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Chairman Conaway, Ranking Member Boswell, and Members of the Subcommittee, thank you for inviting me to testify at today's hearing.

My name is Patrick Pearson, and I am the Head of the Financial Market Infrastructures Unit at the European Commission. The European Commission is responsible for the preparation and enforcement of legislation in the European Union. The European Parliament and the Council are responsible for the final enactment of that legislation, while the European Commission, together with the European Securities Market Authority (ESMA), has direct rulemaking powers in technical areas and in determining the 'equivalence' of the rules of foreign countries.

The financial crisis exposed serious shortcomings with respect to the OTC derivatives market which amplified shocks and impacted our economies in several ways. Collateral calls generated by sharp movements in the mark-to-market value of the OTC derivative trades drained liquidity buffers and provoked the fire sales of assets. Second, the bilateral nature of the OTC derivatives market—between the two parties to the contract—be it dealer and customer or dealer and dealer—created its own set of difficulties. When counterparties became concerned about the health of a particular dealer, they moved their business and collateral with them, which worsened the funding crunch in the market. Third, when a large counterparty, Lehman Brothers, filed for bankruptcy, it could no longer meet its obligations. Open OTC derivatives positions with its customers were frozen, which created large problems for Lehman's counterparties. Fourth, the opaqueness of the OTC derivatives market made the situation much worse because no-one had clear insight into the financial health of their counterparties. Because there was no easy way to know who was in difficulty or not, the incentives were all on the side of assuming the worst—closing out open trades, hoarding liquidity, and retreating to the sidelines.

The crisis made it crystal clear that the regulatory regime had not kept pace with the rapid growth of the global OTC derivatives market. In assessing the shortcomings of the OTC derivatives market after the crisis, a global consensus has been reached. The United States and the European Union showed genuine leadership in pushing for this global consensus.

Standardizing trades improves transparency and price discovery. This mitigates the opaqueness that helped to generate the illiquidity and loss of market function evident during the crisis. Clearing such trades through CCPs reduces the aggregate amount of risk in the system. In a CCP framework, the bilateral exposures of each dealer to one another are replaced by a single set of claims to and from the CCP. Inserting a CCP in between two counterparties to a trade reduces the run risk faced by a potentially troubled dealer. If trades with the dealer are cleared through a CCP, direct exposures to the dealer are eliminated and replaced by exposures to the CCP itself. Mandatory reporting of trades to trade repositories is designed to ensure that the details of each contract are preserved and available to the regulatory authorities. They will have a full overview of risk in the system. Finally, the fact that CCPs will be central to the system dramatically increases their importance. In essence, global CCPs will be systemically important. Thus, for the system to be safer, it is necessary that CCPs be as safe as the United States Bullion Depository. They have to have the ability to perform and meet their obligations regardless of the degree of stress in the financial system and even if one or more of their participants were to fail in a disorderly manner. Hence, there is a compelling need for tougher principles that are broadly enforced.

These derivative reforms involve a significant change in regulation, covering both the regulation of firms (legal entities) and the process for entering into and performing individual derivative transactions.

The U.S. and the EU have been working in parallel over the past 30 months to adopt the necessary legislative reforms to achieve these common goals. The U.S. adopted the Dodd-Frank Wall Street Reform Consumer Protection Act in July 2010, including some 80 pages (Title VII) on derivatives reform. Two months later, in September 2010, the European Commission adopted its legislative proposal to introduce similar reforms in the 27 Member states of the European Union. This legislative proposal – the European Market Infrastructure Regulation(EMIR) – which runs to some 60 pages was adopted by the European Parliament and the Council last July. It entered into force last August. As in the U.S., many detailed implementing rules need to be in place to specify the technical details of the legislation. In the U.S. the CFTC and the SEC are advanced in this process. The EU will adopt its technical implementing rules before the end of this year.

The European Commission has worked closely with the CFTC and the SEC over the past years. Staff have held many meetings, sometimes even on a weekly basis, to understand and discuss the thrust and details of our respective approaches and draft rules. Wherever possible we have attempted, often successfully, to align our approaches to avoid discrepancies. The Chairman of the CFTC and European Commissioner, Michel Barnier, have met in Brussels and Washington to discuss derivatives reform on a number of occasions. This has been a very useful process of international cooperation.

Nevertheless, there remains one key area where we believe further work is required to deliver reforms that will meet our common objectives. Our respective rules must also work on a cross-border basis.

This is important because the $640 TR OTC derivative market is global. The Euro or the US dollar are the most important underlying currencies used for OTC derivatives. The global nature of OTC derivatives markets, with the two counterparties to transactions frequently located in different jurisdictions to each other, or in a different location to the infrastructure being used, makes the effective and consistent regulation of cross-border activity crucial.

We need rules that work not only for regulators and market participants in a national jurisdiction, but also in a cross-border environment and *between* jurisdictions. OTC derivative reforms that are consistent and coherent within a single jurisdiction can have adverse impacts when they apply to cross-border transactions. This is so even where the different jurisdictions involved have apparently similar rules. Cross-border application of multiple rules will inhibit the execution and risk management of cross-border transactions. Recent detailed analysis of U.S and EU rules has identified numerous potential conflicts, inconsistencies and gaps between our rules that should be addressed through mutually acceptable solutions. Failure to address these issues will render many of our collective reform efforts to reduce risk in the system obsolete.

