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BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

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Good morning Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for inviting me to testify today regarding the regulation of over-the-counter (OTC) derivatives and, specifically, this Committee's OTC Derivatives Markets Act of 2009 Discussion Draft.

I would like to address much-needed regulatory reform of OTC derivatives in the context of two principal goals: lowering risk to the American public and promoting transparency of the markets.

We embark upon this reform effort as the financial industry has become ever more concentrated. Given the events of the last decade, there are fewer providers of financial services today. There may be 15 to 20 large complex financial institutions that are at the center of today's global derivatives marketplace. Five to ten years from now, it is quite possible that the financial system will become even more concentrated. With fewer actors on the stage, it is especially important that we lower the risk of these participants and bring sunshine to the activities in which they are involved.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. Exhibit A of these twin failures was the collapse of AIG. Every single taxpayer in this room – both the members of this Committee and the audience – put money into a company that most Americans had never even heard of. Approximately $180 billion of our tax dollars went into AIG – that is nearly $414 million per each of your Congressional districts. While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in our regulatory structure.

Lowering Risk

To lower risk to the American public, the Administration proposed four essential components of reform.

First, those financial institutions that deal in derivatives should be required to have sufficient capital. Capital requirements reduce the risk that losses incurred by one particular dealer or the insolvency of one of its customers will threaten the financial stability of other institutions in the system. While many of these dealers, being financial institutions, are currently regulated for capital, I believe that we should explicitly – both in statute and by rule – require capital for their derivatives exposure. This is particularly important for nonbank dealers who are not currently regulated or subject to capital requirements.

Second, swap dealers should be required to post and collect margin for individual transactions. Margin requirements reduce the risk that either counterparty to a trade will fail to perform its obligations under the contract. This would protect end-users of derivatives from a dealer's failure as well as guard dealers from end-users' failures.

Third, regulators should be able to mandate robust business conduct standards to protect market integrity and lower risk. Business conduct standards should ensure the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions. Implementation of standards for what are commonly referred to as "back office" functions will help reduce risks by ensuring derivatives dealers, their trading counterparties and regulators have complete, accurate and current knowledge of their outstanding risks. "Back office" standards are currently voluntarily implemented by individual firms. I believe that comprehensive regulation requires mandatory business conduct standards for all derivatives dealers.

Fourth, where possible, OTC transactions should be required to be cleared by robustly regulated central counterparties. By guaranteeing the performance of contracts submitted for clearing, the clearing process significantly reduces systemic risks. Through the discipline of a daily mark-to-market process, the settling of gains and losses and the imposition of independently calculated margin requirements, regulated clearinghouses strive to ensure that the failure of one party to OTC derivatives contracts will not result in losses to its counterparties. Right now, however, trades mostly remain on the books of large complex financial institutions. These institutions engage in many other businesses, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other

hand, are solely in the business of clearing trades. To reduce systemic risk, it is critical that we move trades off of the books of large financial institutions and into well-regulated clearinghouses.

Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdictions. This well-established practice of having the agency which regulates an exchange or trade execution facility also regulate the clearinghouses for that market should continue as we extend regulations to cover the OTC derivatives market.

AIG highlights the need for each of these four priorities. AIG was not required to meet capital standards or post margin for individual transactions. It was not subject to business conduct standards for its back office functions. AIG's failure was essentially a failure of a central counterparty in the sense that it internalized the credit risks of its trades. By moving bilateral trades into regulated clearinghouses, we will reduce the risk that a failure of one firm will cause other firms to fail as well. Ineffective regulation allowed the failure of AIG Financial Products and the derivative dealers affiliated with Lehman Brothers, Bear Stearns and investment banks to affect the entire financial system. We must ensure that this never happens again. We cannot afford any more multi-billion-dollar bailouts.

Improving Transparency

The second principal goal as we discuss proposals to regulate OTC derivatives is to promote transparency. Economists have for decades recognized that transparency benefits the marketplace. After the last great financial crisis facing the nation, President Roosevelt called for transparency in the futures and securities marketplaces. It is now time to promote similar transparency in the relatively new marketplace for OTC derivatives. Lack of regulation in these markets has created significant information deficits:

- Information deficits for regulators who cannot see and police the markets;

- Information deficits for the public who cannot see the aggregate scope and scale of the markets; and

- Information deficits for market participants who cannot observe transactions as they occur and, thus, cannot benefit from the transparent price discovery function of the marketplace.

To address information deficits in the OTC derivatives markets, the Administration has proposed – and I fully support – the following priorities:

First, stringent recordkeeping and reporting requirements should be established and vigorously enforced. This includes an audit trail so that regulators can observe all trading activity in real time and guard against fraud, manipulation and other abuses.

