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BEFORE THE

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Good morning Chairman Lucas, Ranking Member Peterson and members of the Committee. I thank you for inviting me to testify on the status of Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) Title VII implementation. I also want to thank the Commodity Futures Trading Commission's (CFTC) Commissioners and staff for their hard work and dedication.

Introduction

I am pleased to have the opportunity to discuss with you the CFTC's efforts on behalf of the public. The agency has been directed by Congress to oversee and police the nation's derivatives markets, both in the futures and swaps markets. It strives to promote transparency, fairness and integrity in these markets. The CFTC continues to carry out its historical mission regarding the rapidly changing futures market, while developing and integrating comprehensive standards for the swaps market. The Commission has reorganized its divisions to best ensure ongoing oversight of the futures market, as well as the swaps markets. We also have implemented improvements in protections for customer funds and are developing others. We continue to engage in targeted enforcement efforts in the public interest. These include the historic actions regarding benchmark rates, such as the London Interbank Offered Rate (LIBOR), a reference rate for much of the U.S. futures and swaps markets.

The New Era of Swaps Market Reform

Congress made history with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and the CFTC now oversees the entire derivatives marketplace – across both futures and swaps. The common-sense rules of the road for the swaps market that Congress included in the law have taken shape and market participants are adapting to them.

For the first time, the public is benefiting from seeing the price and volume of each swap transaction. This post-trade transparency builds upon what has worked for decades in the futures and securities markets. The new swaps market information is available free of charge on a website, like a modern-day ticker tape.

For the first time, the public will benefit from the greater access to the markets and the risk reduction that comes with central clearing. Required clearing of interest rate and credit index swaps between financial entities began this week.

For the first time, the public is benefitting from specific oversight of swap dealers. More than 70 swap dealers have provisionally registered. They are subject to standards for sales practices, recordkeeping and business conduct to help lower risk to the economy and protect the public from fraud and manipulation.

An earlier economic crisis led President Roosevelt and Congress to enact similar common-sense rules of the road for the futures and securities markets. I believe these critical reforms of the 1930s have been at the foundation of our strong capital markets and many decades of economic growth.

In the 1980s, the swaps market emerged. Until now, though, it has lacked the benefit of rules to promote transparency, lower risk and protect the public, rules that we have come to depend upon in the futures and securities markets. What followed was the 2008 financial crisis – a crisis that was due in part to the swaps market. Eight million American jobs were lost. In contrast, the futures market, supported by earlier reforms, weathered the financial crisis.

Congress and the President responded to the worst economic crisis since the Great Depression and carefully crafted the Dodd-Frank swaps provisions. They borrowed from what has worked best in the futures market for decades: transparency, clearing and oversight of intermediaries.

The CFTC has largely completed swaps market rulewriting, with 80 percent behind us. On October 12, the CFTC and Securities and Exchange Commission's (SEC) foundational definition rules went into effect. This marked the new era of swaps market reform.

The CFTC is seeking to consider and finalize the remaining Dodd-Frank Act swaps reforms this year. In addition, as Congress directed the CFTC to do, I believe it is critical that we continue our efforts to put in place aggregate speculative position limits across futures and swaps on physical commodities.

The agency has completed each of these Congressionally-directed reforms with an eye toward ensuring that the swaps market works for end-users, America's primary job providers. It's the end-users in the non-financial side of our economy that provide 94 percent of private sector jobs.

Dodd-Frank Act swaps market reforms benefit end-users by lowering costs and increasing access to the markets. They benefit end-users through greater transparency – shifting information from Wall Street to Main Street. Following Congress' direction, end-users are not required to bring swaps into central clearing. Further, the Commission's proposed rule on margin provides that end-users will not have to post margin for uncleared swaps. Also, non-financial companies, other than those genuinely making markets in swaps, will not be required to register as swap dealers. Lastly, when end-users are required to report their transactions, they are given more time to do so than other market participants.

Congress also authorized the CFTC to provide relief from the Dodd-Frank Act's swaps reforms for certain electricity and electricity-related energy transactions between rural electric cooperatives and federal, state, municipal and tribal power authorities. Similarly, Congress authorized the CFTC to provide relief for certain transactions on markets administered by regional transmission organizations and independent system operators. The CFTC is looking to soon finalize exemptive orders related to these transactions, as Congress authorized.

