<u>Centralized Treasury Units</u>

Many non-financial end-users employ centralized treasury units to reduce risk by having a single entity centralize and net the hedging needs of all of its affiliates. In fact, nearly half of the respondents to a Coalition survey indicated that they use CTUs to execute over-the-counter (OTC) derivatives. This makes sense, as many companies find it more efficient to manage their risk centrally by netting exposures and having one affiliate trade in the open market, instead of dozens or hundreds of affiliates trading with third parties in uncoordinated fashion.

Section 723 of the Dodd-Frank Act makes the end-user clearing exception available to only those separate, CTUs that "act[] on behalf of the [affiliate] and as an agent." In other words, CTUs that are financial in nature and that act as a "principal" in trades for affiliates would not be eligible for the end-user clearing exception. This distinction in existing law renders the provision irrelevant as CTUs that operate in an "agent" capacity are not party to a swap and the non-financial affiliates on whose behalf they are trading are themselves exempt from mandatory clearing and margin requirements.

The reality is that most end-user CTUs that are separate legal entities act in a principal capacity in order to net exposures, consolidate hedging expertise and maximize efficiencies. By using CTUs in this way, non-financial companies are denied the end-user clearing exception even though their non-financial affiliates can go to the market directly without having to clear their trades. This is an anomalous result. Forcing an end-user's non-financial affiliates to enter into trades directly with external counterparties simply increases risk to the corporate family as a whole and risk to the market more generally as potentially offsetting trades cannot be netted, resulting in significantly more externally facing trades with third-parties.

For these reasons, the CFTC has recognized the value provided by CTUs that operate in a principal capacity and granted relief through the staff no-action process. The Coalition is very appreciative of this well-intended relief.

In light of the no action relief, some have asked whether legislation is still needed. The answer is "yes". Put simply, a no-action letter doesn't change the law. It is an assurance from the agency staff that they will not open an enforcement action for a violation of the law; the law itself remains unchanged. As a result, the no-action process is not sufficient for many companies, especially public companies and their boards that, under Dodd-Frank and the CFTC's no-action letter, need to certify that they are eligible for the clearing exception, which is technically not true. This outcome has competitive ramifications, as under European law, CTUs are not treated

as financial entities. Consequently, European law does not apply clearing and other requirements to CTUs of non-financial end-users.
The Dodd-Frank Act does not define the term "end-user". As a result, when an agency needs to define a non-financial"end-user" in a regulation, it refers to the section of Dodd-Frank that created the end-user clearing exception. In other words, an end-user is a company that is eligible for the exception. The only problem is, some end-users are technically not eligible – in spite of the no action relief – because they use CTUs. This is a problem because it means the glitch in Dodd-Frank gets propagated through every regulation that references an end-user. The solution, of course, is to fix the glitch. And that is what the Chairman's CTU bill does.

The Coalition strongly supports S.876, sponsored by Chairman Roberts and, in the last Congress, Senators Collins and Klobuchar. The bill would clarify that certain swaps entered into by a CTU when it is hedging the commercial risk of a non-financial affiliate as "principal" are eligible for the end-user exceptions from mandatory clearing and the requirement to post margin for their derivatives positions. The bill is narrowly tailored to address the needs of non-financial end-users. The bill would not permit the trades of financial entities or speculative trades to take advantage of the exception, and does not increase the likelihood of evasion under the provisions of the Dodd-Frank Act or CFTC regulations. The bill would allow the CFTC to deploy staff to matters other than the overly complex task of monitoring end-user compliance with the complicated and changing conditions of their no-action relief.

Non-financial end-users that operate CTUs do so because they provide an efficient, cost-effective and risk reducing means of managing and hedging the exposures of their affiliated operating entities. The risk-mitigating function of aggregating exposures on the books of a special-purpose subsidiary within their corporate group, netting the inter-affiliate exposures, and then entering into smaller derivatives with a bank or other swap dealer for the net amounts is an industry best practice. Without the certainty of legislative relief, companies could be forced to rethink or wind down these units and hedge less efficiently or meet burdensome new regulatory requirements. The cost of the latter option is extremely difficult to justify given that the operating entities on whose behalf the CTU is hedging are themselves exempt from mandatory clearing and margin requirements. Given these choices, it is possible that end-users may also be forced to contemplate simply retaining more risk.

Capital and Liquidity Requirements

In an effort to lessen the costs and impact on end-users seeking to hedge risk, the Dodd-Frank Act provided relief from a number of regulatory burdens, including trade execution and clearing requirements. Subsequently, relief was also provided to end-users from burdensome margin requirements. Unfortunately, this relief is in danger of being eroded by costs associated with increased capital requirements for derivatives transactions.

