Testimony Concerning the Over-the-Counter Derivatives Markets Act of 2009

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I. Introduction

Chairman Frank, Ranking Member Bachus, Members of the Committee:

Thank you for the opportunity to testify on behalf of the Securities and Exchange Commission concerning the regulation of over-the-counter ("OTC") derivatives and, in particular, the Over-the-Counter Derivatives Markets Act of 2009, which was proposed in August by the Department of the Treasury (the "Treasury's proposal") and revised in a discussion draft circulated by the Chairman a few days ago (the "discussion draft").

The recent financial crisis has revealed serious weaknesses in U.S. financial regulation. Among them are gaps in the existing regulatory structure; failures to enforce existing standards; and failures to adapt the existing regulatory framework and provide effective regulation over traditionally siloed markets that had grown interconnected. One very significant gap in the regulatory structure is the inadequate regulation of OTC derivatives, which were largely excluded from the regulatory framework in 2000 by the Commodity Futures Modernization Act. Fixing these weaknesses is vital, particularly in the current market environment. The SEC is committed to working closely with policy makers to develop appropriate regulation and restore a sound structure for U.S. financial regulation.

It is critical that we work together to enact legislation that will bring greater transparency and oversight to the OTC derivatives market. The derivatives market has grown enormously since the late 1990s to approximately $450 trillion of outstanding notional amount in June 2009.

This market presents a number of risks. Chief among these is systemic risk. OTC derivatives can facilitate significant leverage, result in concentrations of risk, and behave unexpectedly in times of crisis. Some derivatives, like credit default swaps ("CDS"), can reduce certain types of risk, while causing others. For example, CDS permit individual firms to obtain or reduce credit risk exposure to a single company or a sector, thereby reducing or increasing that risk. In addition to obtaining or reducing exposure to credit risk, a CDS contract participant will take on counterparty and liquidity risk from the other side of the CDS. Through CDS, financial institutions and other market participants can shift credit risk from one party to another. Thus, the CDS market may be relevant to a particular financial institution's willingness to participate in an issuer's securities offering or to lend to a firm, or the ability of derivatives dealers to engage in market-making.

However, CDS can also lead to greater systemic risk by, among other things, concentrating risk in a small number of large institutions and facilitating lax lending standards more generally.

These risks are heightened by the lack of regulatory oversight of dealers and other participants in this market. This combination can lead to inadequate capital and risk management standards. Associated failures can cascade through the global financial system.

Moreover, OTC derivatives markets directly affect the regulated securities and futures markets by serving as a less regulated alternative for engaging in economically equivalent activity. An OTC derivative is an incredibly versatile product that can essentially be engineered to achieve almost any financial purpose. Any number of OTC derivatives or strategies based on such derivatives can, for instance, allow market participants to enjoy the benefits of owning the shares of a company without having to purchase any shares.

Indeed, OTC derivative contracts custom-tailored to the highly individualized desires of a market participant can allow the participant to obtain economic exposure to as large or small a portion of the market as the participant desires. Perhaps surprisingly, exposure to the fortunes of a single company can be attained through strategies involving derivatives that reference a broad index of companies. The ability to custom-tailor OTC derivatives is one of these contracts' strengths, for it allows hedging particularized to the precise risk management needs of the client. Regulatory reform of OTC derivatives needs to not only consider the concerns OTC derivatives raise, but also the benefits OTC derivatives provide to companies, investors and the markets as a whole.

The ability to custom-tailor OTC derivatives, however, can also create regulatory arbitrage possibilities that can facilitate a flow of funds out of the regulated markets and into the less regulated markets. The lack of transparency and oversight also enables bad actors to hide trading activities that would be more easily detected if done in the regulated markets. Because of the link to regulated securities markets and the SEC's responsibility for the integrity of those markets, it is important that the SEC also have the tools to see all related activity so that it is in the best position possible to detect and deter market abuses that can disrupt the integrity of the market. These issues must be addressed.

The discussion draft helps to establish a framework for regulating OTC derivatives. The original proposal was designed to achieve four broad objectives: (1) preventing activities in the OTC derivatives markets from posing risk to the financial system; (2) promoting efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. Importantly, it emphasizes that the securities and commodities laws should be amended to ensure that the SEC and CFTC, consistent with their respective missions, have the authority to achieve – together with the efforts of other regulators – the four policy objectives for OTC derivatives regulation.