Second, all non-cleared transactions should be reported to a trade repository that makes the data available to regulators. This will complement regulators' ability to obtain transaction data on trades conducted in a central clearinghouse. U.S. regulators and foreign regulators should both have unfettered access to see all transactions, regardless of whether the physical locations of the trade repositories and clearinghouses are in the United States or elsewhere.

Third, data on OTC derivatives transactions should be aggregated and made available to the public. The CFTC currently collects and aggregates large trader position data and releases it to the public. We should apply the same transparency standards to OTC derivatives. This will promote market integrity and protect the American public.

Fourth, all standardized OTC products should be moved onto regulated exchanges or regulated trade execution facilities. I believe that this is the only way that we can best address information deficits for market participants. Exchanges greatly improve the functioning of the existing securities and futures markets. This is through the transparency they provide both before and after a trade. We should shine the same light on the OTC swaps markets. Increasing transparency – including a timely consolidated reporting system – for standardized derivatives should enable both large and small end-users to obtain better pricing on standard and customized products. A municipality, for example, could better decide whether or not to hedge an interest rate risk based upon the reported pricing from exchanges. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will benefit all end-users, whether trading with standardized or customized swaps.

G-20 Heads of State Agreement

At the conclusion of the G-20 summit held in Pittsburgh last month, President Obama, along with other heads of state, made lowering risk and promoting transparency in the OTC derivatives marketplace a key goal. The leaders concurred that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements." It is now our challenge, working with Congress, to achieve that goal.

Working with the SEC

Comprehensive regulation of OTC derivatives will require ongoing cooperation between the CFTC and the SEC. The President asked that our agencies provide recommendations to Congress and the Administration on how to best tailor our regulations in the interest of protecting the American public. Last month, we held two unprecedented joint public meetings to look into gaps that exist between the two agencies' financial regulatory authorities, overlap of regulatory authority and inconsistencies when the two agencies' regulate similar products, practices and markets. We intend to release a report next week that will highlight how both agencies can adapt regulations to the evolving financial markets and best protect the American public. These proposals will be available to Congress as we bring reform to financial regulation.

OTC Derivative Markets Act of 2009 Discussion Draft

I will now turn to six issues raised by the Discussion Draft released last week by this Committee. I believe that the draft is an important contribution to the process of moving toward comprehensive regulation of the OTC derivatives markets. I look forward to working with this Committee to ensure that we cover the entire marketplace without exception.

Clearing

First, in the Administration proposal, there is a presumption that any contract that would be accepted for clearing must be cleared. This is essential to lowering risk. While the Discussion Draft endorses a requirement for central clearing, it shifts from the presumption that all standardized derivatives must be cleared to one where products would be cleared only if required by market regulators. The Discussion Draft then puts the burden on the regulators to determine whether specific contracts, according to specific criteria, should be cleared. The Draft also is unclear as to whether the CFTC would have to determine the necessity for mandatory clearing of swaps on a contract-by-contract basis.

Though there must be appropriate regulation of the clearing process, I believe it is best for a clearinghouse that is managing its risk to determine if a particular product should be cleared. The market regulators would oversee those determinations. If Congress decides to shift from the presumption of mandatory clearing, the market regulators should be given the authority to determine that broad classes of swaps must be cleared rather than be required to make such determinations on a swap-by-swap basis.

Clearing Requirements for End-Users

Second, with regard to a clearing requirement, a number of end-users that use OTC derivatives for hedging have asked whether their contracts would be required to be cleared. I believe that such end-users should be allowed to fully use customized or tailored contracts to meet their particular hedging needs and that these would not need to be centrally cleared.

Thus, the only question that remains is: should the end-users' standard, or clearable, contracts be subject to a clearing requirement? The CFTC has recommended that the swap dealers should bring those transactions to a central clearinghouse to lower risk. The end-users would be allowed to enter into individualized credit arrangements with the financial institutions that enter into transactions for them, i.e., their clearing firm. End-users would not be required to post cash collateral or any other particular form of collateral – they would simply be required to work with the clearing firm to determine the most appropriate credit arrangement. Clearing firms would thus intermediate credit for an end-user while concurrently bringing the end-user's transactions to a clearinghouse. This will both lower risk and accommodate the end-users' concerns.

To the extent that Congress decides not to follow this approach, I believe that any clearing exception for end-users should be very narrowly defined to only include nonfinancial entities that use swaps incidental to their business to hedge actual commercial risks. We would not want an unintended consequence of an end-user exception to be that hedge funds, financial firms or other investment funds would be able to evade the clearing requirement.

