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United States Senate

COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY

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April 13, 2010

Dear Senators Cantwell, Feinstein, Dorgan and Snowe:

Thank you for your letter concerning much needed financial regulatory reform. As thoughtful and strong advocates for meaningful reform of the derivatives markets in the U.S. Senate, I am grateful for your input. I've reviewed your comments and concerns and I agree - we must have a strong derivatives title as part of the regulatory reform bill.

After months of hearings, conversations with my constituents, and, importantly, letters such as yours, I have come to the conclusion that we must enact vigorous reform of these unregulated markets. I look forward to your input moving forward and I hope that you will not hesitate to continue to be an equal partner in this process. It is my hope that by working together, we can craft strong regulatory language which will shine a light on these dark markets.

As Chairman of the committee of jurisdiction I have a responsibility to write this legislation in a way that best serves the country and our economy. I will propose strong trading and mandatory clearing requirements, higher capital standards for systemically important market participants, real-time reporting of derivatives trades to regulators and the public, and laws which will ensure that all loopholes are closed.

As you know, the Administration proposal, H.R. 4173, and all of the Senate drafts to date have included an end-user exemption from clearing requirements. However, I agree with your letter that these proposals could open up major loopholes that could be exploited to the detriment of our financial system. Therefore, I will propose a narrow exemption for only those end users who are hedging legitimate commercial risk. Speculators will not be exempted and all trades will be reported to regulators and the public. This common sense approach

will give investors and employers the transparency, flexibility, and the information they need to safely use these markets.

I would like to address other concerns from your letter, specifically:

1. You are concerned that we make sure that there are no “Enron Loopholes.” I agree completely. My legislation will require any facility used for the trading of any swaps, including energy swaps, to be registered with the CFTC as either a Designated Contract Market (DCM) or a Swap Execution Facility (SEF) and therefore subject to a complete regulatory regime. This mirrors the Administration’s proposal and is sound policy.
2. You have expressed concerns about continued off-exchange swaps and transparency. My bill will bring 100% transparency of this market to both regulators and, most importantly, the public. No exceptions. As Justice Louis Brandeis once said, “sunlight is the best disinfectant”. For these currently dark markets, full exposure to the light of day is long overdue.
3. Again, I agree with you whole heartedly that the end user clearing exemption is a very important issue as recognized by its inclusion in every regulatory reform proposal to date. Commercial entities, as opposed to financial firms, have strong arguments regarding regulatory costs and their impact on keeping jobs in the United States. My legislation will be surgical in its scope by avoiding loopholes and ensuring that tough regulations on Wall Street don’t cost us jobs on Main Street. I agree with you that only commercial firms which are solely hedging their own commercial risks should be able to use some limited exemption. It is very clear to me that the opportunities for abuse in this area are readily apparent. My proposal, unlike others, will ensure that this is narrowly tailored by providing regulators with the authority to punish entities who abuse this exemption. In an effort to make it abundantly clear, that this exemption is not for Wall Street entities, I have a provision that identifies those financial firms who are prohibited from using the clearing exemption.

4. It is essential that any OTC Derivatives reform bill demand capital and margin requirements for Wall Street firms that reflect the significant risk they are taking. The undervaluing of risk was one of the biggest reasons for the credit crisis. The fact that blue chip financial institutions previously above reproach such as Bear Stearns, Lehman Brothers, Merrill Lynch, Wachovia, Washington Mutual, Fannie Mae, Freddie Mac, AIG, Bank of America, and others all failed, were rescued, or needed government funds should not be forgotten. Requiring trading and clearing of standardized, high volume transactions is an important step in lowering systemic risk in the economy. Imposing risk based requirements which distinguish between safe transactions (cleared) and those which pose a greater threat to the economy (uncleared) is also included in my proposal. The more risky a financial transaction is the more supervision and capital to back up those transactions will be required. As risk increases, so too will regulatory supervision and costs. It's the logical and right thing to do.
5. I agree that systemically important institutions should be required to clear their swap contracts which are subject to the mandatory clearing requirement. As noted above, my proposal requires not only swap dealers and major swap participants to trade and clear their standardized, high volume swaps but also pulls in the systemically important institutions identified by the new Financial Services Oversight Council. While it isn't exactly clear at this point which entities are systemically important, I believe that we must capture large financial firms and entities such as AIG, Enron, Long-Term Capital Management and others like them that pose a systemic risk to the financial system. For that reason I have included those entities as ones which must clear the swaps which are subject to the mandatory clearing requirements. I believe this fully addresses your stated concern.
6. The disparity between a swap dealer's upfront costs on OTC swaps and a clearinghouse's margins is a significant concern. Clearinghouse margins are risk-based and calculated twice a day in a transparent manner. I cannot say the same for swap dealer collateral and margin arrangements. In a perfect world, the costs should be similar, if not identical. It is my

hope that as the volume of transactions going into clearing rises, that costs will drop and end users will find better pricing to go along with the safety of being opposite AAA credit entities like a clearinghouse as opposed to some third party in a bilateral, uncleared swap. This legislation acknowledges that uncleared swaps are potentially riskier because they are not subject to the conservative capital and margin standards of a central counterparty clearinghouse. Regulators will be required to consider this when setting capital standards for swaps.

7. My reform proposal is focused on transparency, clearing, and exchange trading. As stated earlier, 100% of all financial transactions must be reported to regulators and the public. No exceptions. Clearing of financial transactions is also essential to reform. It was AIG's uncleared swaps, and the failure to see this build up of risk, that triggered the credit crisis. Again, under my legislation there will be a mandatory clearing requirement and real time public reporting of those transactions, including any swaps which are subject to the end user clearing exemption.

Exchange trading is also important. It provides pre-order transparency to the public, which is essential to price discovery and keeping bid offer spreads narrow. This provides tremendous benefits to consumers by moving the pricing and valuing of contracts out from behind closed-doors on Wall Street. In addition, exchange trading helps in monitoring for fraud and manipulation. I would note, however, that as the Administration and CFTC have made clear, exchange trading is not appropriate for all swaps contracts. I happen to agree with the Administration and the CFTC on this point. To the extent the CFTC determines that certain swaps should be subject to a mandatory clearing requirement, it would seem that these standardized, high volume swaps contracts would be good candidates for mandatory exchange trading. Under my proposal, I provide the CFTC with the latitude of determining what swaps must be traded on an exchange.

8. The use of non-cash for collateral and margin purposes needs to be addressed. While it is quite common in the uncleared swaps markets for

a swap dealer to accept “non cash collateral,” it is my understanding that this could be a problem with cleared swaps given the current clearinghouse model. There are serious questions about putting that model and those clearinghouses at risk. We must find some mechanism which permits asset rich entities such as those you have identified to pledge interests in their non-cash assets as collateral. I hope you will work with me through the Committee and floor process to find a solution.

In closing, I want to thank you again for your letter. It is helpful as I draft my OTC Derivatives proposal. It is absolutely essential that the U.S. Senate pass strong legislation which restores the public’s faith in financial and commodity market stability and assures strong market oversight. I ask for your continued input as we move forward.

Sincerely,

A handwritten signature in blue ink that reads "Blanche L. Lincoln". The signature is written in a cursive style with a large initial "B".

Blanche L. Lincoln
Chairman