The proposed legislation is an important step forward. It would bring currently unregulated swaps, swaps dealers, and swaps markets under a regulatory framework, thereby improving transparency and regulatory oversight. It also would facilitate central clearing of swaps, thereby fostering a "better" market and reducing counterparty risk.

II. Strengthening the Proposal

The discussion draft is a step in the right direction towards bringing OTC derivatives under a regulatory framework. However, certain aspects of the discussion draft could unintentionally preserve existing regulatory gaps. As described below, certain draft provisions would not apply the full panoply of securities law protections to products that are the functional equivalent of securities and in some cases, products that currently are regulated as such. Relatively simple changes to the discussion draft would ensure that the legislation results in the improved supervision of the OTC derivatives market that all of us are seeking to achieve.

A. Minimize Regulatory Arbitrage Opportunities by Regulating Swaps Like Their Underlying "References"

Market participants often view derivatives and the "underlying" assets they reference almost interchangeably. Thus, a participant may well decide to take a position in the fortunes of a company by entering into transactions in OTC derivatives like equity swaps rather than through the purchase of common stock. When carefully structured, the economic payoffs could be similar, if not virtually identical. Yet the legal consequences attached to these alternatives may be different.

Regulatory arbitrage possibilities abound when economically equivalent alternatives are subject to different regulatory regimes. An individual market participant can have incentives to migrate to products that are subject to lighter regulatory oversight.

The proposal would for the first time bring the OTC derivatives market under a regulatory umbrella by establishing a new regulatory framework for OTC derivatives. The discussion draft would divide regulatory responsibility for securities-related OTC derivatives between the SEC and the CFTC, and provide regulatory responsibility for other OTC derivatives to the CFTC.

The proposal, however, would appear to enable significant regulatory arbitrage opportunities that warrant additional consideration as the legislation moves forward.

As to securities-related OTC derivatives, the discussion draft adopts a distinction between derivatives referencing a single security or a narrow-based index of securities and derivatives referencing a broad-based index of securities. This distinction is not meaningful in the context of the OTC derivatives market. A market participant can conceivably use a broad-based swap as part of a strategy to gain highly targeted exposure to a single company or a narrow group of companies. One way of doing this would be by taking the long side of an equity derivative referencing one broad index (e.g., S&P 500 index) while simultaneously taking the short side of an equity derivative referencing a

different broad index (e.g., a subset of the S&P 500 index) customized to the client's desires, such that the net economic exposure is to a narrow-based index or single stock.

In addition, the discussion draft could result in significant regulatory differences between "swaps" products and the currently "regulated" securities and futures products. For example, energy swaps would not be regulated in the same way as energy futures, and securities swaps would not be regulated in the same way as securities. The differences would result because the discussion draft establishes a new regulatory framework for swaps and securities swaps. This framework, which is focused principally on minimizing differences in the regulation of swaps and security-based swaps, would be different from the regulations applicable to either securities or futures. This is significant because, in evaluating whether to engage in a swap transaction, market participants are far more likely to focus on the choice between a swap and regulated alternatives (e.g., between a Microsoft swap on the one hand and a Microsoft option or Microsoft stock on the other), than between swaps involving different "underlying" assets (e.g., a Microsoft swap and an oil swap). Thus, these regulatory differences could perpetuate existing regulatory arbitrage opportunities that encourage the migration of activities from the traditional regulated markets into the differently regulated swaps market. Accordingly, Congress should consider modifying the discussion draft so that all securities-related OTC derivatives are regulated more like securities; and commodity and other non-securities-related OTC derivatives are regulated more like futures.

The concern is compounded if security-based swaps are not considered securities under both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). The discussion draft revises the Securities Act to include "security-based swaps" in the definition of "security," but does not make the corresponding change to the Exchange Act. Including security-based swaps in the Exchange Act definition of security is necessary to reduce the risk of regulatory arbitrage and ensure that securities law protections apply to security-based swaps markets and investors in these markets, including the anti-fraud protections of Exchange Act Section 10(b) and Rule 10b-5, the key anti-fraud provisions – including the insider trading prohibitions – of the federal securities laws.

