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Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

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Chairman Kanjorski, Ranking Member Garrett, members of the Subcommittee. My name is Thomas F. Callahan, and I am an Executive Vice President and Head of US Futures for NYSE Euronext. I am pleased to appear today on behalf of NYSE Euronext and its affiliated exchanges as the Subcommittee considers possible amendments to the various federal laws that affect over-the-counter derivatives transactions.

NYSE Euronext operates one of the world's largest and most liquid exchange groups, bringing together seven cash equities exchanges in five countries and seven derivatives exchanges. In the United States, we operate the New York Stock Exchange, NYSE Arca, NYSE Amex, and NYSE Liffe US. In Europe, we operate five European-based exchanges that comprise Euronext — the Paris, Amsterdam, Brussels and Lisbon stock exchanges, as well as the NYSE Liffe derivatives markets in London, Paris, Amsterdam, Brussels and Lisbon. Moreover, we will shortly begin providing clearing for our London derivatives market, having received approval in principle from the United Kingdom's Financial Services Authority in late May to launch NYSE Liffe Clearing. We also provide technology to more than a dozen cash and derivatives exchanges throughout the world. NYSE Euronext's geographic and product diversity has informed our views on the principal issues we are discussing with you today.

NYSE Euronext supports appropriate regulation of OTC derivatives

NYSE Euronext has a strong interest in supporting the appropriate regulation of OTC derivatives transactions, the dealers that sell them and markets they serve. In coordination with LCH.Clearnet Ltd., which is both a recognized clearing house in the UK and a derivatives clearing organization registered with the Commodity Futures Trading Commission ("CFTC"), NYSE Liffe has received temporary exemptive relief from the Securities and Exchange Commission ("SEC") to provide clearing services for credit default swaps. (This relief expires in September.) NYSE Liffe Clearing also anticipates offering clearing services for OTC derivatives. Further, to the extent that OTC derivatives are required to be traded on an exchange, NYSE Liffe expects to list such products for trading.

As important, our larger cash equity and derivatives exchange members have affiliates that are OTC derivatives dealers. As we learned from the bankruptcy of Lehman Brothers Holdings, the failure of an OTC derivatives dealer will have collateral consequences for its regulated affiliates, even when those latter entities are properly capitalized and have no direct exposure to OTC derivatives. Finally, we are aware that a number of our listed companies use OTC derivatives to manage their interest rate risk and otherwise hedge obligations incurred in connection with the conduct of their business. It is essential that these companies have confidence both in the integrity of the transactions they enter into and the ability of their counterparties to perform their financial obligations. An appropriate regulatory regime for OTC derivatives is a necessary element in restoring and retaining this confidence.

NYSE Euronext supports the balanced approach to OTC derivatives regulation advanced by Secretary Geithner and Chairmen Schapiro and Gensler

We strongly support the proposed framework for the regulation of OTC derivatives set forth in Treasury Secretary Geithner's May 13 letter to the Congressional leadership. We believe the nuanced view that Secretary Geithner, in coordination with the SEC and CFTC, took in crafting this proposal is critically important to the building of investor confidence, ensuring the integrity of the marketplace and fostering more efficient trading of OTC derivatives.

While evidencing a strong preference for clearing and, where appropriate, exchange trading of OTC derivatives, the proposed framework takes into consideration the differences among OTC derivatives products and the legitimate needs of market participants that use these products to manage their business risks and adopts a tiered approach to the regulation of OTC derivatives markets. We agree that the fundamental principles of an appropriate regulatory framework for OTC derivatives should include:

- OTC derivatives that are standardized should be traded on an exchange and cleared through a central counterparty**.**

- To the extent the market for certain standardized derivatives is not liquid or deep enough to survive in an exchange-traded environment, they should be traded through an electronic trading system and cleared through a central counterparty**.**

- To the extent a limited class of OTC derivatives are appropriately customized and, therefore, cannot be (1) executed through an exchange or electronic trading system or (2) cleared through a central counterparty, such transactions should nonetheless be subject to recordkeeping and reporting requirements with a regulated trade repository.

The requirement to clear OTC derivative transactions and, where appropriate, to execute such transactions on an exchange or electronic trading system will provide significant regulatory benefits

The requirement that OTC derivatives be cleared through a central counterparty will achieve four critical regulatory benefits:

- **Reduction of systemic risk.** Centralized clearing of OTC derivatives would significantly reduce the risk posed to the financial system by the failure of a major market participant. Rather than having to sort through potentially hundreds of thousands of bi-lateral transactions to determine the credit and market risk posed by a major counterparty's failure in a bilateral, OTC environment, credit and market risk would be known and quantified in a centrally-cleared environment. In times of crisis, such knowledge is vital if regulators are to take necessary remedial steps for the financial system and broader economy.

- **Elimination of significant operational risk.** Centralized clearing also would remove the remaining operational risk posed by OTC derivatives trading relying on paper confirmations.