By way of example, it is possible that two parties to a transaction may be required to trade in different venues, clear on different CCPs or report to different trade repositories. Trades would be subject to mandatory clearing in one jurisdiction and to margining requirements in another jurisdiction – this is particularly relevant for corporate end-users.

In order to achieve the effective and consistent implementation of our objectives, two weeks ago international Treasury departments, regulators and central banks meeting in the Financial Stability Board insisted on international coordination on the cross-border scope of regulations and cooperation on implementation in order to avoid unnecessary overlap, conflicting regulations and regulatory arbitrage.

To be more precise, 'scope' is the root cause of many cross-border problems that we have identified. We have significant concerns with proposals from the CFTC that would extend the territorial reach of its rules to counterparties outside the USA. This will create conflicts and undue burdens for market participants. The scope of persons who are subject to the application of our respective rules and regulations should be defined in the most narrow manner possible and be based on the establishment of the counterparty in the territory of our respective jurisdictions, where those jurisdictions have comparable and consistent requirements. What is important is that all the counterparties in two jurisdictions be subject to the requirements we all agreed to in the G-20 to ensure global safety. This is better done by ensuring comparability of rules than by over-extending the reach of national rules. What ultimately matters is where the counterparties to a transaction are established, not the location where that transaction is concluded.

The principles of 'recognition', 'equivalence' or 'substituted compliance' – as referred to in our respective jurisdictions – are important underpinnings of a cross-border regulatory system. 'Substituted compliance' will avoid the application of multiple rules to the same entity or the same transaction. Appropriate deference to foreign regulations is the most effective means of achieving our shared goals. We applaud the CFTC for proposing to rely on substituted compliance in the application of its OTC derivative rules. We agree that where different requirements achieve the same objectives market participants, intermediaries and infrastructures should be subject to one set of rules for their cross-border activity. We also believe that the CFTC is too modest in the way it proposes to use substituted compliance; it should be applied more broadly. We believe that the following key points should be applied by the U.S. regulators:

First, regulators should apply substituted compliance between a domestic and a third-country counterparty established in a jurisdiction with comparable and consistent requirements, and should not seek to restrict this only to transactions between two non-domestic counterparties. The former situation reflects the area where the large majority of conflicts and inconsistencies exist between our rules. It is therefore necessary to apply one set of rules to such transactions to ensure legal certainty for cross-border transactions;

Second, substituted compliance should apply to *transaction* level requirements between counterparties in different jurisdictions, and not only to entity level requirements as U.S. regulators have suggested. Where transaction level requirements are comparable, counterparties should be able to discharge their obligations by complying with one set of requirements. We believe that the CFTC has the statutory powers to do this, and has even done this in the past in other areas of its rulemaking.

Third, foreign infrastructure which is subject to comparable requirements in its own jurisdiction should not be required to comply with domestic requirements in order to service the domestic market. Agreement on this is essential to ensuring clearing obligations can be complied with in respect of cross border transactions.

We also believe that registration should be required only in respect of those jurisdictions that lack comparable and consistent requirements. To the extent that registration is unavoidable, it should be combined, from the very outset, with recognition/substituted compliance in order to limit as far as possible any legal complications and burdens. Market participants must be afforded absolute certainty ahead of any registration in respect of the consequences if they apply for registration. However, the registration approach suggested by the CFTC has serious shortcomings. Foreign Swap Dealers would be required to register without knowing with sufficient certainty the complete set of rules that will bind them as a consequence, and how those rules will be applied in an international context - including how substituted compliance will work. A possible waiver or no action letter could provide solace. However, this will only delay, but not eliminate the problem. Even if registration only triggers certain trade reporting requirements, lack of substituted compliance could immediately create issues in terms of conflicting requirements. For example, conflicts with data privacy and data protection considerations in national and European law may well arise. We cannot put firms in the impossible position where they are forced to choose between breaching either U.S. law or EU law. Applying a registration requirement to EU firms without upfront clarity about whether and how substituted compliance will apply will do precisely this.

Finally, timing is essential. We need the right cross-border rules, and not just rapid rules. We would strongly urge U.S. regulators not to enforce rules that will obstruct cross-border business *before* any solutions for cross-border transactions have been finalised.

If we do not reach agreement on a sensible approach to applying our rules on a cross-border basis, and entities and particularly transactions are not subject to full substituted compliance, then conflicts, inconsistencies and gaps will persist, and we believe that trades will not take place, will not be able to be cleared and will, at best, be reported in a fragmented manner to repositories. In short, firms in our economies will not be able to hedge risks, commercial or financial, and our common objectives agreed in the G-20 will not be met.

The European Union is committed to creating an appropriate regulatory framework for OTC derivatives that provides comprehensive oversight, ensures systemic stability and promotes market transparency. The EU, like the U.S, is in the final stage of implementing the rules to achieve these policy objectives. We are also committed to working with you and other market participants to ensure that our rules work on a cross-border basis. We look to the U.S. to work with other jurisdictions to achieve our common objectives.

Thank you, Chairman Conaway and Ranking Member Boswell. I appreciate the opportunity to testify, and look forward to your questions.