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

by Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

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I. Introduction

Chairman Peterson, Ranking Member Lucas, Members of the Committee:

Thank you for the opportunity to testify on behalf of the Securities and Exchange Commission[1] 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. I am pleased to appear with CFTC Chairman Gary Gensler with whom I have worked closely over the last several months on a variety of issues. As you know, our two agencies have already begun an ambitious program of joint work to better harmonize our rules and procedures. Earlier this month, we held two days of joint hearings that highlighted some of the key differences in our regulatory approaches. We are eager to address these issues. Although some differences may remain over time, I believe this process will help ensure that any differences are justified by meaningful distinctions between markets and products and the others will be harmonized and improved. I also look forward to continuing our joint efforts to push for real regulatory reform.

The recent financial crisis has revealed serious weaknesses in U.S. financial regulation. Among them were 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 through globalization, deregulation and technological advances. Fixing these weaknesses is vital, particularly in the current market environment, and it is a goal to which the SEC is absolutely committed.

One very significant gap in the regulatory structure was the lack of regulation of OTC derivatives, which were largely excluded from the regulatory framework in 2000 by the Commodity Futures Modernization Act.

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

[1] Commissioner Paredes does not endorse this testimony.

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, and thus the CDS market may be relevant to a particular firm's willingness to participate in an issuer's securities offering or to lend to a firm. 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. The regulatory arbitrage possibilities can facilitate a flow of funds out of the regulated markets and into the unregulated shadow 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. These issues must be addressed, and I am committed to working closely with this Committee, the Congress, the Administration, and the CFTC to close this gap and restore a sound structure for U.S. financial regulation.

The Treasury proposal would establish a comprehensive framework for regulating OTC derivatives. The framework is 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 comprehensive regulatory framework, thereby improving transparency and regulatory oversight. It also would facilitate the standardization and central clearing of swaps, thereby fostering a "better" market and reducing counterparty risk.

II. Strengthening Treasury's Proposal

While Treasury's proposal would go a long way towards bringing OTC derivatives under a comprehensive regulatory framework, I believe it should be strengthened in several ways to further avoid regulatory gaps and eliminate regulatory arbitrage opportunities. I agree with Chairman Gensler that Treasury's proposal can be enhanced to prevent the exclusions for foreign currency swaps and forwards from being used by market participants to avoid regulation and from undermining the CFTC's enforcement authority over retail foreign currency fraud. I also agree that the proposal can be enhanced to bolster protections against insolvency risk, and on other matters.

In addition, I offer the following suggestions:

A. Minimize Regulatory Arbitrage and Gaming 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.

Gaming – 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.

Treasury's proposal would for the first time bring the OTC derivatives market under a regulatory umbrella by establishing a new regulatory framework for OTC derivatives. Treasury's proposal 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. Although we believe this approach would do much to eliminate differences within the broad and varied world of "swaps," it 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. 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, or between an oil swap and an oil future), 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.

In addition, Treasury's proposal would create regulatory arbitrage between narrow-based security index swaps and broad-based security index swaps. For example, market participants could engage in the synthetic transactions in the swaps market, or craft swaps specifically to fall within the broad-based category instead of the narrow-based category. These risks are particularly high in customized over-the-counter transactions where individual market participants can self-select the particular securities in one or more swaps.

Accordingly, Congress should consider modifying the proposal 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. At the core of this approach is the principle that similar products should be regulated similarly, or equivalently, if possible. This straightforward approach would result in securities-related OTC derivatives – which can be used to establish either synthetic "long" exposures to an underlying security or group of securities, or synthetic "short" exposures to an underlying security or group of securities – and the underlying securities being regulated consistently. 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. This would significantly reduce the arbitrage opportunities between the regulated markets (securities or futures) and the differently regulated 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 would likely remain (as they currently do between the SEC and CFTC regimes), these differences could be addressed through the harmonization process that we already have underway.

B. Strengthen Existing Anti-Fraud and Anti-Manipulation Authority

Treasury's proposal also attempts to retain the SEC's existing anti-fraud authority over all securities-related OTC derivatives, even those securities-related OTC derivatives over which the SEC would not have regulatory authority. This authority is essential to policing fraud in the securities markets; to be effective, though, enforcement also requires: (1) examination authority over entities dealing in securities-related swaps; (2) direct access to real-time data on these swaps; and (3) comprehensive anti-fraud and anti-manipulation rulemaking authority for these swaps.

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.

If Congress determines to split regulatory responsibility over securities-related OTC derivatives, Congress should provide these tools to help ensure effective anti-fraud enforcement over all securities-related OTC derivatives.

C. 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. To avoid gaming by financial engineers under the new regulatory regime, Congress should consider clarifying that the definition of "security-based swap" includes not only single-name and narrow-based index CDS, but also broad-based index CDS, and other similar products, when payment is triggered by a single security or issuer or narrow-based index of securities or issuers. This also would be consistent with the approach advocated above to extend the federal securities laws to all securities-related OTC derivatives.

D. 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. There is a need for more stringent business conduct standards. This is an area in which I believe we and the CFTC are largely in agreement. 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, and we fully support it. But these provisions should be stronger. We believe that Congress should strengthen this authority so that the SEC and CFTC may adopt stronger and 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.

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.

E. Protecting Customer and Counterparty Assets

One key issue is how best to protect customer and counterparty assets in the event of insolvency. I agree with Chairman Gensler that it would be prudent for legislation to address this issue. Recent events have focused attention on bankruptcy protections with respect to resolution regimes for OTC derivatives dealers and other major participants in the OTC derivatives market. Chairman Gensler suggests that legislation should provide for an insolvency framework that protects, first and foremost, customers. I absolutely agree. I believe that a resolution regime should provide legal restrictions on 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.

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

Treasury's proposal contains an exclusion from the regulatory scheme for OTC derivatives for products that are "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." I 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 Treasury proposal is a significant step toward addressing current problems in the OTC derivatives marketplace. It provides a comprehensive regulatory framework that addresses risks to the financial system and promotes efficiency and transparency in the markets. I 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.