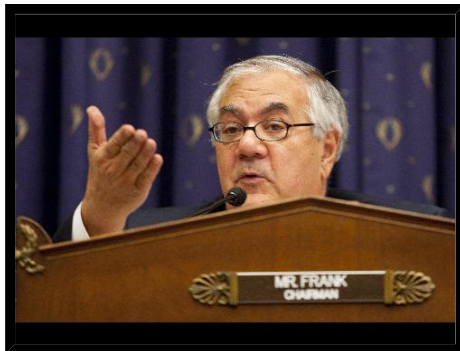





## Derivatives Lobby Links With New Democrats to Blunt Obama Plan

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By Dawn Kopecki, Matthew Leising and Shannon D. Harrington



Oct. 9 (Bloomberg) -- As President **Barack Obama** vowed in a Sept. 14 **speech** in New York's Federal Hall to correct "reckless behavior and unchecked excess" on Wall Street, **Mike McMahon** and **Barney Frank** sat in the audience discussing how to ease proposed rules for the \$592 trillion over-the-counter derivatives market.

Side by side at 26 Wall St., across from the New York Stock Exchange, freshman congressman McMahon told House Financial Services Committee Chairman Frank he was worried that Obama's derivatives plan, released in August, would penalize a wide swath of U.S. corporations and could push jobs in his home district overseas, McMahon said in an interview.

"It's not just the farmers, and it's not just the Wall Street guys," said McMahon, a member of the **New Democrat Coalition**, a group of 68 self-described pro-growth Democrats in the U.S. House of Representatives. "It's across the nation. American industry uses these products for a very useful purpose, which keeps down prices and makes consumer products cheaper."

McMahon said Frank agreed it was important to protect so-called end-users, the corporations that rely on derivatives to hedge everyday operational risk, such as fluctuations in foreign currency rates, interest rates and commodity prices. The Obama plan would subject companies to higher collateral requirements whether they trade standardized or customized contracts. It also calls for most trades to be executed on an exchange or an "alternative swap execution facility."

'Working Together'

"He said we'd be working together on this," said **McMahon**, who represents a large constituency of Wall Street workers on Staten Island and in southwest Brooklyn. "We never had a philosophical difference."

It's not just end-users who won concessions from McMahon and Frank. **JPMorgan Chase & Co., Goldman Sachs Group Inc.** and Credit Suisse Group AG lobbied McMahon and fellow New Democrat Coalition member Representative **Melissa Bean** of Illinois, among others, to expand the ways the legislation allows dealers and major investors to trade the contracts, according to people familiar with the matter.

Bean's spokesman Jonathan Lipman rejected the notion that the New Democrats made any changes to the bill at the behest of banks.

"New Dems have promoted strong regulatory reform that institutes trade and price reporting, capital requirements, and margin requirements, all of which puts mandates on these institutions that they don't like," Lipman said. "New Dems have been focused on increasing transparency, reducing systemic risk, and preserving the ability for end-users to hedge their risk."

JPMorgan spokesman **Justin Perras**, Goldman Sachs spokesman **Michael DuVally** and Credit Suisse spokeswoman **Victoria Harmon** declined to comment.

#### Loopholes

The battle over derivatives legislation is a test for the Obama administration's efforts to tighten financial regulation to prevent a repeat of the financial crisis that shook the global economy -- a crisis exacerbated by derivatives trading.

Frank, a Massachusetts Democrat who rose through the ranks in Congress fighting homelessness and advocating for gay and consumer rights, found his handiwork panned by administration officials after he released draft **legislation** last week that they criticized as too friendly to business. Frank's bill allows for no change in how standardized over-the-counter derivatives are traded as long as they are reported to regulators.

**Commodity Futures Trading Commission** Chairman **Gary Gensler** and **Henry T.C. Hu** of the **Securities and Exchange Commission** said Frank's "discussion draft" created too many loopholes and had the potential to exclude all hedge funds and corporate end-users from oversight.

#### New Democrats

"That's why it's called a discussion draft, because it brings forth people's comments," Frank said in an interview after an Oct. 7 hearing at which Gensler and Hu testified. "It's an ongoing process."

Frank told the committee that he agreed to "tighten up" the legislation before it is voted on next week.

With 68 of the Democrats' 256 votes in the House, the New Democrats have become a growing force within their party. Democrats hold a 38-member voting majority over Republicans and cannot pass financial legislation without coalition support.

"Oh, they were very important," Frank said. "A couple of them have some experience in this area. They are also an important part of our caucus."

Derivatives dealers became concerned that Obama's plan didn't adequately define "alternative swap execution facility" and that, in the end, regulators would write rules making them similar to exchanges, people familiar with the lobbying effort said. Over the last two months, the banks pressed to have Frank's draft allow standardized trades to be executed privately via telephone, as they've been traded for decades, as long as they are reported to regulators, the people said.