- **Creation of market surveillance databases.** Housing a significant volume of derivative exposure in regulated central counterparties would exponentially increase the visibility that key regulators such as the SEC, CFTC and Federal Reserve would have into market participants' trading activity. This visibility would streamline such agencies' reviews for fraudulent and manipulative activity as well as provide the capability to design an early warning system for institutions taking on imprudent risks, potentially threatening the wider financial system. The very nature of clearinghouse functions would promote the standardization of recordkeeping for regulators in their effort to identify and address (1) fraudulent trading, such as insider trading, (2) market manipulation, and (3) imprudent and excessive risk.

- **Transparency for market participants.** Finally, the daily functioning of regulated clearinghouses marking to market positions, and charging and collecting margin on cleared positions would provide significantly improved transparency to the marketplace generally. Such transparency should foster competition, which should ultimately benefit the end-user community.

The further requirement that OTC derivatives be traded on an exchange or other electronic trading system only enhances these regulatory benefits. In particular, market surveillance databases will be improved through the creation of a more complete audit trail, as will market transparency by providing a more public forum for price discovery.

The legislation enacting regulatory reform of OTC derivatives should ensure continued growth and innovation in the OTC derivatives market

As it undertakes the task of developing a regulatory regime for OTC derivatives, we encourage the Subcommittee to take care to strike a regulatory balance similar to that suggested in Secretary Geithner's letter and Chairman Gensler's testimony. However significant the shortcomings in the regulation of OTC derivatives have been, the fact remains that OTC derivatives are a vitally important tool in managing economic risk and, if used properly, will continue to add value to the marketplace

In this regard, we note that different bills have been discussed, and in some cases introduced, in Congress since the start of the financial crisis that appear to be designed to force a particular solution to the perceived deficiencies of the OTC derivatives markets by, among other things, (i) requiring that all derivatives be traded on an exchange, (ii) requiring that all OTC derivatives be traded on a CFTC-registered derivatives clearing organization, and (iii) prohibiting non-hedgers from participating in these markets. We would oppose efforts to so restrict the use of OTC derivatives.

The OTC derivatives market is a global market, requiring a global regulatory approach. It would be inappropriate — and a mistake — for Congress to impose a narrow solution that would effectively designate winners and losers among exchanges, clearing organizations and products and potentially invite regulatory retaliation by international regulatory authorities.

We are in the early stages of the development of a regulatory regime for OTC derivatives, and it would be appropriate, consistent with the framework proposed by the financial regulatory agencies to provide this newly-regulated market and the authorities that will oversee it sufficient flexibility to evolve and adjust over time. We believe we are off to a good start. The financial regulatory authorities cooperated in authorizing central counterparties for the clearing of credit default swaps. More recently, the CFTC and SEC have indicated that they have reached an informal agreement with respect to the oversight of the OTC derivatives market. In addition, principal OTC derivatives participants on both the buy-side and the sell-side have pledged their support in implementing a more structured and efficient market.

Congress should use this opportunity to address other issues that inhibit the development of centralized clearing and a more efficient market generally

Facilitate Portfolio Margining. We recommend that Congress consult with the SEC, CFTC and the industry to enact such amendments to their respective statutes as may be necessary to expand the benefits of portfolio margining beyond that which the agencies have currently authorized. Portfolio margining permits more efficient use of capital across securities and derivatives markets. The several securities exchanges and FINRA have adopted rules to authorize portfolio margining for customers holding securities, including security futures contracts in a securities account and futures on broad-based security indices in a futures account. However, the CFTC and SEC have been unable to agree on the treatment of customer funds deposited to margin a combined securities and futures positions. Consequently, the promise of portfolio margining is largely unfulfilled.

Update Regulation of Alternative Trading Systems. Further, consistent with the goals of enhancing market transparency and oversight of the derivatives generally, we believe Congress should take a fresh look at alternative trading systems ("ATS"), which have come to play an increasingly important role in the execution of securities transactions. Over one-third of equity transactions now occur on ATS, which are not subject to the same regulatory oversight as organized exchanges. In particular, through so-called "dark pools", ATS operators have been allowed to create private markets for securities transactions, which the acting co-director of the SEC’s Division of Trading and Markets has acknowledged “can harm price discovery and worsen short-term volatility.”

When the SEC first established the more flexible regulatory regime for ATS, these execution platforms were to provide necessary competition to exchange markets. Over time, however, the disparity in regulation between organized securities exchanges and ATS has placed exchanges at a significant competitive disadvantage. We ask the Subcommittee to encourage the SEC to revisit its regulatory regime for ATS and assure that ATS are held to the same standards as organized exchanges.

Conclusion

On behalf of NYSE Euronext, I want to thank the Subcommittee again for the opportunity to appear before you today. We look forward to working with the Financial Services Committee and other committees of the House of Representatives and the Senate in crafting appropriate amendments to the several securities acts, the banking laws and the Commodity Exchange Act, as appropriate, to implement a regulatory regime for OTC derivatives.

I would be pleased to answer any questions the Subcommittee may have.