The CFTC has worked to complete the Dodd-Frank reforms in a deliberative way – not against a clock. We have been careful to consider public input, as well as the costs and benefits of each rule. CFTC Commissioners and staff have met more than 2,000 times with members of the public, and we have held 23 public roundtables. The agency has received more than 39,000 comment letters on matters related to reform. The rules also have benefited from close consultation with domestic and international regulators and policymakers.

Throughout this process, the Commission has sought input from market participants on appropriate schedules to phase in compliance with swaps reforms. Now, over two-and-a-half years since the Dodd-Frank Act passed and with 80 percent of our rules finalized, the market is moving to implementation. Thus, it's the natural order of things that market participants have questions and have come to us for further guidance. The CFTC welcomes inquiries from market participants, as some fine-tuning is expected. As it is sometimes the case with human nature, the agency receives many inquiries as compliance deadlines approach.

My fellow commissioners and I, along with CFTC staff, have listened to market participants and thoughtfully sorted through issues as they were brought to our attention, and we will continue to do so.

I now will go into further detail on the Commission's efforts to implement the Dodd-Frank Act's swaps market reform, our efforts to enhance protections for futures and swaps customers, and the CFTC's work with international regulators regarding benchmarks.

Transparency – Lowering Cost and Increasing Liquidity, Efficiency, Competition

Transparency – a longstanding hallmark of the futures market, both pre- and post-trade – lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition. A key benefit of swaps reform is providing this critical pricing information to businesses and other end-users across this land that use the swaps market to lock in a price or hedge a risk.

As of December 31, 2012, provisionally registered swap dealers are reporting in real time their interest rate and credit index swap transactions to the public and to regulators through swap data repositories. These are some of the same products that were at the center of the financial crisis. Building on this, swap dealers began reporting swap transactions in equity, foreign exchange and other commodity asset classes on February 28. Other market participants will begin reporting April 10.

With these transparency reforms, the public and regulators now have their first full window into the swaps marketplace.

To further enhance liquidity and price competition, the CFTC is working to finish the pre-trade transparency rules for swap execution facilities (SEFs), as well as the block rule for swaps. SEFs would allow market participants to view the prices of available bids and offers prior to making their decision on a transaction. These rules will build on the democratization of the swaps market that comes with the clearing of standardized swaps.

Clearing – Lowering Risk and Democratizing the Market

Since the late 19th century, clearinghouses have lowered risk for the public and fostered competition in the futures market. Clearing also has democratized the market by fostering access for farmers, ranchers, merchants and other participants.

The Commission approved the first clearing requirement last November, following through on the U.S. commitment at the 2009 G-20 meeting that standardized swaps be cleared by the end of 2012. A key milestone was reached this week with the requirement that swap dealers and the largest hedge funds clear as of March 11. The vast majority of interest rate and credit default index swaps are being brought into central clearing. Compliance will continue to be phased in throughout this year. Other financial entities begin clearing June 10. Accounts managed by third party investment managers and ERISA pension plans have until September 9.

Consistent with the direction of Dodd-Frank, the Commission in the fall of 2011 adopted a comprehensive set of rules for the risk management of clearinghouses. These final rules were consistent with international standards, as evidenced by the Principles for Financial Market Infrastructures (PFMIs) consultative document that had been published by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS-IOSCO).

In April of 2012, CPSS-IOSCO issued the final Principles. The Commission's clearinghouse risk management rules cover the vast majority of those standards. Commission staff are working expeditiously to recommend the necessary steps so that the Commission may implement any remaining items from the PFMIs not yet incorporated in our clearinghouse rules. I look forward to the Commission considering action on this in 2013.

I expect that soon we will complete a rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement. This year, the CFTC also will be considering possible clearing determinations for other commodity swaps, including energy swaps.

Swap Dealer Oversight - Promoting Market Integrity and Lowering Risk

Comprehensive oversight of swap dealers, a foundational piece of the Dodd-Frank Act, will promote market integrity and lower risk to taxpayers and the rest of the economy. Congress directed that end-users be able to continue benefitting from customized swaps (those not brought into central clearing) while being protected through the express oversight of swap dealers. In addition, Dodd-Frank extended the CFTC's existing oversight of previously regulated intermediaries to include their swaps activity.

As the result of CFTC rules completed in the first half of last year, 73 swap dealers are now provisionally registered. This initial group of dealers includes the largest domestic and international financial institutions dealing in swaps with U.S. persons. It includes the 16 institutions commonly referred to as the G16 dealers. Two major swap participants also are registered. Other entities will register once they reach the de minimis threshold for swap activity.

