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BEFORE THE

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Good morning Chairman Bachus, Ranking Member Frank and members of the Committee. I thank you for inviting me to testify at today's hearing. I'm pleased to be on a panel along with my fellow regulators. I appreciate the opportunity to discuss the Commodity Futures Trading Commission's (CFTC) ongoing efforts to implement swaps market reforms, including for the credit default swap (CDS) index products traded by JPMorgan Chase's Chief Investment Office (CIO).

The CFTC's Division of Enforcement has opened an investigation related to credit derivative products traded by JPMorgan Chase's CIO. Although I am unable to provide any specific information about a pending investigation, I will, however, describe generally the Commission's oversight of the markets for CDS index products.

Following Congress' direction, the CFTC has made significant progress on bringing reform to the swaps market, as mandated in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). With regard to the CDS index products traded by JPMorgan

Chase’s CIO, the agency is currently midstream in standing up reforms that promote transparency and lower risk to the market.

Dodd-Frank Swaps Market Reforms and CDS Indices

Swaps were developed to help manage and lower risk for commercial companies. But they also concentrate and heighten risk in international financial institutions. When these entities fail, as they have and surely will again, swaps can quickly spread risk across borders.

In 2008, AIG’s subsidiary, AIG Financial Products, brought down the company and nearly toppled the U.S. economy. It was run out of London – actually as a branch of a French-registered bank – though technically organized in the United States.

The 2008 crisis – caused in part by swaps – was the worst financial and economic crisis Americans have experienced since the Great Depression. Eight million Americans lost their jobs, and millions of families lost their homes.

Following the crisis, when the President convened the G-20 leaders in Pittsburgh in 2009, a new consensus formed internationally. Swaps, which were basically not regulated in the United States, Asia or Europe, should now be brought into the light of regulation.

In 2010, Congress and the President came together and passed the historic Dodd-Frank Act. To date, the CFTC has completed 33 rules to implement the law's reforms with just fewer than 20 to go.

The goal of the law is to:

- Bring public market transparency and the benefits of competition to the swaps marketplace;
- Protect against Wall Street's risks by bringing standardized swaps into centralized clearing; and
- Ensure that swap dealers and major swap participants are specifically regulated for their swaps activity.

I am going to discuss each of these areas and how they relate to CDS indices, as well as how reform promotes market integrity.

Transparency

Dodd-Frank financial reform shines bright lights of transparency – to the public and to regulators – on the swaps market for the benefit of investors, consumers, retirees and businesses in America. Transparency is critical to both lowering the risk of the financial system, as well as reducing costs to end-users. The more transparent a marketplace is to the public, the more efficient it is, the more liquid it is, and the more competitive it is.

Once complete, the swaps market transparency reforms Congress mandated would mean prices and volume for all CDS index transactions would be reported to the public. Detailed transaction information would be available to regulators. In addition, the market for standard CDS indices would benefit, as many of them likely would be traded on transparent exchanges and swap execution facilities.

The Commission has adopted final rules establishing registration and regulatory requirements for swap data repositories (SDRs), which will gather data on all swaps transactions, including for CDS indices. Through SDRs, timely and accurate data on all swaps will be available to the CFTC and other regulators.

As soon as September, in conformance with already finalized rules, real-time reporting to the public will begin for CDS indices and interest rate swaps, with similar reporting on other swaps later this year.

By contrast, in the fall of 2008, there was no required reporting about swaps trading.

Clearing

For over a century, through good times and bad, central clearing in the futures market has lowered risk to the broader public. Dodd-Frank financial reform brings this effective model to the swaps market. Standard swaps between financial firms, including for CDS indices, will move into central clearing, which will significantly lower the risks of the highly interconnected financial system.

The CFTC has made significant progress on central clearing for the swaps market. We have completed rules establishing new derivatives clearing organization risk management requirements. In addition, we finished rules on client clearing documentation, clearing member risk management, and so-called “straight-through processing,” or sending transactions immediately to the clearinghouse upon execution.

Commissioners are now reviewing staff recommendations on the first clearing requirement determinations, which include a number of CDS indices. I expect these recommendations will be put out for public comment this summer and hopefully completed this fall. The requirement likely will cover certain North American investment grade and high yield CDX indices, as well as certain European iTraxx, high volatility, and crossover iTraxx indices.

Currently, voluntary clearing exists between dealers for many CDS indices, as well as standardized interest rate swaps transactions. The major clearinghouses, including Ice Clear Credit, Ice Clear Europe, LCH.Clearnet and the CME Group, providing clearing of these products are registered with the CFTC.

Per data that is publicly available, Ice Clear Credit has 27 clearing members and clears $18.3 trillion gross notional of CDS, of which approximately 90 percent are indices. It clears 46 different indices, including those on CDX North American Investment Grade and CDX North

American High Yield. Ice Clear Europe has 16 clearing members and clears 9.7 trillion Euro, of which approximately 85 percent are indices. It clears 42 different indices. The JPMorgan Chase bank is a clearing member of both houses.

