**WRITTEN TESTIMONY OF GARRY N. O'CONNOR**
**CHIEF PRODUCT OFFICER**
**INTERNATIONAL DERIVATIVES CLEARING GROUP**
**BEFORE THE**
**COMMITTEE ON AGRICULTURE**
**UNITED STATES HOUSE OF REPRESENTATIVES**
**SEPTEMBER 17, 2009**

Chairman Peterson, Ranking Member Lucas, my name is Garry O'Connor, and I am the Chief Product Officer of the International Derivatives Clearing Group (IDCG). The objective of IDCG is to bring a centrally cleared solution to the largest segment of the over-the-counter (OTC) derivatives market, specifically interest rate derivatives. This is something that we do today through the operation of a U.S. Commodity Futures Trading Commission (CFTC) regulated clearinghouse. IDCG is independently operated with majority ownership held by the NASDAQ OMX Group and minority stakes held by Bank of New York, founders, and management. I have spent close to two decades in the OTC derivatives markets trading interest rate derivatives for large U.S. Investment Banks. IDCG appreciates the opportunity to appear before you and we look forward to discussing the proposed the Over-the-Counter Derivatives Markets Act of 2009 (the Proposed Legislation) put forward by the U.S. Department of Treasury on August 11, 2009.

Today we will show our support for the form of the Proposed Legislation, highlight the urgency with which it should be introduced, and point out three areas where we feel that it can be made more effective.

First and most importantly we want to point out the urgent need for regulatory reform. It is perhaps becoming a worn out point, but we now stand one year on from the collapse of Lehman Brothers and we cannot look back with pride upon the changes we have made. There is no doubt that these are complex issues that require due consideration but at the same time we hold grave concerns that the further away from the trauma of the financial crisis that we move the less urgency will be felt to address the underlying faults in our system of regulation. We must not fall into this trap. The OTC derivatives markets currently represent a greater risk to our underlying economy than they did before the financial crisis began. They are failing to

effectively fulfill their role as a venue for the efficient pricing and transfer of risk, are further exposed by the attrition amongst major banks who act as the major liquidity providers, resulting in tremendous levels of concentration, and finally are dominated by the world's largest banks, which are rapidly returning to the same levels of risk that drove them to the brink of collapse less than twelve months ago.

The OTC derivatives markets are failing to provide a venue for the efficient pricing and transfer of risk. Reduced competition within the banking sector, the traditional providers of liquidity to these markets, has allowed the major banks to increase their price for liquidity. A number of much respected individuals within significant market participants have made this observation;

- Larry Fink, Chief Executive of BlackRock, has highlighted the "luxurious" profits being enjoyed by Wall Street banks, reflecting their ability to take advantage of diminished competition.
- Mohamed El-Erian, Chief Executive of PIMCO, pointed out "bid-offer spreads have remained unusually wide, notwithstanding the normalisation of financial markets".
- Ken Griffin, Chief Executive of Citadel, commented in his testimony to the Senate Banking Committee on the egregious spreads being charged by traditional liquidity providers on OTC derivative transactions, in part because of the lack of price depth.

While the commercial interests of the major banks are clear the market structure in which this situation has been allowed to develop needs to be addressed. End users are desperate for a more diverse base of liquidity providers to bring transaction costs back to pre-crisis levels and to provide a buffer to the extreme volatility that has been present in financial markets since the summer of 2007. Only by allowing new and existing participants access to these markets in an open and competitive manner can this be addressed. All to all central clearing and exchange trading are the tools to achieve this.

In a market with a high concentration of participants, the risk of the failure of a single entity becoming a systemic event is increased. The Comptroller of the Currency indentified just such a situation in the OCC's Quarterly Report on Bank Trading and Derivatives Activities (2009 Q1). It

was shown that derivatives activity in the U.S. banking system is dominated by five large commercial banks which represent 96% of the total industry notional outstanding and 83% of the industry net current credit exposure. 90% of this derivatives activity was reported as being OTC in nature. ***IDCG's own shadow clearing service, which has currently processed close to USD 600 billion in notional, has confirmed the presence of this kind of imbalance in the USD interest rate swap market.*** Further evidence of this concerning situation can be seen in the Bank of International Settlements (BIS) Semiannual OTC derivatives statistics (2008 Q4). The Herfindahl Index, which measures market concentration, is at its highest level in published history for USD OTC interest rate derivatives. Perhaps more concerning is how the U.S. market has fallen behind other major markets, notably Europe, in this regard and now demonstrates a higher concentration than much smaller markets such as Sweden and Japan where one would expect a natural bias towards a smaller number of participants. Only by allowing new and existing participants access to these markets in an open and competitive manner can this be addressed. All to all central clearing and exchange trading are the tools to achieve this.