Unfortunately, the provisions of the discussion draft calling for the SEC to adopt certain "business conduct" rules do not fill the gap. The rules would relate only to the conduct of security-based swap dealers and major security-based swap participants. The rules would not reach brokers who sell security-based swaps to retail investors, and as drafted such brokers would not be required to register with the SEC as broker-dealers nor would they be required to be members of FINRA. Including "security-based swaps" in the definition of "security" in the Exchange Act is also important for ensuring that the SEC has the tools needed to oversee security-based swaps trading on exchanges, which would not be required to register with the SEC because "security-based swaps" would not be securities under the discussion draft.

Similarly, so-called inter-dealer brokers, another group of important participants in the OTC derivatives market today, would remain outside of any regulatory framework. Indeed, it is our understanding that most credit default swap trading in this country are

done through interdealer brokers. Adding "security-based swaps" to the definition of "security" would ensure that the SEC can oversee the activities of these important market participants.

The longstanding regulatory regime applicable to securities is specifically designed to promote vibrant capital markets through the protection of investors, the maintenance of fair and orderly markets, and the facilitation of capital formation. These objectives apply with no less force to securities-related OTC derivatives. In addition, simply including security-based swap agreements within the definition of "security" is a straightforward approach that would make real progress toward ensuring that securities-related OTC derivatives – which can be used to establish either synthetic "long" or "short" exposures to an underlying security or group of securities – and the underlying securities themselves are being regulated consistently. A single regulatory regime should reduce regulatory arbitrage and the likelihood of manipulation in interconnected markets. Similarly, commodity-related OTC derivatives, such as swap contracts for oil and natural gas, would be regulated in a similar manner as the underlying oil or natural gas futures.

This approach also would be simpler to implement. Congress should extend the federal securities laws to all securities-related OTC derivatives and extend the Commodity Exchange Act to all commodity-related and non-securities related OTC derivatives. Moreover, by including security-based swaps in the definition of "security" in both the Securities Act and the Exchange Act, Congress could build off an existing regulatory regime, rather than building a new one from scratch. Treating OTC derivatives differently from the underlying security or commodity future has been ineffective. Again, treating security-based swaps like any other OTC security, such as OTC security options, would significantly reduce the arbitrage opportunities between the regulated markets (securities or futures) and the swaps market, as well as between narrow-based security index swaps and broad-based security index swaps, while building off the existing regulatory framework. Although some differences likely would remain (as they currently do between the SEC and CFTC regimes), where appropriate, these differences could be addressed through the harmonization process that is already underway.

B. "Abusive Swap" Provision

The discussion draft contains a new provision that would permit the CFTC and SEC to jointly prohibit transactions in swaps or security-based swaps which they find would be detrimental to the stability of a financial market or of participants in the market.

This tool, or a variation of it, might be useful for regulators protecting participants and market stability, but requires careful consideration. The Commission has begun analyzing the impact and workability of the provision. Our initial thoughts are that this provision raises a number of questions and potential concerns about regulation of financial products and systemic risk more generally. In considering this language, policymakers should consider how regulators would: quantify the destabilizing effects of products on financial stability and participants; balance the possible tension between destabilizing effects on the system as a whole and large individual participants; and make determinations for products that are both "useful" and potentially destabilizing.

Given the likely reaction from other regulators and policymakers who might disagree with a finding, processes may also need to be considered. For example: how should agencies make this determination; what findings would need to be made; and what would happen if there were a conflict between the SEC/CFTC and other regulators that also play an important role in this area?

Given this, Congress may want to consider (1) whether this is an authority that should be provided jointly to the SEC/CFTC or instead to another forum like the Financial Stability Oversight Council; and (2) the consequences of limiting this type of authority to swaps, as opposed to other financial products. We look forward to working with the Congress as it considers these issues.

C. Strengthen Existing Anti-Fraud and Anti-Manipulation Authority and Extend Necessary Tools

It appears the new discussion draft may inadvertently weaken the SEC's anti-fraud and anti-manipulation authority over security-based swaps. The SEC would continue to have anti-fraud authority over those securities-related OTC derivatives over which the SEC would not have regulatory authority. However, security-based swaps over which the SEC would have regulatory authority would not be subject to all anti-fraud prohibitions under the federal securities laws.