To protect banks and the financial markets from the stress experienced in 2008, the U.S. Prudential Banking Regulators have finalized rules implementing Basel III, requiring our bank counterparties to hold more capital against their derivatives positions. With additional capital and liquidity measures still being promulgated, including the Net Stable Funding Ratio and other outstanding Basel capital reforms, bank counterparties will see additional requirements that result in increased transaction costs. Bank counterparties will seek to recover these costs by passing them on to end-users seeking to use derivatives to hedge their business risks.

There are alternatives however. For example, European capital charges on derivatives positions are significantly more favorable to end-users than parallel charges in the United States. European policy makers have recognized that end-users' hedging activities are risk reducing and therefore require less capital as compared to financial entities keeping open positions or making markets in derivatives. The European rules exempt transactions with non-financial end-users from certain of the additional capital requirements. The indirect costs imposed by U.S. Prudential Banking Regulators are real and impact end-users and their decisions about managing risk. The impact could be significant enough to put American companies at a meaningful competitive disadvantage compared to European competitors. We therefore suggest that U.S. Prudential Regulators reassess how the capital rules are impacting end users and make adjustments to reduce unnecessary burdens and costs.

Cross Border Concerns

The Coalition recognizes the efforts being made by regulators in the U.S. and abroad to resolve differences that exist between different countries' regulatory regimes. The global nature of the derivatives markets adds levels of complexity to this exercise. As more foreign jurisdictions begin implementation of their regulations, end-users are turning their attention to other new regulatory regimes.

As new foreign regulations begin impacting non-U.S. affiliates and more cross-border transactions, multinational companies, as they did with the implementation of the Dodd-Frank Act, once again face the expensive undertaking of digesting complex regulation and implementing compliance frameworks--only now they must do so across multiple jurisdictions. Where rules between jurisdictions are harmonized this burden will be lessened, as standardized rules allow for the use of existing or similar processes across affiliated entities. Where the rules are not standardized, the concept of substituted compliance should be used as broadly as possible by regulators to allow entities in cross-border transactions to satisfy one set of regulatory requirements, and not require them to satisfy the requirements of multiple jurisdictions for a single transaction. At the same time, the United States should use its leverage to ensure that foreign jurisdictions provide exemptions to end-users that are similar to those provided under U.S. law.

The impact of multiple derivatives regulatory regimes is already being felt by end-users, even in the most straightforward, domestic transactions. Just as U.S. end-users may not want to be subject to foreign regulations, non-U.S. market participants, who in the past have provided liquidity to derivatives markets, are opting not to transact with U.S. persons. The result is a fragmentation of what were once deep, global markets into less liquid, more expensive and more volatile, local markets, all of which contribute to higher costs for end-users and their consumers. It is critical that U.S. regulators continue to work closely with their foreign counterparts and move quickly to recognize equivalency and substituted compliance with foreign regulatory regimes when the objectives of foreign regulations are comparable to those under the Dodd-Frank Act and where foreign regulations do not unduly burden end-users.

Finally, the Coalition believes that consistent data and reporting standards across jurisdictions could benefit end-users, regulators and the derivatives markets. The OTC derivatives markets are global and consistency in data requirements will not only help to increase transparency, but will ease the reporting and recordkeeping burdens for multinational companies.

Summary

In summary, the Coalition would like to stress three main points.

First, we support S. 876, which would ensure our ability to use CTUs to execute swaps on behalf of non-financial affiliates. There is no other means for companies to attain the same risk-reducing benefits that the CTU provides when it nets out opposite-way trades and enters into fewer, smaller derivative transaction with bank counterparties. Imposing clearing and margin requirements on CTUs trading on behalf of their non-financial end-user affiliates would be so costly as to eliminate their use, leaving companies with no way in which to replicate the CTU's benefits.

Second, while end-users are now exempt from margining requirements thanks to legislation passed earlier this year, excessive capital requirements being imposed on bank counterparties for over-the-counter transactions with end-users threaten to eviscerate the benefits of that legislation. As the cost of those capital requirements is passed on from banks to end-users, end-users are faced with a decision of whether to forego risk mitigation altogether, to enter into an imperfect hedge or to pay substantially increased hedging costs. With every choice, the end-user faces the possibility of being competitively disadvantaged against foreign competitors where bank regulation has not indirectly undermined the relief to which end-users are entitled under the Dodd-Frank Act.

Third, and finally, international harmonization is of great and growing importance and is particularly relevant for derivatives end-users. For the many that have affiliates located around the world and subject to multiple regulatory regimes, inconsistencies lead to increased costs, confusion and duplication. Even for U.S. entities, duplicative and conflicting regulation impacting the derivatives markets is causing fragmentation of markets and decreasing liquidity. All of these factors could lead end-users to abandon efficient hedging practices or cause them not hedge at all. In your oversight of the implementation of the Dodd-Frank Act, we urge you to encourage U.S. regulators to continue to work with foreign regulatory regimes to recognize equivalence between jurisdictions using an outcomes-based analysis.

Thank you, and I am happy to answer any questions you may have.