With reform, clearing will expand to include transactions between dealers and hedge funds, as well as other financial entities, thus lowering the risk of the interconnected financial system.

Swap Dealers

Regulating banks and other firms that deal in derivatives is central to financial reform. Prior to 2008, it was claimed that swap dealers did not need to be specifically regulated for their swaps activity, as they or their affiliates already were generally regulated as banks, investment banks, or insurance companies. The crisis revealed the inadequacy of relying on this claim. While banks were regulated for safety and soundness, including their lending activities, there was no comprehensive regulation specific to their swap dealing activity. Similarly, bank affiliates dealing in swaps, and subsidiaries of insurance and investment bank holding companies dealing in swaps, were not subject to specific regulation of their swap dealing activities. AIG, Lehman Brothers and other failures of 2008 demonstrate what happens with such limited oversight.

The CFTC is well on the way to implementing reforms Congress mandated in Dodd-Frank to regulate dealers and help prevent another AIG. We finalized internal business conduct rules to require swap dealers to establish policies to manage risk, as well as put in place firewalls between a dealer's trading, and clearing and research operations.

Among the risk management requirements are:

- Ensuring the risk management program takes into account market risk, credit risk, liquidity risk, foreign currency risk, legal risk, operational risk, settlement risk, and risk posed by traders;
- Establishing a system of diligent supervision by qualified personnel over the swap dealing activities; and
- Ensuring risk management issues are elevated within management.

We finished in April a joint rule with the SEC further defining the terms "swap dealer" and "securities-based swap dealer." Based on completed registration rules, dealers will register two months after we finalize the second major definition rule with the SEC: the further definition of the terms "swap" and "securities-based swap." Swap dealers who make markets in CDS indices would be amongst those dealers who may have to register with the CFTC. The further definition rule is now before Commissioners at both agencies. The CFTC and SEC are working together on the rule, and I believe we should consider it expeditiously.

Consistent with the provisions of the Dodd-Frank Act, the further definition proposal provided for CFTC regulation of CDS on broad-based security indices, and SEC regulation of narrow-based security indices (as well as CDS on single name securities or loans). Many of the

CDS indices compiled by the index provider, Markit, would be broad-based indices, including Markit's CDX North American Investment Grade, and its CDX North American High Yield. While the CDS based on these indices would be swaps under CFTC jurisdiction, both the CFTC and the SEC would have anti-fraud and anti-manipulation enforcement authorities over these products.

Following Congress' mandate, the CFTC also is working with our fellow financial regulators to complete the Volcker Rule. In adopting the Volcker Rule, Congress prohibited banking entities from engaging in proprietary trading, an activity that may put taxpayers at risk. At the same time, Congress permitted banking entities to engage in certain activities, such as market making and risk mitigating hedging. One of the challenges in finalizing a rule is achieving these multiple objectives.

The CFTC's role is primarily with regard to derivatives traded by swap dealers and futures commission merchants within banking entities. Last month, CFTC staff held a roundtable on this rule, and the discussion will be taken into account as we finalize the rule.

The CFTC is carefully considering public comments and is working with our fellow financial regulators to complete the Volcker Rule, which is among the remaining Dodd-Frank reforms we must finish to protect the public.

Market Integrity

Congress also provided the CFTC with new tools in Dodd-Frank to enhance market integrity and ensure the public has confidence in swaps markets.

Rules the CFTC completed last summer close a significant gap in the agency's enforcement authorities. These rules implement the Commission's new enforcement authority for swaps and prohibit the reckless use of manipulative or deceptive schemes. Thus, for example, the CFTC has clear anti-fraud and anti-manipulation authority regarding the trading of CDS indices.

Cross-border Application of Dodd-Frank's Swaps Reforms

Recent events at JPMorgan Chase are a stark reminder of how trades executed by traders located overseas can quickly reverberate with losses coming back into the United States.

Section 722(d) of the Dodd-Frank Act states that swaps reforms shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States."

The CFTC plans to soon put out to public comment our interpretation and related guidance on this provision to get public feedback.

The nature of modern finance is that financial institutions set up hundreds, if not thousands of legal entities around the globe. During a default or crisis, risk of overseas branches and affiliates inevitably flows back into the United States.

This was true with AIG. It was also true with Lehman Brothers. Among Lehman Brothers' complex web of affiliates was Lehman Brothers International (Europe) in London. When Lehman failed, this London affiliate, with more than 130,000 outstanding swaps contracts, failed as well. The U.S. mother ship, Lehman Brothers Holdings, had guaranteed many of the contracts.

Another example was Citigroup, which set up numerous structured investment vehicles (SIVs) to move positions off its balance sheet for accounting purposes, as well as to lower its regulatory capital requirements. Yet, Citigroup had guaranteed the funding of these SIVs through a mechanism called a liquidity put. When the SIVs were about to fail, Citigroup in the United States assumed the huge debt, and taxpayers later bore the brunt with two multi-billion dollar infusions. The SIVs were launched out of London and incorporated in the Cayman Islands.