In addition to reporting trades to both regulators and the public, swap dealers will implement crucial back office standards that lower risk and increase market integrity. These include promoting the timely confirmation of trades and documentation of the trading relationship. Swap dealers also will be required to implement sales practice standards that prohibit fraud, require fair treatment of customers and improve transparency.

The CFTC is collaborating closely domestically and internationally on a global approach to margin requirements for uncleared swaps. We are working along with the Federal Reserve, the other U.S. banking regulators, the SEC and our international counterparts on a final set of standards to be published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The CFTC's proposed margin rules excluded non-financial end-users from margin requirements for uncleared swaps. We have been advocating with global regulators for an approach consistent with that of the CFTC. I would anticipate that the CFTC, in consultation with European regulators, would take up final margin rules, as well as related rules on capital, in the second half of this year.

Following Congress' mandate, the CFTC also is working with our fellow domestic financial regulators to complete the Volcker Rule. In adopting the Volcker Rule, Congress prohibited banking entities from 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.

International Coordination on Swaps Market Reform

In enacting financial reform, Congress recognized a basic lesson of modern finance and the 2008 crisis: during a default, risk knows no geographic border.

Risk from our housing and financial crisis contributed to economic downturns around the globe. If a run starts in one part of a modern financial institution, whether it's here or offshore, the risk comes back to our shores. It was true with AIG, Lehman Brothers, Citigroup, Bear Stearns and Long-Term Capital Management.

AIG Financial Products, for instance, was a Connecticut subsidiary of the New York insurance giant that used a French bank license to run its swaps operations out of a Mayfair branch in London. Its near-collapse ultimately required a government bailout of more than $180 billion and nearly brought down the U.S. economy.

Last year’s events of JPMorgan Chase, where it executed swaps through its London branch, were a stark reminder of how when risk is booked offshore, any losses are absorbed back here at home.

Congress addressed this reality of modern finance in Section 722(d) of the Dodd-Frank Act, which 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.”

To give financial institutions and market participants guidance on this provision, the CFTC last June sought public consultation on its interpretation of this provision. The proposed guidance is a balanced, measured approach, consistent with the cross-border provisions in the Dodd-Frank Act and the recognition that risk easily crosses borders.

As the CFTC completes the cross-border guidance, I believe it's critical that Dodd-Frank swaps reform applies to transactions entered into by branches of U.S. institutions offshore, between guaranteed affiliates offshore, and for hedge funds that are incorporated offshore but operate in the U.S. Otherwise, American jobs and markets may move offshore, but, particularly in times of crisis, risk would come crashing back to our economy.

The proposed guidance includes a commitment to permitting foreign firms and, in certain circumstances, overseas branches and guaranteed affiliates of U.S. swap dealers, to meet Dodd-Frank requirements through compliance with comparable and comprehensive foreign rules. We call this "substituted compliance."

The Commission also proposed granting time-limited relief until this July for non-U.S. swap dealers (and foreign branches of U.S. swap dealers) from certain Dodd-Frank swap requirements. In December, the Commission finalized this relief.

Under this time-limited relief, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, it provides relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers.

In July, when the relief expires, various Dodd-Frank Act requirements will apply to non-U.S. swap dealers. Overseas financial institutions who wish to look to substituted compliance to fulfill Dodd-Frank requirements are encouraged to engage now with the CFTC, as well as their home country regulators.

We are hearing that some swap dealers may be promoting to hedge funds an idea to avoid required clearing, at least during an interim period from March until July. I would be concerned if, in an effort to avoid clearing, swap dealers route to their foreign affiliates trades with hedge funds organized offshore, even though such hedge funds are managed (or otherwise have their principal place of business) in the United States or they are majority owned by U.S. persons. Such an effort is not consistent with the spirit of the Dodd-Frank Act or the international consensus to clear all standardized swaps. The CFTC is working to ensure that this idea does not prevail and develop into a practice that leaves the American public at risk.

If we don't address this, the P.O boxes may be offshore, but the risk will flow back here.

Customer Protection

The Dodd-Frank Act included provisions directing the CFTC to enhance the protection of swaps customer funds. While it was not a requirement of the Dodd-Frank Act, in 2009 the CFTC also reviewed and updated customer protection rules for futures market customers. As a result, a number of the enhancements affect both futures and swaps market customers. I would like to review these enhancements, as well as an important customer protection proposal.