Major Swap Participant

Third, the Discussion Draft departs from the proposal submitted by the Administration in its definitions of "major swap participant" and "major security-based swap participant." The Administration recognized that some entities enter into swaps to comply with generally accepted accounting principles. The Discussion Draft, perhaps inadvertently, widened this exception such that the "major swap participant" category would exclude any entity entering into a swap for "risk management" purposes. I am concerned that a great number of swaps could be characterized as risk-management, or hedging, swaps. This could have the unintended consequence of exempting a broad range of entities from the definition of a "major swap participant" and, thus, exempt such entities from regulatory requirements outlined in the proposal. For example, it may be possible for major swap users to avoid regulation by claiming that their swaps were entered into for the purpose of "risk management."

Exchange Trading

Fourth, the Discussion Draft makes trading on regulated exchanges or regulated trading platforms available to swap dealers, but not required. I believe, however, that it should be required for all cleared swaps. Market participants and the public would benefit greatly from the transparency and better pricing afforded by regulated exchanges and trade execution facilities. Transactions should be reported on a real time basis similar to how reporting functions in the corporate bond world work. Congress could authorize the CFTC and the SEC, by rule, to allow transactions to be voice brokered, but still affirmed through the execution facility. This would be similar to the process by which block trades and certain other transactions that might not have

sufficient liquidity on a trading platform are traded subject to the rules of registered futures exchanges. Post-trade reporting should be required. Thus, the public would get the benefit of transparency, but Congress would address the concern of whether sufficient liquidity exists on all contracts that are cleared for them to be traded on exchanges or trade execution facilities.

Foreign Regulation

Fifth, it is essential that the CFTC and SEC as market regulators work cooperatively with foreign regulators on a routine basis to ensure that traders cannot evade U.S. regulation by trading overseas. Two weeks ago, I travelled to Brussels to press for comprehensive regulation of the OTC markets by the European Commission. I know that Chairman Schapiro is in Basel today also working on regulatory issues. The Discussion Draft includes provisions that require coordination with international regulators.

As U.S. regulators, we must have complete and unfettered access to data that bears on U.S. commerce, regardless of whether it is kept overseas. If a foreign entity or a foreign subsidiary of a U.S. entity is trading with an American counterparty, we should know about it. I am concerned that the Discussion Draft could allow foreign financial institutions to be exempted from our requirements. We must ensure that we do not inadvertently create gaps in our regulatory system through exemptions for foreign regulations.

Moreover, we need to ensure that our efforts to accommodate foreign regulatory standards do not generate unintended consequences. For example, I share the Committee's goal of promoting post-trade transparency, as outlined in section 6 of the Discussion Draft, but I

worry that the specific provisions might inadvertently permit market participants to shop for lax foreign regulators. Market participants should only be exempt from American regulation through compliance with foreign standards where there has been a determination by U.S. regulators that the foreign regulatory scheme is comprehensive and comparable to our standards.

Agriculture Swaps

Sixth, I am concerned about the possible unintended consequences the Discussion Draft may have with respect to off-exchange trading of standardized agricultural swaps. Under current law, swaps in agricultural commodities are not considered either an exempt or excluded commodity. Thus, standardized swaps involving agricultural commodities may not be traded in over-the-counter markets. The Administration's bill would remove the distinctions between the various types of commodity swaps, as well as the various exclusions and exemptions for these swaps. At the same time, though, the proposal would impose a requirement that standardized commodity swaps be cleared and traded either on an exchange or trade execution facility.

The Discussion Draft, like the Administration's bill, would eliminate the distinctions between the various types of commodity swaps. It does not, however, include all of the protections provided in the Administration's bill for these OTC markets. With respect to swaps involving agricultural commodities, the Discussion Draft enables, for the first time, standardized agricultural swaps to be traded bilaterally off-exchange, but does not impose the protections that we believe are necessary for this market.

Technical Assistance

In addition to the six points outlined above, the CFTC will work with this Committee to provide further technical assistance. Specifically, the Discussion Draft provides that exchanges and trade execution facilities should have open access to clearinghouses for standardized products. We will work with this Committee to ensure that access is provided in a nondiscriminatory way.

Further, we are pleased that the Discussion Draft supports the goal of segregating customer margin from a dealer's own funds. We will work with this Committee to ensure that Bankruptcy Code provisions that apply to segregated funds for futures and options on futures would also apply to swaps.

Lastly, as I have previously noted for this Committee, I believe that any exception for foreign currency forwards should not allow for evasion of the goal of bringing all interest rate and currency swaps under regulation to protect the investing public. We will work with the committee on this as well.

Conclusion

I look forward to working with the Congress and other federal regulators to apply comprehensive regulation to the OTC derivatives marketplace and to secure additional resources so that the CFTC can effectively regulate the markets. The United States thrives in a regulated market economy. This requires innovation and competition, but also regulation, to ensure that

our markets are fair and orderly. We have a tough job ahead of us, but it is essential that we get it done to protect the American public.

Thank you for inviting me to testify today. I would be happy to answer any questions you may have.