The SEC must have the necessary tools to effectively exercise its authority. In this regard, the discussion draft recognizes the importance of inspections and examinations of swap dealers and major swap participants to the SEC's ability to enforce the securities laws. This authority should be expanded to include central counterparties and swap repositories, so that the SEC can have quick access to comprehensive data on all securities-related OTC derivatives. In addition to inspections and examination, effective enforcement also requires direct access to real-time data on these securities-related derivatives and comprehensive anti-fraud and anti-manipulation rulemaking authority for these derivatives.

For example, in investigating possible market manipulation during the financial crisis, the SEC sought to use its anti-fraud authority to gather information about transactions both in securities-related OTC derivatives and in the underlying securities. Investigations of securities-related OTC derivative transactions, however, were far more difficult and time-consuming than those involving cash equities and options. In contrast to the audit trail data available in the equity markets, data on securities-related OTC derivative transactions were not readily available and needed to be reconstructed manually. The SEC's enforcement efforts were seriously complicated by the lack of a mechanism for promptly obtaining critical information – who traded, how much, and when – that is complete and accurate.

Even if Congress determines to split regulatory responsibility over securities-related OTC derivatives, Congress should provide all tools needed for effective anti-fraud enforcement over all securities-related OTC derivatives.

D. "Major Swap Participant" and "Major Security-Based Swap Participant"

Regulation of major swap participants and dealers is a vital part of the OTC regulatory regime. We understand that there may be entities that use swaps as risk management tools that should not fall into this new framework. The Treasury proposal defined "major security-based swap participant" as any non-dealer who maintains a substantial net position in outstanding swaps "other than to create and maintain *an effective hedge under generally accepted accounting principles*" (emphasis added). The current discussion draft's exclusion is substantially broader and excludes those who, among other things, hold positions *"for risk management purposes."* The term "risk management" is ambiguous and this wording could cause a large number of important entities to fall outside this new needed regulation.

A narrower, objective and verifiable standard would be more consistent with the purposes of the legislation.

E. Ensure that Existing Rules for "Securities" are not Weakened

The discussion draft's overly broad "swap" definition could include a number of products or transactions already subject to the federal and state securities laws. These include investment contracts, certain security options, security forwards and certain contracts involving government securities. There is no benefit to including instruments already subject to the full panoply of securities laws within the definition of "swap."

By including currently regulated securities within the definition of "swap," these instruments would either be regulated as "swaps" under the CFTC's "exclusive jurisdiction," or as "security based swaps," which change the regulatory framework applicable to these instruments. Thus, real legal uncertainty would be created by including currently regulated securities within the definition of "swap" without any clear benefit.

To avoid this possibility, Congress should make clear that products or transactions already subject to the federal securities laws do not fall within the definition of "swap."

F. Credit Default Swaps and Regulatory Arbitrage

As we saw first hand during the financial crisis, trading practices in the CDS market have a direct effect on the underlying securities markets. Both narrow- and broad-based index CDS can be used as synthetic alternatives to debt – and even equity – securities of one or more companies. In addition, market participants may use CDS to establish a short position with respect to the fortunes of a specific company. In particular, a market participant may be able even to use a broad-based index CDS that includes the company as a way to short that company's debt or equity. In brief, debt and equity securities and single-name and narrow- and broad-based index CDS are all economic substitutes, and therefore ripe for regulatory arbitrage.

Under current law, the Commission has stated that exchange-traded CDS on securities, whether on one security or a basket of securities, are securities. Congress should clarify

that the definition of "security-based swap" includes not only single-name and narrow-based index CDS, but also broad-based index CDS. This is particularly important when payment on a CDS, even one characterized as a "broad-based index CDS," is triggered by a single security or issuer or narrow-based index of securities or issuers. This clarification would reduce opportunities for regulatory arbitrage.

G. Clarify the Definitions of "Mixed Swap" and "Security-Based Swap"

The discussion draft would create a new category of "mixed swaps" where dual SEC and CFTC regulation would apply to swaps that are both "security-based" and "non-security based." We have concerns with this new "mixed swap" category.