#### Shrinking Spreads

The change could protect billions of dollars in profit for the dealers. When securities or derivatives are traded on exchanges -- where investors can see real-time prices, rather than indicative prices sent by e-mail in the over-the-counter market -- it can shrink the amount that dealers make on each trade, known as the spread.

"Having more discretion for the dealers in the regulations gives an extra benefit to them by staying away from narrower spreads," said **Darrell Duffie**, a finance professor at Stanford University in California.

The top five U.S. commercial banks, including JPMorgan, Goldman Sachs and Bank of America Corp., were on track through the second quarter to earn more than \$35 billion this year trading unregulated derivative contracts, according to a review of company filings with the Federal Reserve and people familiar with the banks' income sources.

#### Real-Time Pricing

The banks are arguing that an exchange or trading-system mandate that publicizes large trades could make it too expensive or impossible to execute customer orders and hedge those trades at the same time, according to the people familiar. Publicized large orders may dry up the willingness of dealers and investors to buy or sell contracts, they said.

That argument might not get a sympathetic ear at the Commodity Futures Trading Commission. Its chairman has several times called the regulated platforms "electronic trading systems," suggesting that U.S. officials may seek to require banks and investors to use them like exchanges with real-time, public pricing.

"People viewed it as tantamount to an exchange," said **Robert Pickel**, chief executive officer of the International **Swaps and Derivatives Association**, a New York-based group that sets standards in OTC derivatives markets.

'Into the Weeds'

While the concerns were raised through both Republicans and Democrats, "the New Democrats have played a central role here both in terms of interacting with the end-users but also being able to take that concern to Chairman Frank," Pickel said.

A half dozen New Democrats pressed Treasury Secretary **Timothy Geithner** to expand the administration's exemption for end-users in an Oct. 1 meeting.

"We got into the weeds on the derivatives bill," said Connecticut Representative **James Himes**, a former investment banker at Goldman Sachs and a member of the New Democrats, who attended the meeting along with McMahon, Bean and chairman **Joseph Crowley** of New York.

Unlike Obama's plan, Frank's bill doesn't require derivatives users or dealers to execute standardized over-the-counter contracts on a regulated exchange or trading platform, which would force greater price transparency. Instead, it gives them the option to decide if they want to use an exchange or a trading platform, or merely report the transaction to regulators by the end of the day.

Non-Standardized Contracts

Not mandating exchange or other types of electronic trading "will probably prevent spreads from dropping like a rock," said **Kevin McPartland**, a senior analyst in New York at Tabb Group, a financial-market research and advisory firm. "There's no reason, at least that I can see, why anybody would go to an exchange."

The legislation "recognizes that a lot of derivatives contracts are non-standardized, meaning that IBM has exposure to the yen on a certain timetable that just doesn't fit into standard exchange-traded contract," said Himes. "The bill recognizes that some risks are unique. Sometimes you need a custom-made contract that won't be exchange-traded or clearinghouse-cleared."

Executives and lobbyists in finance, manufacturing, agriculture and other industries had been pressing lawmakers and administration officials for months before McMahon's fortuitous seating assignment at Federal Hall.

"We've seen a steady parade of all of the big dealers, all of the major money-center banks have come through Congress," Himes said in an interview.

Derivatives Coalition

The House Agriculture Committee approved legislation in February granting the CFTC or SEC oversight of clearinghouses backing credit-default swaps. It also would have allowed those regulators to suspend trading in the \$26 trillion market.

"That acted as a catalyst, and we formed a small group of companies that were interested in this issue," said **Dorothy Coleman**, vice president of tax and domestic economic policy at the **National Association of Manufacturers** in Washington. Momentum continued to build over the next six months as the Obama administration made derivatives reform a key element of its financial regulatory agenda.

The NAM group was joined by members of the U.S. Chamber of Commerce and the Business Roundtable to form the Coalition for Derivatives End-Users. Its 171 members are all non-financial corporations, including brewer MillerCoors LLC, **International Business Machines Corp.** and tractor-maker Deere & Co.

## Letter to Congress

The coalition sent Congress a **letter** on Oct. 2 saying that some reform proposals “place an extraordinary burden on end- users of derivatives.” Members also met this week with lawmakers and staff on Capitol Hill.

In the end-users coalition, broker-dealers found a powerful ally. Although the two groups say they didn’t coordinate their lobbying, their interests overlapped and many of the concessions won in the bill for end-users ended up benefiting some of the biggest Wall Street banks whose credit-default swaps exacerbated the financial crisis.

“There’s very little sympathy for the plight of money- center banks on Capitol Hill right now,” Himes said.

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