The CFTC's completed amendments to rule 1.25 regarding the investment of customer funds benefit both futures and swaps customers. The amendments include preventing in-house lending of customer money through repurchase agreements. The CFTC's gross margining rules for futures and swaps customers require clearinghouses to collect margin on a gross basis. FCMs are no longer able to offset one customer's collateral against another or to send only the net to the clearinghouse.

Swaps customers further benefit from the new so-called "LSOC" (legal segregation with operational comingling) rules, which ensure funds are protected individually all the way to the clearinghouse.

The Commission also worked closely with market participants on new customer protection rules adopted by the self-regulatory organization (SRO), the National Futures Association (NFA). These include requiring FCMs to hold sufficient funds for U.S. foreign futures and options customers trading on foreign contract markets (in Part 30 secured accounts). Starting last year, they must meet their total obligations to customers trading on foreign markets under the net liquidating equity method. In addition, withdrawals of 25 percent or more of excess segregated funds would necessitate pre-approval in writing by senior management and must be reported to the designated SRO and the CFTC.

These steps were significant, but market events have further highlighted that the Commission must do everything within our authorities and resources to strengthen oversight programs and the protection of customers and their funds.

In the fall of 2012, the Commission sought public comment on a proposal that would strengthen the controls around customer funds at FCMs. It would set new regulatory accounting requirements and would raise minimum standards for independent public accountants who audit FCMs. And it would provide regulators with daily direct electronic access to the FCMs' bank and custodial accounts for customer funds.

The proposal includes a provision on residual interest to ensure that the assets of one customer are not used to cover the positions of another customer. We are considering the many comments we have received on this and plan to finalize the proposal consistent with the specific provisions of the Commodity Exchange Act and the overall goal of protecting customers.

Further, the CFTC intends to finalize a rule this year on segregation for uncleared swaps.

Benchmark Interest Rates

This hearing comes at a critical juncture.

It comes as there has been a lot of media attention surrounding the three enforcement cases against Barclays, UBS and RBS for manipulative conduct with respect to the London Interbank Offered Rate (LIBOR) and other benchmark interest rate submissions.

More importantly, it comes as market participants and regulators around the globe have turned to consider the critical issue of how we reform and revise a system that has become so reliant on LIBOR, Euribor and similar rates.

I believe that continuing to reference such rates diminishes market integrity and is unsustainable in the long run.

Let's look at what we've learned to date.

Foremost, the interbank, unsecured market to which LIBOR, Euribor and other such rates reference has changed dramatically. Some say that it is has become essentially nonexistent. In 2008, Mervyn King, the governor of the Bank of England, said of LIBOR: "It is, in many ways, the rate at which banks do not lend to each other." He went on further to say: "[I]t is not a rate at which anyone is actually borrowing."

There has been a significant structural shift in how financial market participants finance their balance sheets and trading positions. There is an increasing shift from borrowing unsecured (without posting collateral) toward borrowings that are secured by posting collateral. In particular, this shift has occurred within the funding markets between banks.

The interbank, unsecured market used to be where banks funded themselves at a wholesale rate. The 2008 financial crisis and subsequent events, however, have shattered this model. The European debt crisis that began in 2010 and the downgrading of large banks' credit ratings have exacerbated the hesitancy of banks to lend unsecured to one another.

Other factors have played a role in this structural shift. Central banks are providing significant funding directly to banks. Banks are more closely managing demands on their balance sheets.

Looking forward, recent changes to Basel capital rules will take root and will move banks even further from interbank lending. The Basel III capital rules now include an asset correlation factor, which requires additional capital when a bank is exposed to another bank. This was included to reduce financial system interconnectedness. Furthermore, the rules introduce a liquidity coverage ratio (LCR). For the first time, banks will have to hold a sufficient amount of high quality liquid assets to cover their projected net outflows over 30 days.

At an IOSCO roundtable on financial market benchmarks held in London last month, one major bank indicated that the LCR rule alone would make it prohibitively expensive for banks to lend to each other in the interbank market for tenors greater than 30 days. Thus, this banker posited that it is unlikely that banks will return to the days when they would lend to each other for three months, six months or a year.

The public also has learned that LIBOR and Euribor – central to borrowing, lending and hedging in our economies – has been readily and pervasively rigged.