Under the discussion draft, even quintessentially security-based swaps could be considered "mixed swaps." For example, a swap referencing IBM shares offers a synthetic substitute for owning IBM shares. A market participant entering into such an equity swap will often have to make, in effect, interest payments to the derivatives dealer providing the swap. Those interest payments can be either on a fixed rate basis or a floating rate basis. Under the proposed "mixed swap" definition, the mere and incidental fact of the interest rate payments being on a floating rate basis could cause the IBM swap to be considered a "mixed swap," subject to joint SEC-CFTC jurisdiction. Congress should clarify that a swap is not considered a "mixed swap" merely because the swap has a floating interest rate component or, for similar reasons, a foreign currency component.

H. Ensure an Effective Joint Rulewriting Process

The discussion draft would establish a joint rulemaking process between the CFTC and the SEC that may be difficult to implement. The discussion draft places important definitions on the securities side, such as the definition of "security-based swap," within the Commodity Exchange Act. This would establish a rulemaking and oversight process that undercuts the ability of the SEC to interpret terms as necessary to be responsive to market and regulatory developments, and could compound the difficulties inherent in joint rulemaking. If Congress determines to use joint rulemaking rather than a clear securities/non-securities-based line and individual rulemakings, we believe Congress should put all definitions into the text of the legislation itself, cross-referencing as necessary from both the securities laws and the Commodity Exchange Act.

I. Business Conduct Standards and Eligible Contract Participants

One of the lessons learned from the most recent financial crisis is that certain smaller and less sophisticated institutions need protections from abusive practices by their swaps intermediaries. In some circumstances, there is a need for improved business conduct standards. Treasury's proposal would require the SEC, the CFTC, and other regulators to adopt business conduct rules for dealers and major participants in the OTC derivatives markets. This is an important component of regulatory reform, but these provisions should be improved. We believe that Congress should direct that SEC and CFTC adopt more protective rules in certain situations – for example, where a swaps dealer is selling OTC derivatives to smaller or less sophisticated participants, including certain

municipalities, in the OTC derivatives market. Naturally, no participant should enter into the OTC derivatives market without understanding both the benefits and risks to the participant from doing so.

In addition, Congress should consider revising the qualification standards for participation in the OTC derivatives markets. The standards for being an "eligible contract participant" ("ECP") are important under Treasury's proposal because only ECPs may trade derivatives over-the-counter. All other market participants must trade on exchanges, which provide better protections for less sophisticated participants. More specifically, Congress should consider raising the qualification standards for a governmental entity or political subdivision – such as a municipal government – to qualify as an ECP. Higher standards may also be appropriate for individuals, corporations and other entities.

J. Protecting Customer and Counterparty Assets

One key issue is how best to protect customer and counterparty assets in the event of insolvency. Regulators should have the authority to address this issue by, for example, requiring swap intermediaries to segregate counterparty funds and securities. The discussion draft includes a number of important account segregation requirements that will do much in this regard.

We also note the importance of legislation providing for an insolvency framework that protects, first and foremost, customers. We believe that a resolution regime should clarify how counterparty assets held by OTC derivatives dealers and other major market participants would be treated in the event of an insolvency, as well indicate the extent to which counterparties would have a prior claim on the other assets of the estate. Without legal certainty, the insolvency of an OTC derivatives dealer or other major OTC derivatives participant could result in further market disruptions and systemic risk.

K. Ensuring that the "Identified Banking Products" Exception is Not Abused

Treasury's proposal contained an exclusion from the regulatory scheme for OTC derivatives for products that fall within a category called "identified banking products." Although this exclusion may make sense for banks that are regulated in the U.S., we believe that this exclusion could allow foreign banks (and their subsidiaries) that are not subject to oversight by any federal banking regulator, to offer OTC derivatives to U.S. persons in the guise of "bank products." We believe this exclusion should be revised to make clear that it is not available to foreign banks or their subsidiaries that are not subject to federal banking oversight.

III. Conclusion

The discussion draft is a significant step toward addressing current problems in the OTC derivatives marketplace. It helps to establish a regulatory framework that addresses risks to the financial system and promotes efficiency and transparency in the markets. We strongly encourage Congress to build off this proposal and enact legislation that will bring even more vital transparency and oversight to this market.

Thank you for the opportunity to address issues of such importance for the strength and stability of the U.S. financial system, and the integrity of the U.S. capital markets. I look forward to answering your questions.