We can see through Regulatory Filings that Banks are increasingly and heavily reliant on their trading desks for revenue as their traditional banking revenues still struggle to recover from the financial crisis. Specifically, as Stevenson Jacobs has recently reported for the Associated Press, the same five largest banks which dominate the OTC derivatives markets average potential loss from a single days trading exceeded one billion dollars in the second quarter. This represents a 75% increase over the past two years. When you consider large banks are taking more risk in markets that are more intertwined and less liquid than they were two years ago it is easy to see why we say the OTC derivatives markets currently represent a greater risk to our underlying economy than they did before the financial crisis began. Again the only solution is to allow new and existing participants access to these markets in an open and competitive manner. All to all central clearing and exchange trading are the tools to achieve this.

Urgency aside, IDCG applauds the considered approach of all the regulatory bodies who contributed to the Proposed Legislation. The stated goals of; guarding against activities in OTC

derivatives markets that would pose an excessive risk to the financial system, promoting the transparency and efficiency of OTC derivatives markets, preventing market abuses and the inappropriate marketing of OTC derivative to unsophisticated parties, are an appropriate response to the financial crisis that we have all faced over the past few years. We believe that these goals are achieved by the Proposed Legislation without substantive change but think that they can be made more effective in three areas:

1. The test that OTC Derivates is “standardized” for the purpose of clearing should be different to the test that an OTC derivatives is “standardized” for the purpose of trading on a regulated exchange or alternative swap execution facility,
2. The definition of Major Market Participants, and
3. The importance of the independence of clearinghouses.

**What is “standardized”?**

The presumption in the Proposed Legislation that an OTC derivative that is accepted for clearing by a regulated central clearing house is “standardized” is a very simple solution to a difficult problem. The risk in a more traditional definition was a raft of unintended consequences and a definition which failed to adapt to changes in the marketplace. The term “standardized” itself however, can lead to confusion, as it suggests that the customized aspects of the contract need to be stripped away, which is not the case. This has been particularly troubling to corporate America who sees tremendous value in these customized products. In a traditional futures clearinghouse this may have been the case due to technology constraints, but as clearinghouses adapt OTC risk management systems and approaches they will be more than capable of offering cleared solutions for the vast majority of these products. If there exists a strong valuation backbone and sufficient market liquidity to cure defaults then there is no good reason why these products cannot be cleared.

Some products however are not suitable for exchange trading, even if they can be cleared. There is little reason to force an infrequently traded customized product onto an exchange. Doing so will only result in wide prices and potentially erroneous price information, effectively the opposite of the price transparency and efficient execution that an exchange is

designed to deliver. If the price of this customized product can be easily implied from a pool of deeply liquid instruments, which are suitable for exchange trading, then the benefits of price transparency and market efficiency are more easily reached through central clearing without the potential misinformation generated by forcing them to an exchange.

We noted with interest the change in language from the original Administration white paper, which suggested the encouragement of exchange trading, to the final proposal which mandates it for all "standardized" contracts. There is no doubt this decision was not taken lightly, and motivated by significant benefits that exchange trading can bring and the difficulty in effectively defining what is suitable in legislation. We would discourage the mandating of exchange trading for products simply because they are suitable for clearing; we see this as restricting the amount of clearing that is done. Instead we would recommend a presumption of the same style that has been used to define "standardized" clearing products. ***If an OTC derivative is accepted for trading by a regulated exchange, then it should be considered "standardized" for that purpose.*** In the same way as the original definition, this prevents forcing the exchanges and clearinghouses into something they do not have the capability for and remains flexible enough to adapt to changes in the marketplace.