Bear Stearns is yet another case. Bear Stearns' two sinking hedge funds it bailed out in 2007 were incorporated in the Cayman Islands. Yet again, the public assumed part of the burden when Bear Stearns itself collapsed nine months later.

A decade earlier, the same was true for Long-Term Capital Management. When the hedge fund failed in 1998, its swaps book totaled in excess of $1.2 trillion notional. The vast majority were booked in its affiliated partnership in the Cayman Islands.

Balanced implementation of regulatory reform requires an acknowledgment that the activities of financial institutions engaging in transactions or setting up operations abroad can pose a profound threat to U.S. taxpayers and the economy.

As the JPMorgan Chase CIO trades were executed by traders located abroad, I would like to provide for the Committee a description of the CFTC staff recommendation that has been before Commissioners.

First, it provides the guidance that when a foreign entity transacts in more than a de minimis level of U.S. swap dealing activity, the entity would register under the Dodd-Frank Act swap dealer registration requirements.

Second, it includes a tiered approach for overseas swap dealer requirements. This is largely consistent with comments received from major international swap dealers. Some requirements would be considered entity-level, such as for capital, risk management, recordkeeping and reporting to SDRs. Some requirements would be considered transaction-level, such as clearing, margin, real-time public reporting, trade execution and sales practices.

Third, entity-level requirements would apply to all registered swap dealers, but in certain circumstances, overseas swap dealers could meet these requirements by complying with comparable and comprehensive foreign regulatory requirements, or what we call "substituted compliance."

Fourth, transaction-level requirements would apply to all U.S. facing transactions. For these requirements, U.S. facing transactions would include not only transactions with persons or entities operating or incorporated in the United States, but also transactions with their overseas branches. Likewise, this would include transactions with overseas affiliates that are guaranteed by a U.S. entity, as well as the overseas affiliates operating as conduits for a U.S. entity's swap activity.

Fifth, for certain transactions between an overseas swap dealer (including a foreign swap dealer that is an affiliate of a U.S. person) and counterparties not guaranteed by or operating as conduits for U.S. entities, Dodd-Frank transaction-level requirements may not apply. For example, this would be the case for a transaction between a foreign swap dealer and a foreign insurance company not guaranteed by a U.S. person.

This means if a legal entity has over $8 billion in U.S. swap dealing activity, it should be preparing to register as a swap dealer. For foreign financial institutions, swaps with U.S. persons or their overseas branches would count toward the de minimis threshold. In the midst of a default or a crisis, there is no satisfactory way to really separate the risk posed to a branch from being transmitted to its parent bank.

As a swap dealer, the entity would have to comply with the various Dodd-Frank provisions applicable to swap dealers, though in certain cases, this may be done through substituted compliance.

In addition to the interpretive guidance, the CFTC also is considering a release on phased compliance for foreign swap dealers. The separate release addresses comments from U.S. and international market participants. For overseas swap dealers, the staff recommendation provides for phased compliance in the following manner:

- Foreign swap dealers would be required to register with the CFTC upon the compliance date of the registration requirement;
- Compliance with transaction-level requirements with U.S. persons and branches of U.S. persons would be required;
- Entity-level requirements (other than reporting to SDRs) that might come under substituted compliance may be delayed for up to one year. During that time, the CFTC would be moving to complete the cross-border interpretive guidance and would work with market participants and foreign regulators on plans for substituted compliance; and
- For overseas swap dealers, swap transactions with U.S. persons and branches of U.S. persons would be required to be reported to a SDR (or the CFTC).

Resources

Confidence in the futures and swaps markets is dependent upon a well-funded regulator. The CFTC is a good investment of taxpayer dollars. This hardworking staff of 710 is just 10 percent more than what we had at our peak in the 1990s though the futures market has grown fivefold. The CFTC also will soon be responsible for the swaps market – eight times bigger than the futures market.

Picture the NFL expanding eightfold to play more than 100 football games in a weekend, leaving just one referee per game, and, in some cases, no referee. Imagine the mayhem on the field, the resulting injuries to players, and the loss of confidence fans would have in the integrity of the game.

Market participants depend on the credibility and transparency of well-regulated U.S. futures and swaps markets. Without sufficient funding for the CFTC, the nation cannot be assured that the agency can adequately oversee these markets.

Conclusion

Nearly four years after the financial crisis and two years since the passage of Dodd-Frank, it's critical that we fully implement the historic reforms of the law.

It’s critical that we do not retreat from reforms that will bring greater transparency and competition to the swaps market, lower costs for companies and their customers, and protect the public from the risks of these international markets.

The financial storms of 2008 continue to reverberate with the debt crisis in Europe affecting the economic prospects of people around the globe.

The CFTC has made significant progress implementing reform having largely finished the rule proposals, and now having completed well over half of the final rules.

We are on schedule to complete the remaining reforms this year, but until we do, the public is not fully protected.