Barclays, UBS and RBS were fined approximately $2.5 billion for manipulative conduct by the CFTC, the U.K. Financial Services Authority (FSA) and the U.S. Justice Department. At each bank, the misconduct spanned many years; took place in offices in several cities around the globe; included numerous people – sometimes dozens, and even senior management; and involved multiple benchmark rates and currencies. In each case, there was evidence of collusion.

In the UBS and RBS cases, one or more inter-dealer brokers painted false pictures to influence submissions of other banks, i.e., to spread the falsehoods more widely. Barclays and UBS also were reporting falsely low borrowing rates in an effort to protect their reputation.

These findings are shocking, though the lack of an interbank market made the system more vulnerable to such misconduct.

In addition, a significant amount of publicly available market data raises questions about the integrity of LIBOR and similar rates today.

A comparison of LIBOR submissions to the volatilities of other short-term rates reflects that LIBOR is remarkably more stable than any comparable rate. For instance, in 2012 – looking at the 252 submission days for three-month U.S. dollar LIBOR – the banks did not change their rate 85 percent of the time. Some banks did not change their submissions for three-month U.S. Dollar LIBOR for upwards of 115 straight trading days. This means, in effect, that one bank represented that the market for its funding was completely stable for 115 straight trading days or more than five months.

Further, when comparing LIBOR submissions to the same banks' credit default swaps spreads or to the broader markets' currency forward rates, there is a continuing disconnect between LIBOR and what those other market rates tell us.

Nassim Nicholas Taleb, the bestselling author of *The Black Swan*, has written a recent book called *Antifragile: Things that Gain from Disorder*. He notes that systems that are not readily able to evolve and adapt are fragile. Such systems succumb to stress, tension and change. One of his key points is that propping up a fragile system in the interest of maintaining a sense of stability only creates more instability in the end. One can buy an artificial sense of calm for a while, but when that calm cracks, the resulting turmoil is invariably greater.

I think that the financial system's reliance on interest rate benchmarks, such as LIBOR and Euribor, is particularly fragile. These benchmarks basically have not adapted to the significant changes in the market. Thus, the challenge we face is how the financial system adapts to this significant shift.

International regulators and market participants have begun to discuss transition. The CFTC and the FSA are co-chairing the IOSCO Task Force on Financial Market Benchmarks.

One of the key questions in the consultation with the public is: how do we address transition when a benchmark is no longer tied to sufficient transactions and may have become unreliable or obsolete?

Without transactions, the situation is similar to trying to buy a house, when the realtor cannot provide comparable transaction prices in the neighborhood – because no houses were sold in the neighborhood in years.

Given what the public has learned, it is critical to move to a more robust framework for financial benchmarks, particularly those for short-term, variable interest rates. A reference rate has to be based on facts, not fiction.

I recognize that moving on from LIBOR and Euribor may be challenging. Today, LIBOR is the reference rate for 70 percent of the U.S. futures market, most of the swaps market and nearly half of U.S. adjustable rate mortgages.

Yet, as the author Nassim Taleb might suggest, it would be best not to fall prey to accepting that LIBOR or any benchmark is "too big to replace."

Resources

The CFTC's hardworking team of 684 is just 7 percent more in numbers than at our peak in the 1990s. Yet since that time, the futures market has grown five-fold, and the swaps market is eight times larger than the futures market.

Investments in both technology and people are needed for effective oversight of these markets by regulators.

Though data has started to be reported to the public and to regulators, we need the staff and technology to access, review and analyze the data. Though 75 entities have registered as new swap dealers and major swap participants, we need people to answer their questions and work with the NFA on the necessary oversight to ensure market integrity. Furthermore, as market participants expand their technological sophistication, CFTC technology upgrades are critical for market surveillance and to enhance customer fund protection programs.

Without sufficient funding for the CFTC, the nation cannot be assured this agency can closely monitor for the protection of customer funds and utilize our enforcement arm to its fullest potential to go after bad actors in the futures and swaps markets. Without sufficient funding for the CFTC, the nation cannot be assured that this agency can effectively enforce essential rules that promote transparency and lower risk to the economy.

The CFTC is currently funded at $207 million. To fulfill our mission for the benefit of the public, the President requested $308 million for fiscal year 2013 and 1,015 full-time employees.

Thank you again for inviting me today, and I look forward to your questions.