**Who are Major Market Participants?**

We would urge caution in allowing exceptions for those who do not qualify for designation as Major Market Participants. Many of the problems of the current crisis were caused by the activities of institutions that slipped through the regulatory cracks, the obvious example being AIG. We worry that by introducing exceptions into the legislation these same cracks may be opened up. There is no way to identify who the next systemically devastating organization may be other than by throwing a wide and thorough regulatory net. Corporate America has been very vocal to ensure their beneficial use of OTC derivatives is not impacted by regulatory reform. However, as detailed earlier in this testimony there is no reason why central clearing should curtail their use of these products. Nor do we see why Corporate America should be immune from being part of the solution to the crisis we find ourselves in.

One of the most frustrating aspects of the current financial crisis is that all the American people are paying the price for it, not just those who instigated the problem. While it is the task of Legislators and Regulators to limit the impact of failure of a systemically significant institution in the future, it should also be the obligation of our captains of commerce to ensure that their institutions are not exposed unduly to the same failure. To simply assume that the government of the day will continue to support their counterparts in the financial system is not good enough. Central clearing is the tool that allows them to mitigate this exposure and contribute to a stronger financial system.

We would encourage the adoption of CFTC Chairman Gensler's suggested enhancements to the Proposed Legislation which he outlined in a letter to the Chairman and Ranking Member of the U.S. Senate Agriculture Committee on August 17, 2009. In particular the categories dealing with removing the suggested exclusion of foreign exchange swaps and the removing of exceptions to the mandatory clearing and trading requirements. This last section especially demonstrates the CFTC's in depth understanding of the mechanics of the industry and how they impact the objectives of policy. As an aside, the major market participants that IDCG speaks to all identify a Futures Commission Merchant (FCM) cleared solution under the auspices of the CFTC as the most robust clearing model available and one that is easiest, cheapest, and fastest for them to adopt. This is something that the CFTC and its officers should take great pride in.

**Why is independence important?**

The final point we would make is regarding the independence governance of clearinghouses and exchanges. Given the important role that clearinghouses have to play in facilitating the migration of the OTC derivatives market into a centrally cleared and exchange traded environment and their role in determining what is "standardized" I would encourage their substantial independence from any single participant or group of like participants. This will be essential to the development, perceived or otherwise, of open and competitive platforms. Clearinghouses must navigate a fine line when establishing an appropriate price for risk. Charge too much and become uncompetitive, charge too little and fail at their mandate. When a

market participant with a significant governance position has a clear interest for that balance to be tipped in their favor, regardless of how appropriate the price for risk is, confidence will be eroded and the value provided by central clearing will be lost.

In conclusion, we have highlighted the urgent need for change in our regulatory system to correct the imbalances in the current marketplace and prevent a repeat of the financial crisis that we find ourselves in today. IDCG supports the form of the Proposed Legislation that is before you and offers three suggestions where the effectiveness of this proposal may be enhanced; standardization, exceptions, and independence. Thank you, Mr. Chairman, on behalf of IDCG and myself for the opportunity to appear here today. IDCG looks forward to continue working with all branches and agencies of government to help develop the strongest and most competitive market place possible. I would be happy to answer any questions you may have.

**Garry O'Connor - Chief Product Officer IDCG**

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Garry N. O'Connor is the Chief Product Officer of IDCG. Prior to joining IDCG, Mr. O'Connor spent seventeen years in the Investment Banking industry, pricing and managing interest rate derivative portfolios. He has held senior positions in Sydney, Tokyo, Hong Kong and New York with Bankers Trust and then Merrill Lynch. During his time at Merrill Lynch, Mr. O'Connor held a number of roles managing interest rate derivatives risk including: leading the Australasian interest rate derivatives trading operation out of Sydney; leading the Japanese Yen swaps desk out of Tokyo; and establishing and managing a USD interest rate trading business in Hong Kong. Most recently he was a senior member of their New York interest rate derivatives trading team charged with establishing a North American presence in the European derivatives markets. At Bankers Trust, Mr. O'Connor managed interest rate, foreign exchange, and commodities risk in Auckland and in Sydney. He was also responsible for price making and risk management activities in Australian and New Zealand interest rate derivatives. Mr. O'Connor received a BCom(Hons) from Otago University in 1992.